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When Offering Participant-Directed Accounts, Electing 404(c) is a No-Brainer for Plan Fiduciaries

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Although § 404(c) is among the most often discussed provisions of ERISA, in my experience it is one of the least understood by both Plan Fiduciaries and Plan Advisors. In participant-directed retirement plans like a 401(k) or a 403(b) plan, too often the 404(c) election is made but then the plan fails to satisfy the 30+ on-going conditions for compliance. A bigger mistake is that many participant-directed plans ignore making the voluntary 404(c) election altogether thereby automatically exposing Plan Fiduciaries to significant and unnecessary risk.

What's the risk you ask? If a participant-directed retirement plan doesn't comply with ERISA § 404(c), then Plan Fiduciaries have transferred the power to direct investments to plan participants, but they remain legally responsible for the prudence of the participants' investment decisions. Incredible as it sounds, this means Plan Fiduciaries can potentially be held personally liable for the investment mistakes of the plan's participants. Is that really the law? Yes.

In Tittle v. Enron Corp., U.S. District Judge Harmon concluded, in language that was both brief and to the point: "If a plan does not qualify as a 404(c) [plan], the fiduciaries retain liability for all investment decisions made, including decisions by the Plan participants."[1] And in its amicus curiae (i.e. "friend of the court") brief filed in that case, the Secretary of Labor formally stated and made clear the DOL's long-standing position on the benefits of complying with § 404(c): "The only circumstances in which ERISA relieves the fiduciary of responsibility for a participant-directed investment is when the plan qualifies as a 404(c) plan."

If qualification under § 404(c) can reduce risk, its election should be a no-brainer with all of the litigation we've seen over the last several years. So what's needed for a plan to be qualified under ERISA § 404(c) and what protection does it actually provide to Plan Fiduciaries?

What Does 404(c) Compliance Actually Do?

It's clear that without a § 404 (c) election, the plan's fiduciaries can potentially be held personally responsible for all investment decisions made by plan participants.

But if the conditions for § 404(c) protection are satisfied, it is only a defense to some, but not all claims of a fiduciary breach that can be made by participants. Specifically, it doesn't protect Plan Fiduciaries against a claim for losses due to a failure to select investments prudently and to monitor and remove inferior investments.

DOL Advisory Opinion 98-04A

So, even when a participant directs his/her investments in a 404(c) plan, if the losses realized by participants are due to the poor performance of an investment option that should have been removed, the fault (and liability) lies with the fiduciaries and not with the participant.

As the DOL stated in Advisory Opinion 98-04A: "… the act of designating investment alternatives in an ERISA section 404(c) plan is a fiduciary function to which the limitation on liability provided by section 404(c) is not applicable."

What Does 404(c) Protect Against?

Simply put, it offers a shield against imprudent investment decisions made by the plan's participants. To understand this distinction further let's explore a situation that is all-to-common today… A 60-year-old participant is playing "catch-up" with their retirement savings and invests his/her account aggressively. When he/she loses a significant amount of money in an eventual bear market… who is responsible?

In a § 404(c) plan, the Plan Fiduciaries cannot be held legally responsible for the imprudence and subsequent losses of these investment decisions. However, if part of the participant's loss was attributable to the imprudent selection or retention of the specific investment option(s) utilized by that participant, then the Plan Fiduciaries would be responsible for that part of the loss, even in a § 404(c) plan.

So, as you can see, § 404(c) offers worthwhile protection, but too many incorrectly believe that it protects Plan Fiduciaries from all investment related claims than can be made by participants.

Obtaining Protection Under ERISA § 404(c)

Plan Fiduciaries must meet strict requirements for investment selection, plan administration, and plan and investment disclosures before they are exempt from any fiduciary liability for the losses participants incur as a result of the direction of their own investments.

Since § 404(c) protections are transaction-based, if you don't comply with all of the requirements in just one tiny way for each transaction made, you lose protection under § 404(c) for that specific transaction as it's an "all-or-nothing" standard applied to each transaction; and "good faith" efforts to comply aren't sufficient under the law.

To be sure, it's not that easy to meet the on-going requirements of § 404(c), but when the Plan Fiduciaries do not even try… they are making the decision to forgo the relief provided by § 404(c) and accept the liability for the imprudent investment decisions made by their participants.[2]

To complicate matters, in my experience, very few plans have an established administrative procedure or process to ensure that they satisfy the 30+ on-going conditions for § 404(c) compliance.

It takes a "village" to properly manage a retirement plan. The company officers, the plan's fiduciaries, the record keeper, the plan investment adviser, the third party administrator, the plan auditor, and the attorney all perform different functions; and in most cases, not one of them has been assigned the responsibility for making sure that all of the § 404(c) requirements are met.

A good practice for Plan Sponsors intending on qualifying under § 404(c) is to make sure that one person on their retirement plan's

administrative team, or an independent 3(16) administrator, is clearly assigned the job of being in charge of 404(c) compliance. You don't want to leave compliance on this important issue to chance.

Fred Reish, a nationally recognized ERISA attorney, has been quoted as saying that while "[t]he vast majority of plans believe that they are 404(c) [compliant] plans but,…,very few of them satisfy all of the 404(c) requirements."[3]

This suggests that investment committee members and other Plan Fiduciaries may be in for a rude awakening if they are hit with a lawsuit including claims for reimbursement of investment losses because of imprudent participant investment decisions.

An election to meet the requirements of § 404(c) is not an airtight defense and you're still going to have to show that you've jumped through all the hoops, but if a participant does sue wouldn't you rather have a shot at the § 404(c) defense to protect yourself and your personal assets?[4]

What Should Plan Fiduciaries Do?

One should consider § 404(c) compliance to be an inexpensive yet essential "fiduciary liability insurance policy" and Plan Fiduciaries should make every effort to obtain its protections.

Being in compliance with § 404(c) offers an extra level of important protection for Plan Fiduciaries that is hard to find in other aspects of a retirement plan's day-to-day management.

By understanding the requirements and putting the administrative practices and procedures in place to fulfill those requirements, § 404(c) compliance can eventually become a matter of routine housekeeping. For most Plan Fiduciaries, the long-term protection this provides easily outweighs the additional effort and costs.

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Footnotes:

1. *In re Enron Corp. Securities, Derivative & ERISA* (S.D. Tex. 2003, 284 F. Supp. 2d 511 at 578).

2. The fiduciary relief provided by § 404(c) is elected by Plan Fiduciaries on a voluntary basis.

3. Are You Sure You're 404(c) Compliant? Navigate the voluntary safe-harbor provisions that protect 401(k) sponsors from fiduciary liability. Diane Cadrain, HR Magazine (September 2004).

4. A defense under ERISA § 404(a) may be available, but this approach offers no guidelines nor any specified statutory relief (and has not been pre-approved by the DOL as is § 404(c) compliance.)