3 Reasons Your 401(k) is a Ticking Time Bomb

Thoroughly understanding your 401(k) plan is the law. Plan sponsors have fiduciary responsibilities that they may not understand. Plans are complex and opaque. The things companies did not know are resulting in expensive lawsuits. Protect yourself.

Plan Sponsors Face Massive 401(k) Lawsuits

In FY 2015, the Department of Labor closed 2,441 civil investigations into employee benefits programs, recovering over $696 million in funds.[i] According to a Towers Watson survey, it costs an average company about $365,000 in legal costs to defend a claim under the federal Employee Retirement Income Security Act of 1974 (ERISA). The average settlement was just under $1 million.[ii] Court decisions favor litigants, with 69% of substantive ERISA litigation resolved in favor of plaintiffs.[iii]

401(k) Lawsuit Epidemic

Company	Year	Settlement
Lockheed Martin	2015	$62 million[iv]
Boeing	2015	$57 million[v]
Ameriprise	2015	$27.5 million[vi]
Fidelity	2014	$12 million[vii]
Walmart	2011	$13.5 million[viii]
Bechtel	2010	$18.5 million[ix]
Caterpillar	2009	$16.5 million[x]
General Dynamics	2010	$15.15 million[xi]
International Paper	2013	$30 million[xii]
Kraft Foods	2012	$9.5 million[xiii]

Time Bomb #1: Hidden Fees

Section 408(b)(2) of ERISA dictates that a comprehensive fee analysis be performed by a 401(k) sponsor to avoid potential liability for excessive fees. Both "direct and indirect" costs of a 401(k) plan are potential sources of liability for a service provider.[xiv] "Direct compensation" comes directly from the plan and "Indirect compensation" is most commonly revenue sharing payments from mutual fund companies. Failing to address revenue sharing may cost a plan sponsor dearly.

Revenues sharing payments take several forms. The recordkeeper retains the payments, participants absorb them pro rata, or the recordkeeper returns them to the participants who invested in the mutual funds that generated the revenue sharing. Decisions about what to do with revenue sharing are fiduciary decisions and should be made through a prudent process and documented.

Plan sponsors are not only required to understand the provider's fees, but also the amount of fees paid by plan participants. Fees may be included for legal services, accounting, audit, investment advice, recordkeeping, 12b(1) fees, revenue sharing expenses, contract charges, internal operating expenses of mutual funds, educational seminars, trustee services, and sales charges among others.

Lockheed Martin's record $62 million settlement under ERISA was in part a result of unmonitored recordkeeping fees hidden in its 401(k) program.[xv] A $12 million settlement by Fidelity Investments similarly punished the company for not controlling its fees.[xvi]

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Time Bomb #2: Underperformance or Unsuitability of Funds

On May 18, 2015, the Supreme Court released a unanimous ruling in Tibble v. Edison stating, "A trustee has a continuing duty to monitor trust investments and remove imprudent ones".[xvii] This not only includes cost, which Tibble focused on, but also performance, competence, and suitability. [xviii]

Prudent decisions regarding plan investments consider both qualitative and quantitative criteria. Well advised plan sponsors adopt a documented due diligence process with periodic reports to compare investment performance to appropriate index, peer group, and investment policy statement objectives.

Closely scrutinize the suitability of funds offered. In a 2015 lawsuit, Intel came under fire for offering high-risk hedge fund and private equity investment without properly disclosing the risks to its participants. Even money market funds are under fire for poor disclosure, as in the Lockheed Martin lawsuit.[xix]

Time Bomb #3: Failure to Negotiate Fees

On December 29, 2015, plaintiffs sued Indianapolis-based health care insurer Anthem Inc. for excessive fees despite having the majority of their funds provided by the Vanguard Group. In addition to missing identical lower-cost versions of funds offered, the lawsuit accuses Anthem of failing to negotiate for lower investment fees.[xx]

While the lawsuit is still pending at the time of publication, the implications are dire for plan providers. Not only does it show that picking a big name is insufficient, it also demands that plan sponsors actively monitor their choices and negotiate for lower fees.

How To Protect Yourself

Ultimately, ensuring your legal safety in offering a 401(k) plan requires flexibility and constant vigilance. From initial selection of investment options and service providers to periodic review, participant education, and plan design, the process is both wide and deep.

A plan audit can help identify potential liability pitfalls, proactively eliminate shortfalls, and mitigate litigation risk:

1. Establish an Ongoing Review Process

Continuous documentation and attention is necessary to provide proof of a prudent process. Establish a formal investment policy statement to organize plan implementation and monitoring. Evaluate periodic reports on plan investments to determine ongoing conformance to the investment policy statement. Committees must be closely involved to ensure an airtight plan.

2. Benchmark Fees & Fund Options

Hidden fees or underperforming funds can easily become easy targets for a lawsuit. Investment expenses above 0.5% in total fees are a "red flag",[xxi] according to a leading litigator.

3. Conflicts of Interest

If a decision not conducted at arm's length harms a participant, then a breach of the fiduciary duty of loyalty has occurred. Providers offering their own potentially underperforming funds, for example, are a lawsuit waiting to happen.

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Phillips & Company provides plan audits, which can mitigate the potential that you become a litigation target. An audit helps identify strengths and potential liability pitfalls in a number of areas:

- Assessment of fiduciary processes
- Investment policy statements
- Evaluate fee reasonableness
- Employee engagement and education
- Investment performance
- Plan design and plan document review

If you find any of this information troubling or are in a situation that has you losing sleep, call Phillips 401(k) Advisors and have us prepare a free audit of your plan.

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