

## Rethinking 401(k) Litigation Risk Management

### The goals of 401(k) litigation risk management are to:

- Minimize the likelihood that your plan will be a tempting target to knowledgeable plaintiffs' attorneys. The easiest way of doing this is through the use of targeted participant communications that reflect both the sponsor's goals for the participants and the well-publicized research describing the attitudes, educational capabilities, and limitations of the participants.
- Maximize the likelihood that a case alleging 401(k) fiduciary breaches will be dismissed by enabling your defense counsel to easily and convincingly demonstrate that the 401(k) plan was and is managed with the sole goal of helping participants achieve a financially secure and comfortable retirement.

### There are several realities that fiduciaries and sponsors must recognize in order to create effective 401(k) risk management programs, including the few that are discussed below:

- Congress and the DOL never defined the duties of loyalty, prudence, and disclosure. In a recent decision, Judge Mark R. Kravitz (*CIGNA v. Amara*) wrote: "... ERISA, and the regulations under it, are often lamentably obscure – to describe them as a tangled web does not do them justice..." Thus, expensive, time-consuming litigation will most likely be the manner by which fiduciaries and sponsors learn what these duties really involve. This learning process will likely be painful as Judge Richard A. Posner has pointed out: "*If changing judges changes law, it is not even clear what law is.*"

- Strategy:** The fiduciaries should have a written document that frames the 401(k) plan from the perspective of the participants and that clearly states that the employees will be told:
- The 401(k) plan is not a pension in the sense of a defined benefit plan even though the sponsor may make contributions to it. The 401(k) plan is a tool that enables participants to fund, in a tax-advantaged manner, their retirement.
  - The employee alone is responsible for achieving a financially secure retirement. The employee bears all the risks, including outliving his retirement nest egg and having the stock market incur significant losses for extended periods of time. It is the employee's responsibility to determine how much he must contribute to the plan to ensure his own retirement security.
  - Planning for retirement should begin in your twenties so as to minimize funding costs and to exploit compound growth and dollar-cost averaging.

**Query:** Do the fiduciaries periodically remind their participants of the above points?

**Strategy:** The fiduciaries should routinely analyze—for the plan as a whole as well as for individual employee segments—their participants' retirement readiness. The analysis should show the number of years it will take to deplete the participant's retirement nest egg given a specified replacement ratio, a set of assumptions, and the inclusion of Social Security and other company benefits.

- Fiduciaries should assume that Congress’s good intentions and DOL regulations are merely guidelines to follow rather than “end alls, be alls” since they are often not well thought-out or up-to-date. Congress’s “anointing” of target-date funds and managed accounts as QDIAs and the regulations regarding them are examples of this.
  - Fiduciaries are neither required to tell auto-enrolled participants that the default contribution rate is probably way too low to enable them to achieve retirement security nor to—as the GAO has strongly recommended to the DOL—provide each participant with a gap analysis showing a higher and more realistic suggested contribution rate.

**Query:** Have the fiduciaries documented their reasoning for implementing the auto-enrollment process the way they did, including their choice of the default contribution rate, their approach to auto-escalation of contributions rates, and their process for selecting their specific QDIA?

(Selecting the generic type of QDIA is not a fiduciary duty. Deciding whether to use an off-the-shelf target-date fund or a customized one is a fiduciary duty. Likewise, the choice of the product’s investment manager and how that QDIA will be monitored are also fiduciary duties.)

- By “anointing” target-date funds and managed accounts as QDIAs, Congress implicitly endorsed the legitimacy of Modern Portfolio Theory (MPT), the underlying basis for creating the asset allocations of and glide paths of target-date funds (as well as the asset allocations for managed accounts). Unfortunately, there is no good evidence that this theory has much value in the real world. In fact, Morningstar maintains that few, if any, glide paths have a strong conceptual basis.

**Strategy:** The fiduciaries should document the reason for their faith in the model underlying the QDIA they have chosen, the process used for selecting their investment manager, and the standards they will use in assessing whether or not their expectations for the QDIA (investment manager) have been realized.

**Query:** Can the fiduciaries document the thoroughness of their approach to selecting and monitoring their QDIA?

**Query:** Have the fiduciaries asked their investment manager whether or not their model anticipated that stocks would have had a near zero rate of return over the last ten years while bond returns would be in the mid-single digits? How does their model factor in “animal spirits” and other human emotions?

**Query:** Have the fiduciaries asked their recordkeeper to describe in detail the criteria it uses to select QDIAs to make available for its clients?

**Fiduciaries should always keep in mind the advice of the SEC’s Robert Khuzami: “*Whether you’re dealing with terrorism or securities fraud, it’s better to be in the prevention business than the cleanup business.*”**