

## Fiduciary Focus: Protection Offered by ERISA Section 404(c)

W. Scott Simon | 6-03-04 |

Chapter XII of Charles Dickens' novel *David Copperfield* opens with these words: "Annual income twenty pounds, annual expenditure nineteen six, result happiness. Annual income twenty pounds, annual expenditure twenty pounds ought and six, result misery."

Dickens reminds us how tiny differences can sometimes result in radically different consequences. It's sort of like being an A+ student and gaining admission to UCLA while being an A student and having to settle for the University of Michigan. (Don't ask, it's a family thing.)

Sponsors of 401(k) plans face the same stark consequences when it comes to securing--or not securing--the protection offered by section 404(c) of the Employee Retirement Income Security Act (ERISA). Plan sponsors that obtain 404(c) protection can virtually eliminate their exposure to a certain kind of liability: *result happiness*. Those that fail to obtain such protection expose themselves to that liability in an open-ended way: *result misery*.

### 401(k) Plan Sponsors Must Provide Participants with Healthy Food

Sponsors of 401(k) plans have a number of duties under ERISA. Whether you follow the fiduciary or even the anti-fiduciary model described in [last month's article](#), you can bring real value to plan sponsors by alerting them to the existence of one of their duties and showing them how to shift the liability for that duty.

The duty to which I am referring is the duty of a 401(k) plan sponsor to ensure that every plan participant makes prudent investment decisions. Many sponsors are surprised to learn that they even have this duty. They think that all they have to do is provide their participants with a properly diversified variety of prudent 401(k) investment options (i.e., a healthy menu of foods to eat).

### 401(k) Plan Sponsors Must Make Participants Eat Their Food

Plan sponsors, however, have the additional duty to ensure that their participants actually invest prudently (i.e., eat their food). If participants invest imprudently (i.e., fail to eat their food or eat it and get sick), plan sponsors may incur liability as a result. Plan sponsors cannot delegate their fiduciary duty to ensure that every plan participant makes prudent investment decisions. The only way sponsors have of shifting the risk that their plan participants may not eat or that they will eat the wrong food and get sick is to secure the protection of ERISA section 404(c).

It may be hard to believe, then, but ERISA requires a plan sponsor to, in a way, "look over the shoulder" of each and every plan participant to ensure that he or she is "eating their spinach" with respect to making prudent investment decisions.

## The Implications of Sponsor Liability without 404(c) Protection

Think of the breadth of this duty owed to plan participants and what ERISA, in effect, says to a 401(k) plan sponsor: "You bear personal responsibility for the investment decisions (such as asset allocations) made by each and every participant in your plan as if they were your own decisions." This means, for example, if a 60-year-old plan participant invests 100% of his or her plan account in an aggressive growth stock fund and the fund goes south--thereby devastating the value of the account--the participant could sue the plan sponsor for, in effect, *not making the plan participant eat its spinach*.

Now, think of the open-ended liability that can ensue for failing to carry out the duty to ensure that each and every plan participant makes prudent investment decisions. One way of thinking about this is to take the total number of investment decisions made by all the participants in a 401(k) plan over the course of their investment lives and multiply that by the number of participants (dozens, hundreds, thousands?) in the plan.

Added to the breadth of the duty and the vast liability for breaching it is the *personal* nature of that liability. [ERISA Interpretive Bulletin 96-1](#) (now codified as a regulation at 29 CFR §2509.96-1) states: "Fiduciaries of an employee benefit plan [e.g., a 401(k) plan] are charged with carrying out their duties prudently and solely in the interest of participants and beneficiaries of the plan, and are subject to personal liability to, among other things, make good any losses to the plan resulting from a breach of their fiduciary duties."

Plan sponsors that understand these realities begin to get an idea of the vast number of potential opportunities available to attorneys that specialize in ERISA litigation. If the number of plan participants is large enough, of course, a plan sponsor needn't worry about a lot of individual lawsuits; ERISA litigation attorneys will oblige the sponsor with a class action lawsuit. *Result misery*.

It's probable that the great majority of 401(k) plan sponsors have no idea they have the duty to ensure that every one of their plan participants makes prudent investment decisions. Even many sponsors that are aware of this duty don't know how to carry it out. And many of those that attempt to carry it out fail to do so correctly.

### Obtaining the Protection of 404(c)

A participant in a "participant-directed" 401(k) plan is not considered to have "effective control" over its plan account. (This terminology is a bit confusing since the words "directed" and "control" mean virtually the same thing outside ERISA law.) A participant is able to "exercise control" over the investments in its 401(k) plan account only when the plan becomes 404(c) compliant.

And *only* when a 401(k) plan complies with section 404(c) is the plan sponsor relieved of liability for any losses that plan participants incur as a direct consequence of their imprudent investment decisions. The Department of Labor could not be clearer about this: "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." ("U.S. Department of Labor Amended Brief of the Secretary of Labor as Amicus Curiae Opposing the Motion to Dismiss" in *Tittle v. Enron Corp.*, Civil Action No. H-013913 (S. D. Tex.).)

Making a 401(k) plan 404(c) compliant seems, at first blush, pretty complicated. After all, the 404(c) regulations issued by the Department of Labor describe 20-plus requirements. While the requirements are somewhat extensive, they are really not that difficult to implement. The law firm of Reish Luftman Reicher & Cohen [lists these requirements](#). In addition, a helpful 404(c) [compliance checklist](#) is offered by the

law firm of Snell & Wilmer.

A 401(k) plan must meet *every* requirement under the 404(c) regulations in order for it to be 404(c) compliant. For example, even a very simple requirement that calls for the plan sponsor to merely inform plan participants that the 401(k) plan is a 404(c) plan must be met. If it isn't, the sponsor cannot use ERISA section 404(c) as a defense against participant lawsuits even if all the other requirements are met. The burden of proof is on the plan sponsor to show that it has complied fully with section 404(c) in order to obtain its protection.

In contrast to situations where a plan sponsor delegates its investment and management functions to an agent to avoid liability for *its own* investment mistakes, successful compliance with ERISA section 404(c) allows the sponsor to avoid liability for the investment mistakes made by *plan participants*. In both situations, though, the sponsor *always* retains the ultimate oversight responsibility for prudently selecting and monitoring the plan's investment options and--if delegation occurs--its investment agents.

Informing 401(k) plan sponsors of their duty to ensure that plan participants make prudent investment decisions and their ability to transfer the liability for that duty by complying with ERISA section 404(c) allows you to bring real value to them. When sponsors of 401(k) plans take this good advice to heart and then actually implement the 404(c) requirements: *result happiness*.

Sponsors of 401(k) plans that become 404(c) compliant can also help plan participants enhance their investment experience. After all, the primary reason for having 401(k) plans is to help participants retire comfortably so that they don't end up in a food line in their old age echoing the words of Oliver Twist, the title character of another Dickens novel: "Please, sir, may I have some more?"

---

W. Scott Simon is an expert on the Uniform Prudent Investor Act and the Restatement 3rd of Trusts (Prudent Investor Rule). He is the author of two books, one of which, *The Prudent Investor Act: A Guide to Understanding* is the definitive work on modern prudent fiduciary investing.

Simon provides services as a consultant and expert witness on fiduciary issues in litigation and arbitrations. He is a member of the State Bar of California, a Certified Financial Planner® and an Accredited Investment Fiduciary Auditor™. Simon's certification as an AIFA™ qualifies him to conduct independent fiduciary reviews for those concerned about their responsibilities investing the assets of endowments and foundations, ERISA retirement plans, private family trusts, public employee retirement plans as well as high net worth individuals.

For more information about Simon, please visit [www.prudentinvestoract.com](http://www.prudentinvestoract.com) and [www.prudentinvestoradvisors.com](http://www.prudentinvestoradvisors.com) or you can e-mail him at [wssimon@mindspring.com](mailto:wssimon@mindspring.com).

---

© Copyright 2003 Morningstar, Inc. All rights reserved. Please read our Privacy Policy.  
If you have questions or comments please contact Morningstar.

Morningstar.com | Australia | Canada | Europe | Finland | Hong Kong | Japan | Korea | Netherlands | New Zealand | Norway | Sweden