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Best Practices For Minimizing the Potential For Retirement Plan Fiduciary Liability

Let's be honest--maintaining a tax-qualified retirement plan can be a challenging task. Not only are the myriad of nondiscrimination rules complex, they change frequently and are not necessarily logical. Oversight of day-to-day matters often falls to human resources personnel who either lack the necessary background or do not have the time or motivation to devote to it. Moreover, many plan sponsors and fiduciaries are themselves ill-prepared and rely heavily on their vendor or investment provider to take the lead to assure compliance, and the sponsor's and fiduciaries' oversight and monitoring of the vendor or provider is minimal at best.

Although ERISA[1] was enacted in part to prescribe detailed rules of conduct for plan fiduciaries, the risk of personal liability for a fiduciary breach up to now has not been that great, except in egregious situations. That is no longer remaining true. Over time, mostly over the past five or six years, a number of unrelated developments have arisen and are converging to significantly increase the potential for disputes over benefits matters and therefore the potential for fiduciary liability. Because plan sponsors may themselves be fiduciaries or may be obligated to indemnify the plan's fiduciaries, the issues raised by these developments are more than simply a matter of intellectual curiosity to plan sponsors. In this Commentary, we will discuss these developments and suggest actions that retirement plan sponsors and fiduciaries should consider undertaking to minimize their potential for liability.

Effect Of Shift In Predominant Plan Type

Aside from more recent developments, one development bearing on the risk of fiduciary liability that has evolved over a longer period of time is the type of retirement plan most commonly maintained by employers. When ERISA was enacted in 1974, the predominant form of retirement plan was a defined benefit plan. In such plans, the benefit the participant or beneficiary is entitled to receive is specified in the plan document, usually in some form of life annuity, and the plan sponsor obligates itself to actuarially fund the plan in order to provide those benefits. In light of the sponsor's obligations, the entire risk for an underperforming plan falls on the plan sponsor.

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FREE BACKGROUND INFORMATION IS AVAILABLE UPON REQUEST.

Over time, defined contribution plans, such as profit sharing and 401(k) plans, have replaced defined benefit plans as the predominant form of retirement plan. Unlike defined benefit plans, however, defined contribution plans have no guaranteed benefit; instead, the plan sponsor's commitment is limited to making certain contributions on the participant's behalf, with the participant being entitled to his or her vested interest in those contributions and the earnings accumulated thereon at the time a distributable event occurs. Thus, the entire investment risk in defined contribution plans is on the participant, not the plan sponsor.

From the perspective of plan fiduciaries and sponsors, the shift from defined benefit plans to defined contribution plans increases the likelihood that a dispute will later arise and increases the risk of personal liability. Since the plan fiduciaries are frequently upper management employees of the plan sponsor, the likelihood of the sponsor asserting a claim against one or more of the fiduciaries--in the case of a defined benefit plan - is probably remote. Moreover, because the benefit is specified in the document, there are seldom disputes with participants over miscalculations of the benefit. In a defined contribution plan, however, because the investment risk is upon the participants and the participants likely contributed from their own pocket, the chances of a participant asserting a claim against the fiduciaries or the sponsor or both are much more likely.

Effect of More Current Developments

More recently, a number of unrelated developments have arisen that have increased the potential for benefit disputes and the risk of personal liability for a fiduciary breach.

Baby Boomers Starting to Retire: The first wave of baby boomers recently turned 60 and many have begun serious consideration of retirement. Even counting social security, most of them, unfortunately, are financially unprepared for retirement due to inadequate savings and/or overly optimistic expectations as to their living expenses in retirement. Statistics vary but may surveys show that the median 401(k) plan account balance is somewhere in the neighborhood of $100,000. If you assume a generally accepted rate of withdrawal of 4% per year, even a retiree with an account balance of $100,000 would only be able to draw a retirement income of $4,000 per year, hardly enough to make those retirement years "golden", especially when you consider longer life expectancies and the effects of inflation (especially health care inflation).

Lagging Investment Returns: The high flying investment returns of the 90's are long gone. When investment returns were high, less attention could be paid to the details. In these days of more modest investment growth, participants are apt to be more focused on the details in trying to assess responsibility for their inadequate preparation to retire comfortably.

Enter the Trial Lawyers: At one time, plan participants unhappy with their retirement benefit might have had difficulty finding a lawyer who would take their case. That is less of a problem these days as plaintiff lawyers are "discovering" ERISA now that other types of litigation are becoming less profitable or more difficult to pursue. Although punitive damages and jury trials are not available under ERISA, an award of attorney's fees is within the discretion of the court.

The Mutual Funds Scandals and Their Progeny: The mutual funds scandals (market timing and late trading) of a number of years back and the subsequent lagging investment returns have led to intense media scrutiny on fees and expenses charged by retirement plan investment providers, which has highlighted the deleterious effect of fees on investment returns and the inherent conflicts of interest of some investment providers. Lawsuits have been filed against a large number of well-known companies and their plan fiduciaries alleging inadequate oversight of investment providers and insufficient disclosure of plan related fees and expenses. These cases are continuing to wind through the system and copycat suits against other plans, including smaller plans, can be expected with a victory or partial victory in one of these initial cases.[2]

Blurring of Line on Fiduciary Obligations: There have been a number of U. S. Supreme Court cases recently that have blurred the line between plan settlor functions (for which the sponsor or fiduciary is immune from liability), reporting and disclosure obligations and fiduciary obligations, as well as who may be sued and the remedies that are available. The upshot of these cases is that getting out of litigation before the trial level will be much more difficult than previously.

The Enron Case: The Enron collapse has resulted in a number of new laws and a re-examination of many existing laws to see "what went wrong". In a significant ruling in the retirement plan area, the court in *Tittle v. Enron* highlighted a common deficiency of plan fiduciaries--the failure to adequately monitor appointed fiduciaries--and expanded the potential liability of those with limited roles to impose greater duties to monitor other fiduciaries and service providers. Suffice it to say that plaintiff's counsel are using the *Tittle* decision in formulating their positions against plan sponsors and fiduciaries.

Remedies for Fiduciary Breach and Standing to Assert a Claim: In a unanimous decision handed down earlier this year, the U.S. Supreme Court ruled that a participant in a 401(k) or other defined contribution plan may sue a plan fiduciary to recover losses for a breach of fiduciary duty even if the participant was the only participant affected by the alleged breach. Previously, most courts had permitted recovery for a fiduciary breach only for the plan as a whole, not just for a single participant or subset of participants. To the Court, the size of the participant's account balance was not relevant to a participant's right to bring a claim, nor was the fact that a participant might have received a distribution of his or her benefit already so long as the participant had a "colorable claim" to additional benefits (i.e., the participant's account balance in the plan had been diminished by the alleged breach). Experts disagree whether this decision will lead to an "avalanche" of additional claims by plan participants; the consensus is that at the very least it will lead to more claims, if not more litigation.

New Sheriff in Town: In the 2006 elections, the Democrats gained control of both houses of Congress and raised expectations of greater regulation of retirement plans, as illustrated by three different bills introduced to address greater transparency in retirement plan fees and expenses. If they retain or increase their majority in 2008, and especially if they capture the White House, greater regulation of benefit plans and greater enhancement of participant rights (translated, greater obligations on plan sponsors and fiduciaries) can be expected.

Greater Access to Information: Information that once would have been obtained only after a great deal of research using cumbersome methods is now readily available via the internet. What this means is that plan sponsors and fiduciaries will face participants who are better and more timely informed.

Individually, these developments may not be sufficient to trigger concerns of increased potential for fiduciary liability. Taken together, however, these developments suggest that it can no longer be "business as usual" for plan sponsors and fiduciaries and that much more will be expected of them.

What Plan Fiduciaries and Sponsors Should Consider

There are a number of steps that plan sponsors and fiduciaries can and should consider undertaking to minimize their potential for personal liability in light of these developments.

Identify the Fiduciaries: Many problems with fiduciaries arise because individuals do not know that they are, in fact, fiduciaries. The first step then should be to review the plan document and the plan operations to identify all fiduciaries with respect to the plan and ideally, to get an acknowledgement of fiduciary status in writing from those persons.

Assure Fiduciaries Understand Their Duties: Another common shortcoming is that few fiduciaries understand their duties and responsibilities and even fewer understand the implications of the standard of care imposed upon retirement plan fiduciaries by ERISA, which has been described by some courts as "the highest obligation known under law." What this suggests is that plan fiduciaries need some type of educational initiative upon taking office so they understand their duties and obligations, including the difference between "settlor" functions, for which there is no risk of personal liability, and "fiduciary" functions, for which the individual may be held personally liable. Corporate insiders (i.e., officers and directors) who are serving as plan fiduciaries must understand that their loyalties must lie to plan participants in the event of a conflict between their corporate and plan duties. Moreover, procedures should be in place for periodic updates to assist fiduciaries in staying up-to-date in this rapidly changing area of the law.

Equally as important as understanding their duties, fiduciaries should understand their potential personal liability for making good any loss of the plan caused by their breach of duty, especially since most retirement plans provide for an offset of all or part of a fiduciary's benefit under the plan to satisfy his or her obligations to the plan for failing to adhere to the requisite standard of care.

Establish Standard Procedures: There should be standard procedures in place for handling all operations of the plan. ERISA is essentially a procedural statute; the reasonableness of a fiduciary's conduct will be judged by whether he or she engaged in a careful, thoughtful course of action based on the information then at hand and not whether there was a successful outcome. Thus, the test is whether the fiduciary employed appropriate methods to independently investigate and acted accordingly. Having standard procedures in place and following them will demonstrate the requisite due diligence.

One of the most important procedures to have in place are procedures to regularly monitor the actions of appointed fiduciaries and service providers and replace them in appropriate circumstances. Case law makes clear that a fiduciary has a duty to monitor which cannot be delegated, yet many commentators suggest that the failure to monitor remains a serious deficiency in many plans.

Use Independent Experts: Despite the high standard of care, a fiduciary is not expected to be an expert in all things. Accordingly, a fiduciary who lacks the necessary training, skill or experience required to adequately investigate must retain an expert to assist him or her. Reliance on the expert, however, generally will not be justified unless the fiduciary first determines that the expert is sufficiently independent, qualified, has been provided complete and accurate information, has undertaken a sufficient analysis to make an informed decision, and that his or her conclusions appear reasonable. Most typically, outside experts are used for legal and administration advice, investment selection and monitoring, vendor/provider selection, and investment and vendor fee and expense reviews and audits and compliance examinations. Equally as important as the technical competence of the expert to assist the fiduciary, the expert must also be free from personal or financial bias that would taint the advice provided.

Take Advantage of Available Fiduciary Protections: Prudent fiduciaries will take advantage of the protections afforded them under current law. For example, a fiduciary will not liable for losses which are the direct result of a participant's exercise of investment control over his or her account, provided the fiduciary has satisfied the requirements of the regulations under ERISA Section 404(c). Similarly, plan fiduciaries will not be responsible for losses resulting in a participant's account where a participant's account is invested in a "qualified default investment alternative" when the participant fails to direct the investment of his her account.

Document Actions and Deliberations: Perhaps the most important of the plan procedures to have in place are procedures for the fiduciary to document all actions and significant deliberations undertaken. A lack of adequate substantiation will undoubtedly be viewed with great skepticism. From a perspective of hindsight, a lack of good records will naturally cause the fact finder to focus more on the ultimate outcome (which cannot be favorable if there is in fact a dispute), and not on the information available when the action was taken or the decision made. Accordingly, it is imperative that procedures be in place to contemporaneously document in written form all significant actions and deliberations of the fiduciaries.

Consider Use of IRS and DOL Correction Programs: If an operational, document or fiduciary problem is discovered, consideration should be given to correcting the defect utilizing one of the correction programs administered by the Internal Revenue Service or the Department of Labor. These programs offer standardized corrections at reduced penalty amounts so long as the programs are utilized before matters are discovered upon examination. It would not be a far stretch for a court to permit a claim of breach of fiduciary duty to lie where a fiduciary was aware of a compliance problem and did nothing to rectify it, provided, of course, that he or she was in a position to effect a correction.

Keep Abreast of Trends: Advances in computer technology and other factors are constantly changing the retirement plan marketplace. Prudent plan sponsors and fiduciaries will stay attuned to these changes and implement appropriate enhancements. Among the most frequently discussed current trends include automatic 401(k) plan enrollment -- where the participant is required to contribute at a certain rate unless he or she makes an affirmative election to defer at a lesser rate; using lifestyle and target maturity funds for participants who fail to make an investment election; adding investment advice programs; and improving periodic participant statements to assist participants in measuring whether they are on track to meet their retirement savings goals.

Identifying Potential Problems With A Compliance Review

A problem cannot be fixed without knowing that the problem exists in the first place. Many plan sponsors and fiduciaries, however, lack internal risk management resources so they must rely upon information and advice given to them from external sources. Unfortunately, and often unknown to the plan sponsor or fiduciary, many of the sources providing information to plan sponsors and fiduciaries do not owe to them the duties imposed under the fiduciary standard of care. Thus, not all of the advice received by the plan sponsor or fiduciary may necessarily be what is in the best interests of the plan but rather will be tainted by the source's personal bias or financial interests. For these reasons, many plan sponsors and fiduciaries will find it prudent to engage an outside independent third party to review their plan and its operations. Depending upon the plan involved, these reviews may include a review of the adequacy of plan documents; compliance with tax qualification and related tax rules; disclosures to participants and government authorities; existence of, and adherence to, appropriate administrative practices and procedures; adherence to appropriate standards for investment management; and proper maintenance of records.

Aside from highlighting potential problem areas, such a compliance review demonstrates the exercise of sound business judgment by the fiduciary and the importance of preventive planning to avoid problems. Moreover, such a compliance review will also identify where improvements in the plan are desirable, for example due to changes in the marketplace.

An important consideration in engaging an outside third party to make an assessment of the fiduciary and compliance status of the plan is the independence of the party undertaking the review. It should go without saying that the party retained to provide the advice should not have any financial or other interests that would be affected by the results of the review. As the old saying reminds us, the fox should not be guarding the hen house.

Another important consideration in engaging an outside third party to make an assessment of the fiduciary and compliance status of the plan is whether the report prepared and the materials compiled to issue the report may be shielded from disclosure in any subsequent dispute or litigation. If it will not be protected from disclosure and the plan sponsor or fiduciary fails to follow the recommendations of the reviewer without good reason, the sponsor or fiduciary has significantly helped a disgruntled participant build his or her case. Some courts recognize a so-called "self-critical analysis" evidentiary privilege, under which information obtained in internally conducted investigations is protected from discovery by an opposing party. The theory behind the privilege is to encourage parties to candidly assess their compliance with applicable laws. The privilege is not universally accepted and many exceptions apply even in those jurisdictions where the privilege has been recognized. If properly structured, however, such a review should be protected by the attorney-client privilege regardless of whether the "self-critical analysis" privilege applies.

A final important consideration with a compliance review relates to how the cost for the review is paid. If the cost is paid from plan assets, a court would likely conclude that the review was undertaken for the benefit of plan participants, not the fiduciary or the plan sponsor, so the report would not be shielded from discovery. To minimize the potential for disclosure, the cost instead should be paid by the plan sponsor or the fiduciary and not from plan assets, directly or indirectly.

Concluding Thoughts

There is virtually unanimous agreement among commentators that there will be more employee benefits litigation in the future. Recent studies have shown that most participants have wildly unrealistic expectations as to what will be needed to support them in retirement and most are woefully under funded to meet their retirement needs. As baby boomers retire and discover that they are ill prepared for retirement, they will inevitably look to others to be held accountable. Prudent plan sponsors and fiduciaries should, therefore, consider how their actions will appear in hindsight; establishing standard processes and procedures and conducting a fiduciary and compliance review will help in identifying deficiencies and implementing changes, and thereby minimize the potential for disputes and personal liability.

One may ask whether this is much ado about nothing, much like the "sky is falling" predictions predating Y2K. I would submit that Y2K became a non-issue because people heeded the warnings and took appropriate action. While much about these issues has been covered extensively in the professional literature, a great deal less has been found in the mainstream press. A wise fiduciary can take small steps now to significantly minimize his or her potential for liability and thereby avoid being the "low hanging fruit" when disgruntled participants start looking for someone to be held accountable.

Contact Us

- **Gilbert Van Loon** is an attorney in the Jackson office of Butler Snow. He practices in the areas of employee benefits, executive compensation, professional entities and taxation. Gilbert can be contacted via e-mail at gilbert.vanloon@butlersnow.com.

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1 ERISA is the acronym for the Employee Retirement Income Security Act of 1974, as amended, the federal law governing retirement plans. ERISA supersedes most state laws that "relate to" an employee benefit plan.

2 More litigation over fees and expenses can be expected once the Department of Labor completes its various initiatives to improve the transparency of fee and expense information. Among those initiatives are much more detailed disclosure obligations imposed upon plan fiduciaries and plan service providers. Several bills pending in Congress mandate similar disclosures. If these provisions become law, and disclosures are made, participants may find themselves with more ammunition to question past fiduciary conduct.