Benefit Insights

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A non-technical review of qualified retirement plan legislative and administrative issues **April 2007**

The Prudent 401(k) Fiduciary

Driven by an interest in attracting talented personnel and a natural aversion to the financial risks attached to traditional defined benefit pension plans, employers have embraced 401(k) plans, making them the dominant retirement savings vehicle in the United States. In the past ten years alone, participation has more than doubled.

As the 401(k) universe has expanded, the legal rules and regulations governing plans have become increasingly complex, and countless unwary plan fiduciaries have found themselves in serious trouble for unknowingly breaching their legal duties.

This newsletter explains the basic rules for 401(k) plan fiduciaries in order to make those that control the assets of or exercise discretion over plans aware of the possible pitfalls.

ERISA Fiduciaries and Their Duties

The Employee Retirement Income Security Act of 1974 (ERISA) imposes rigorous standards on plan fiduciaries, and a fiduciary that breaches any obligation or duty can be held personally liable to make good any losses incurred by the plan resulting from the breach. Because the stakes are so high, it is important that all fiduciaries understand and comply with ERISA.

Who is a Fiduciary?

A fiduciary is anyone that controls the assets of a plan or uses discretion in administering and managing the plan. When an employer establishes an ERISA plan, it is the initial fiduciary.

The employer needs to decide whether to appoint individuals or committees to be responsible for those duties. If a plan committee is appointed, then the committee members are fiduciaries and must perform their duties under ERISA's "prudent expert" standard.

Further, the appointment of a fiduciary is itself a fiduciary act. So, whoever appoints the officers or committee members has a duty to prudently select those persons and to periodically review their work to make sure they are doing their job. Typically, it is the board of directors or corporate president who appoints the fiduciaries.

ERISA's General Fiduciary Duties

The primary duty of all ERISA fiduciaries is to act solely in the interest of plan participants and beneficiaries. Plan fiduciaries must:

- Carry out their duties with the care, skill, prudence and diligence of a prudent person;
- Defray reasonable plan expenses; and
- Act in accordance with the plan documents.

Additionally, plan fiduciaries have an obligation to avoid engaging in or causing the plan to engage in prohibited transactions.

Prohibited Transactions

ERISA prohibits fiduciaries from engaging in a variety of transactions that are inherently tainted by conflicts of interest. Specifically, a fiduciary may not engage in transactions with the plan in which he uses plan assets for his own interest, acts for a party whose interests are adverse to the plan or plan participants or receives compensation from a party dealing with the plan.

Consequences of a Fiduciary Breach

Plan fiduciaries can be held liable for both their direct actions or for the actions of co-fiduciaries. In addition to being held personally liable for a fiduciary breach, the fiduciary must restore any profits made by the fiduciary through the use of plan assets and is subject to any equitable or remedial relief as the court may deem appropriate, including removal of the fiduciary.

The DOL will also assess a civil penalty against any fiduciary who breaches the fiduciary duty requirements. Therefore, it is important that all fiduciaries understand and comply with ERISA's fiduciary provisions.

Common Fiduciary Issues

Fiduciaries need to understand the legal requirements for retirement plans and monitor compliance with those requirements. Some of these responsibilities include timely deposits of employee deferrals, enrolling and covering the right employees, satisfying disclosure requirements and selecting and monitoring investment options.

Participant Contributions

DOL regulations state that once a portion of the employee's salary is withheld, the money becomes a plan asset and, therefore, must be remitted to the participant's account as soon as is reasonably possible but no later than the 15th business day of the month following the payday. Failure to do so is a violation of one's fiduciary duties and, if the funds are held commingled with the employer's funds, the fiduciary has engaged in a prohibited transaction.

Many plans operate under the misconception that because they contribute the funds to the plan by the 15th of the month, they are acting in compliance with ERISA. This is simply not the case. What is "reasonably possible" will vary by plan, but it could be as short as a couple of days. The same rule applies to the remittance of plan loan repayments.

Enrolling and Covering the Right Employees

Being a plan fiduciary is largely about paying meticulous attention to detail. That is especially true in the difficult area of plan enrollment. Fiduciaries have a duty to prudently implement the plan's enrollment and eligibility provisions. The plan must carefully monitor the workforce and ensure that employees meeting the plan's eligibility requirements are being afforded the option to take advantage of the plan.

Part-Time Employees

Part-time employees are easily overlooked by plan fiduciaries due to the misconception that all part-time employees can be excluded from participation in the plan. However, the Internal Revenue

Code does not permit part-time employees to be excluded as a class.

A qualified plan may be drafted to require that an employee work a minimum number of hours to enter the plan, but the maximum number of hours that can be required in a twelve-month period is 1,000. This maximum translates into approximately 20 hours a week, making many part-time employees eligible for plan participation.

Controlled Groups and Affiliated Service Groups

If the plan sponsor is a member of a controlled group (businesses that are considered to be under common control) or affiliated service group (two or more service organizations that have a service or management relationship), employees of other companies may be required to be included in the plan.

Controlled groups and affiliated service groups are required to treat the employees of all members of the group as if they were employed by a single employer for nondiscrimination testing purposes. Depending on the test results, it may be necessary to enroll employees from related companies.

It is important for fiduciaries to be aware of the controlled group and affiliated service group rules and to notify the plan's advisors if the plan sponsor forms or acquires any other businesses in order to determine if these employees are eligible for plan participation.

Keeping a careful eye on the employees' eligibility is tricky, and a wrongful denial will result in a fiduciary breach.

Reporting and Disclosure Requirements

401(k) plan fiduciaries have to make two types of disclosures to meet their fiduciary duties: public disclosures made through government reporting and disclosures made directly to participants.

One of the most cumbersome projects a plan fiduciary faces is the annual filing of Form 5500 with the DOL. Form 5500 is a government mandated return comprised of a main document and, in some cases, multiple schedules, that reports information relating to the plan and its operation.

Because most DOL audits are initiated after investigators discover abnormalities on the plan's Form 5500, it is imperative that the 5500 is prepared with the utmost skill and care.

Other disclosures must be made directly to plan participants. First and foremost, the plan must automatically provide participants with a summary plan description (SPD) which explains the benefits provided and how the plan operates. The SPD is essentially an abbreviated version of the plan's governing documents written in a manner calculated to be understood by the common plan participant.

After the SPD is distributed, plan fiduciaries must continue to make participants aware of material changes to the plan through explanations called summaries of material modifications (SMMs).

Also, a summary annual report, which is a brief summary of Form 5500, must be provided annually to each participant or beneficiary.

Selection of Investment Options

401(k) plan fiduciaries are, in most cases, responsible for selecting a plan's investment options. In making these selections, there are a number of factors that a fiduciary should take into account.

First, the fiduciary should regularly monitor the fees, costs and overall performance of a plan's investment options. Putting investment options on "auto-pilot" without review for long periods of time can expose a fiduciary to claims of liability if these investments change focus or go through a long period of decline.

Second, because many 401(k) plans rely on the rule in section 404(c) of ERISA that shields a fiduciary from liability where a participant directs the investment of his account, it is important that the fiduciary comply with section 404(c) regulations. In order to be afforded 404(c) protection, over 20 requirements must be satisfied that fall into the following three categories:

- Offering a broad range of investment alternatives;
- Permitting participants the ability to exercise control of their investments; and
- Providing participants with specific information disclosures to help them make informed investment decisions.

Fiduciaries who comply with all of the provisions of the 404(c) regulations are still liable for choosing and monitoring the plan's investment options.

Third, because some participants have more background in investing than others, it is always important to make sure that a plan's investment options and the descriptions of these options are understandable to the average plan participant.

Delegating Duties

Fortunately, fiduciaries can act to limit potential exposure by relying on competent outside advisors to assist with complicated matters. The plan fiduciary's obligations do not end with the selection of a service provider because ERISA imposes an ongoing duty to monitor with reasonable diligence the providers in order to ensure that they are meeting the plan's expectations.

Conclusion

There is no doubt that employees will continue to want 401(k) accounts and employers will continue to provide them. By understanding ERISA's fiduciary rules and strategically using competent service providers, the prudent 401(k) plan fiduciary can both limit legal exposure and protect participants' retirement accounts.

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