

## WHITE PAPERS

### MITIGATING PLAN FIDUCIARY LIABILITY FOR COMPANIES & INDIVIDUALS

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Retirement plans are rapidly becoming the most valuable asset held by many US citizens. Countless books and articles have been written about the fortunes made and lost in retirement plans. Most recent studies suggest that in 401(k) and profit sharing plans alone, investors have saved more than \$1.5 trillion.

The only growth areas outpacing retirement plan assets are the income needs of the baby boomer generation and civil litigation.

According to the Congressional Budget Office's November 2003 report, "Baby Boomers' Retirement Prospects: An Overview":

- Boomers can expect to live roughly two years longer than their parents, but expect to retire at the same age as their parent;
- Baby Boomers are unlikely to experience the pleasant economic surprises that have benefited current retirees (post-war economic boom, unexpectedly large Social Security payments, dramatic rise in housing prices, etc.);
- Real long-term interest rates have declined in the past few years, translating into lower income in retirement.

Add these factors to the real possibility of limiting Social Security payments to future retirees, and the retirement "readiness" of Boomers is in question.

As for litigation, according to a recent survey from Cornerstone Research, class action filings were up 31% in 2002 from 2001. These numbers are expected to escalate as claimants prepare to seek justice in the courts for mutual fund misconduct discovered in 2003 and 2004.

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A large list of willing claimants has come together with a host of other factors to increase the potential for future litigation regarding retirement plans and their fiduciaries.

- A recent bear market that saw the S&P 500 shed more than 44% of its value in 13 months
- Businesses relying on investment vendors for investment oversight
- The largest investigation of the financial services industry since the Great Depression

Three critical elements have arisen to create potential peril for fiduciaries.

Need – for additional retirement income by Baby Boomers

Greed – of financial services firms in failing to meet their fiduciary duty

Misdeeds – of retirement plan trustees and sponsors (many without malicious intent and many without knowledge of breach)

These have all come together to create a “Perfect Storm” for willing litigants.

### **Potential Areas of Future Litigation**

Litigation over the next decade is likely to focus on issues most impactful on participant balances. Listed below are areas small- to mid-sized businesses need to monitor to ensure their compliance with ERISA.

- Exclusive Benefit – ERISA Sections 403(c) and 404(a)(1)(A) say that failure to operate the plan for the exclusive benefit of participants can result in personal as well as corporate liability. Plan assets cannot benefit the employer and expenses paid by the plan must be reasonable.
- Vendor Selection – Selecting vendors is a fiduciary act according to the Department of Labor’s Advisory Council on Employee Welfare and Pension Benefit Plans. Employers who do not use a rigorous search process increase their liability.
- Selecting Investment Obligations – Choosing investments is also a fiduciary duty under ERISA Section 404(a)(1)(B). Employers must follow the “Prudent Expert Rule” by acting

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with the skill and diligence of a prudent man with knowledge of such matters. As the courts made clear in *Donovan v. Cunningham*, “a pure heart and an empty head are not enough” to meet the prudence standard.

- Investment Monitoring – Fiduciaries have a duty to monitor fees and expenses. In most instances, investment fees represent the majority of total 401(k) plan fees.
- Monitoring Other Plan Functions – Day-to-day operational aspects of the plan are not fiduciary acts, but monitoring them is. The plan sponsor, not the vendor, is charged with oversight to ensure the plan is operated correctly.

### **Limiting and Mitigating Liability**

Trustees and plan fiduciaries cannot eliminate their personal liability for any of the above functions. However, by establishing a clearly documented process for decision-making and oversight and by retaining prudent experts, trustees can mitigate their liability. Diligence is demonstrated by process, not results. The following are best practices to assist your business in the successful management of your retirement plan:

- 1.) Establish a committee to oversee the plan – The mandate of the committee should be established through a board resolution and should specify how often the committee will meet. Identify specific titles or roles within the company to serve on the committee rather than simply appoint individuals, and report to the board of directors annually.
- 2.) Perform a Total Fiduciary Review to determine areas of oversight that need improvement
  - a. Plan Document
  - b. Plan Design
  - c. Administration and Filings
  - d. Vendor Quality
  - e. Investment Policy Statement
  - f. Cost Structure
  - g. Participant Education Program
  - h. Investment Selection and Portfolio Construction

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- 3.) Implement a written Investment Policy Statement that provides a clear road map for how investment decisions are made, investments monitored and, if need be, replaced. The policy should be detailed enough so that someone reviewing investment decisions years later would understand the decisions that were made and why.
- 4.) Review plan investments quarterly – Document that funds meet or exceed IPS standards, and what you have done to understand underperformance.
- 5.) Ensure that plan fees are reasonable for plans of similar size and complexity – Get independent comparisons annually.
- 6.) Conduct periodic, limited scope audits of key operational elements of the plan – Keep committee minutes to document discussions and provide a paper trail.

### **Other Critical Areas for Review**

#### **Avoid Prohibited Transactions**

Duties of company officers and plan fiduciaries can come into conflict, particularly where company stock is involved.

Make contributions at the same time you do payroll. The courts have construed that participant deferrals become an “asset of plan” as soon as they have been segregated as part of the payroll process. Failure to remit those funds to the trust as soon as administratively possible construes a prohibited loan of funds to the company by the plan and is subject to penalties, makeup earnings, and taxation.

#### **Outsource**

Hire an independent third party to oversee investments, costs, and fiduciary process. Demand they serve the plan as fiduciaries. This is particularly important for bundled plans where the vendor’s profitability depends on which funds are selected by the plan and by the participants in 401(k) plans.



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## **Communicate**

Avoid putting the plan on autopilot once it is up and running. Frequent communication is a fiduciary best-practice and builds trust from participants.

## **Listen to Participants**

Communication goes both ways. Participants are often the first to notice a diminution in service levels or errors made by providers. Take each one seriously. Survey participants annually and share the results of those surveys with your vendors.

Managing fiduciary risk, while daunting, is not impossible. The first step is determining what your organization can do effectively in-house, and then finding qualified, objective consultants and vendors to manage the rest.

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