# Q&A

## Litigating an employee benefit claim

**Part 2 of a 2-part series**

**From an interview with Richard A. Naegele, Esq. and Thomas R. Theado, Esq.**

*Last month, attorneys Richard Naegele and Thomas Theado discussed the implications of initiating, or defending against, a participant's claim under ERISA. This month we continue with that discussion. Richard Naegele of Wickens, Herzer, Panza, Cook & Batista in Avon, Ohio, is an ERISA attorney, and Thomas Theado of Gary, Naegele, and Theado, LLC, in Lorain, Ohio, is an ERISA Class Action litigator. Mr. Naegele may be reached at* RNaegele@wickenslaw.com *and Mr. Theado may be reached at* TTheado@GNTLaw.com.

**Q It seems as if most participant lawsuits arise from participation in a defined benefit pension plan. Are there participant lawsuits in 401(k) plans?**

**Thomas Theado (T):** Most of the participant claims arising from participation in a 401(k) plan are related to investment concerns.

**Dick Naegele (D):** I agree, and the most significant lawsuits have to do with investing participant accounts in the employer stock. Good examples are the Enron and WorldCom cases. Participant claims in a 401(k) tend to fall in three specific categories. The first would be the "prudent investment claim." Here the participant alleges that the fiduciaries knew, or should have known, that the employer stock was not a prudent investment option for the plan. These claims generally imply that the fiduciaries had some kind of insight or knowledge that they ignored or did not act upon. Basically, these cases allege that the fiduciaries continued to invest in employer stock when they knew that it wasn't a good thing to invest in. The fiduciaries just continued to let participants direct the investments of their own accounts into that employer stock.

Next are claims related to a failure of the fiduciary to disclose relevant information to a participant who was in the process of making an investment election. Sometimes the participant alleges that fiduciaries actually made knowing misrepresentations that adversely affected decisions over the investments made by the participant.

The third type of claim involves a defined contribution plan that is an ESOP and invests in a privately owned company. These claims generally have to do with allegations about incorrect valuations of the employer stock. For example, the trustee either paid too much for the stock or the amount of cash distributed at the time of the ESOP distribution did not recognize the full value of the stock. In some cases, a 401(k) may include an ESOP component.

**Q Every day I get some information on an investment firm or a lawyer warning plan sponsors about their fiduciary investment liability arising from 401(k) plans. Are you saying that these warnings are unfounded?**

**D**: Not exactly. There could be some participant claims arising from 401(k) plans that do not hold employer stock. This is possible even when you've got a 401(k) plan that is structured as an ERISA § 404(c) plan. The plan fiduciaries have responsibility for the investments of the plan assets under ERISA § 404. Section 404(c) puts up what I like to think of as a shield or an affirmative defense to protect a fiduciary if a participant brings a claim over the imprudent management of the plan's assets. Basically, the plan fiduciaries can raise this ERISA § 404(c) defense and say, "No, we have prudently invested the assets," as long as the plan complies with the requirements of that section.

As a short summary, Section 404(c) compliance requires that the participants must be able to choose from a broad range of investment alternatives with at least three diversified investment choices called the "core alternatives." These generally would be a stock fund, a bond fund, and a balanced fund. Next, the participants must be able to give investment instructions at least once every three months and often more frequently. Most plans that have participant directed investments allow this on a daily basis. Third, the investment mix available must allow all participants to diversify their investments overall, and within the investment categories. And last, participants must receive current investment information from the plan fiduciary. If you do that, at least you've got an argument for a defense under ERISA § 404(c).

Notwithstanding this defense, sponsors still have other retained fiduciary duties. For example, the fiduciary would remain responsible for the prudent selection and monitoring of the plan's investment alternatives. If you're the fiduciary and you go out and pick really bad funds that you never monitor, you may have qualified under ERISA § 404(c), but you did not fulfill your fiduciary responsibility. Another example of retained fiduciary responsibility is a requirement to properly execute the participant's investment decisions. When a participant tells you to change the investments, you need to have a trading arrangement that does not result in an undue delay. That also means you must timely disseminate the required information relating to the investment alternatives. And, of course, the plan fiduciary must avoid a participant or trustee investment that could result in a prohibited transaction. These responsibilities remain, even if you qualify under ERISA § 404(c).

**Q Could we say that it is unlikely that a fiduciary of a 401(k) plan using one of the national investment platforms will be sued over a failure to prudently manage the plan's assets?**

**D:** If you follow the rules and periodically review the funds in your plan, making sure you've got a fairly good mix of investments, then you're not likely to be successfully sued over the plan's investments. Remember, you do not have to select the best funds that are out there, but your process should assure a fairly good selection of funds. You need to monitor those funds to make sure they continue to meet the plan's requirements. And, you don't have to give participants 50 options; 10 alternatives could be plenty.

**Q Are there any significant class action lawsuits on these issues with 401(k) plans?**

**D:** Most of the participant litigation in the 401(k) area deal with employer stock held by the plan and over which participant make investment decisions. Over the last couple of years there have been a number of multimillion dollar settlements with regard to 401(k) plans. The vast majority of these involved investments in employer stock and some sort of impropriety.

Many of the 401(k) plans have trustees who are directed trustees. Today there is a great deal of protection when the trustee is a directed trustee as opposed to a discretionary trustee. In December 2004, the DOL issued Field Advice Bulletin (FAB) 2004-03 that really takes a pretty limited view of the potential liability of a directed trustee. I think some professionals active in this area were surprised at that. The DOL really took the view that unless the directed trustee really knew, or should have known, the material non-public information regarding the plan's investments—*i.e.*, employer securities—the directed trustee is not going to be held liable. That is somewhat contrary to one of the rulings out of Enron litigation that was released in 2003. The DOL really set a very high standard to go after a directed trustee.

**Q Do you think that we could see any participant litigation directed at the 401(k) investment providers?**

**D:** There is a possibility for some derivative suits brought by the plans against some of the providers, rather than by the participants against the plan. These are the things that some of the state funds have done. That litigation typically has to do with the improper payment by the investment provider to individuals involved in the management of the plan. It may just be a few basis points here and a few basis points there—but there's money trading hands that has to do with some of these investments. Those payments can add up to a huge amount of money when you're talking about multibillion dollar plans. Those are some of the things that several of the really large funds are considering at this time. For example, the State of Florida is looking over its past investments managed with one provider.

**Q Are there any areas of plan management that could get a plan fiduciary into hot water?**

**D:** We are beginning to see more litigation over a failure to fully inform participants of pending benefit changes at the time a participant is making an election under the plan. These typically arise with defined benefit pension plans when, for example, a participant makes an election under an early retirement benefit. Then participants want to know if the employer has serious consideration about a future improvement in benefits. This problem can arise when an employer has given serious consideration to a future benefit improvement, but either doesn't inform the participants or worse, tells them, "Absolutely no, we're not going to make any change." That's a misrepresentation. There have been a number of lawsuits where participants have gone out and retired or accepted some early retirement inducement, and within three, four, or five months after they took an early retirement inducement, the employer came back and sweetened the deal even more to induce additional employees to retire.

**T:** By far the most common problems that lead to being sued by a participant relate to the calculation of pension benefits. Benefit calculations present the participant a variety of legitimate questions. For example, did the administrator of the defined benefit pension plan use the appropriate discount rate and projection rate? In the calculation of an early retirement benefit, did the administrator include all of the elements that would apply in the calculation had the participant waited for an age-65 annuity? In many instances, a plan defines the components of an early retirement benefit differently than the components of an age-65 annuity benefit. The question then is, "Are those exclusions appropriate or did the exclusions eliminate a protected benefit?"

And remember, many companies have been bought and sold over the last 20 years. The result is that a participant may have earned a variety of benefit components from five or six different plans. It is easy to lose track of what might have been in the plan originally.

Some errors arising in these benefit calculations are purposeful, and many are not. If you have an employee who

*continued on page 9* ➤

In addition, here is one final twist: even if EGTRRA is extended and a Roth 401(k) distribution fully satisfies the five-year participation requirement, a separate five-year requirement must be met before the earnings of the rollover can be withdrawn tax-free. That is, the investment earnings on a Roth 401(k) that is rolled to a Roth IRA cannot be withdrawn tax-free until the Roth IRA satisfies a separate five-year requirement. This may not be a significant problem for most individuals because of the "ordering rule" that applies to the taxation of withdrawals from Roth IRAs under IRC § 408A(d). The taxation of a distribution from a Roth IRA is calculated on a "first-in, first-out" basis. Therefore, if the Roth 401(k) distribution met the five-year requirement, then the full amount of the rollover may be withdrawn tax-free before any of the distribution is attributed to the earnings on the rollover. ❖

**➤ ABCs of understanding an SAS 70**

*continued from page 2*

zation's internal controls. The purpose of this review is to determine whether the controls over the outsourced services cycle are adequate. In summary, almost all TPAs will need a SAS 70 report, which would then be used by a plan's sponsor.

### What does a SAS 70 include?

There are two types of SAS 70 reports: Type I and Type II. The primary difference between the two reports is the level of assurance provided. Type I engagements only report on controls that are placed in operation, but does not test their operating effectiveness. Type II engagements, on the other hand, not only report on the controls placed in operation, but also require testing of the operating effectiveness of the internal controls. The substantive testing required in a Type II engagement makes it the preferred reporting strategy.

Unlike financial audits, the TPA has the freedom, in its SAS 70 engagement, to tailor the engagement to focus on the controls most pertinent to the needs of its clients. The auditors typically assist with the documentation of the controls; however, it is important to remember that the TPA has the sole responsibility of documenting the controls.

### What are the benefits of a SAS 70 engagement?

The primary advantage of a SAS 70 engagement is a reduction in the scope of audit engagement of a plan sponsor or the plan. A TPA that chooses not to have a SAS 70 engagement potentially subjects itself to audit procedures from each of its clients that require financial audits. For a Plan Sponsor to be in compliance with Generally Accepted Auditing Standards (GAAS), audit procedures are required of the outsourced operations. An unqualified service auditor's opinion provides reasonable assurance to the user auditors that the service organization's internal controls are adequate, without the need for additional audit procedures. ❖

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**➤ Target Maturity Funds**

*continued from page 3*

thrive in an open architecture environment, and are not tied to any one vendor's proprietary products.

The table summarizes a range of problems that may occur as a result of the fiduciary obligation to remove and replace funds that no longer meet the investment standards of a plan. ❖

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**➤ Q&A**

*continued from page 5*

has done the same job in the same place at the same desk for 25 years, but the employer and plan have changed four times, it's easy to overlook a provision that was grandfathered two companies ago. And, in many cases, the SPD may not fully identify all the features of a participant's benefits.

**Q Do you have any recommendations for participants who believe they have a valid claim over a denied benefit?**

**D:** The participants should, obviously, carefully review the calculations that they get, particularly with defined benefit plans. It's a lot easier to perform this review for a 401(k) or a defined contribution plan. If something doesn't look like it was done correctly, then it might be a good idea to seek out an attorney, or an actuary in the case of a defined benefit plan. Those parties can help review your claims and make sure the benefit calculations were done correctly. It's hard for the employee to tell whether the employer was using the proper interest rate or some of the other required calculations. Certainly a participant can check things like whether they have the age right, whether they have your spouse's age right, or if they have the proper number of years of service. It's surprising how often some of that information is just incorrect. If it turns out the calculation is not correct, then you follow up with the HR Department at the company to get a better understanding of exactly what went into the calculations.

**T:** I would go a step further and recommend that the calculation be checked by an independent party. People apply this approach to buying or selling their home, when they spend a couple hundred dollars for an appraisal. When you get your retirement check for $50,000 to $100,000, or more—which is the sum of all your benefits from working for decades and decades—you should be willing to invest a little something to determine whether the plan administrator used the right interest rate and formula applicable to you. I'm astounded that, with the most important asset you may have at that point in your life, you just believe the guy that wrote the check. Why not check yourself? ❖