



# Plan Complexities: Landmines (IRS, DOL and Litigation) and Opportunities

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# Qualified Retirement Plans

Well-designed and well-managed retirement plans can produce valuable results for employees, owners and executives, and companies.

However, those plans are highly “regulated” by the IRS, DOL and plaintiffs’ attorneys.

The Hartford Financial Services, Inc.                      International Paper Co.

Lockheed Martin Corp.                      Polaroid                      ABB, Inc.                      Merrill Lynch

Bechtel Corp.                      United Technologies Corp.                      The Boeing Co.                      Edison International

Countrywide                      A.G. Edwards, Inc.                      Principal                      Enron

US Airways                      Citigroup                      Aon                      Exelon Corp.

John Hancock Life Insurance Co.                      Northrop Grumman Corp.                      Delphi

Deere & Co.                      American Skandia Life Assurance Corp.                      Paychex Inc.

Nationwide Financial Services, Inc.                      Caterpillar, Inc.                      Sempra

General Dynamics Corp.                      CMS Energy                      Fidelity Management Trust Co.

General Motors                      Unisys Corp.                      Kraft Foods Global, Inc.

ING Life Insurance and Annuity Co.                      Xerox                      Cigna Corp.                      EDS

# IRS Audits

The IRS has initiated several LESE enforcement projects (Learn, Educate, Self-Correct and Enforce) and has completed and reported on two of those projects.

In LESE Project #1, the common issues discovered by the IRS in defined contribution plans were:

- Failure to secure adequate bonding per ERISA.
- Failure to timely amend to comply with current law and regulatory guidance.

# IRS Audits

- Failure to allocate contributions and forfeitures per plan terms.
- Failure to make top heavy minimum contributions.
- Failure to obtain joint and survivor annuity waivers.

# IRS Audits

LESE Project #4 found the following additional failures in 401(k) plans:

- Failure to deposit elective deferrals timely into the plan.
- Failure to properly recognize and distribute excess contributions timely.
- Failure to properly cover all eligible employees per IRC §410.



# IRS Checklist for Reviewing Plans

The IRS has established a 401(k) plan checklist for reviewing the operation of retirement plans. Some of the questions are:

- Has your plan document been updated with the past few years?
- Are the plan's operations based on the terms of the plan document?

*continued . . .*



# IRS Checklist for Reviewing Plans

- Is the plan's definition of compensation used correctly?
- Were all eligible employees identified and given the opportunity to make an elective deferral election?
- Have you timely deposited employee elective deferrals?
- Do participant loans conform to the requirements of the plan document and IRC §72(p)?
- Were hardship distributions made properly?



# Investment Losses





# The Prudent Man Rule

ERISA's prudent man rule requires that fiduciaries act . . .

“. . . with the care, skill, diligence and prudence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like arms.”

# A Prudent Process

The prudent man rule has been interpreted to require a “prudent process:”

- A prudent process requires that fiduciaries consider the “relevant” information.
- A prudent process produces an “informed and reasoned” decision.



# ERISA Investment Theories

But what does that mean?

ERISA's investment provisions are based on:

- Generally accepted investment theories, like modern portfolio theory; and
- Prevailing investment industry practices.



# Relevant Factors

- Quantitative analysis.
- Qualitative analysis.
- Evaluation of conflicts of interests.
- Evaluation of costs.
- Evaluation of compensation.



# Risk Management Through Prudent Process

While ERISA fiduciaries are held to the standard of a prudent person, or a hypothetical knowledgeable investor, the courts explain that the law “does not impose a rule that fiduciaries be ‘experts’ on all types of investments they make.”

# Claims in Class Action Litigation

In one of the current class action lawsuits, the complaint asserted, among other things:

Defendants breached their fiduciary obligations to the Plan . . . by:

- Failing to monitor the fees and expenses paid by the Plan and, by such failure, causing and/or allowing the Plan to pay fees and expenses that were . . . unreasonable . . . ;

*continued . . .*



# Claims in Class Action Litigation

- Failing to inform themselves of, and understand, the various methods by which vendors in the 401(k) industry collect payments and other revenues from 401(k) plans; . . .





## ***Wal-Mart:*** **Reasonableness of Expenses**

In the appellate decision in *Braden v. Wal-Mart Stores*, the 8<sup>th</sup> Circuit Court of Appeals explained:

“The complaint alleges that the Plan comprises a very large pool of assets, that the 401(k) marketplace is highly competitive, and that retirement plans of such size consequently have the ability to obtain institutional class shares of mutual funds.” [588 F.3d 585 (2009)]

*continued . . .*



## ***Edison:*** **Reasonableness of Expenses**

In a recent trial court decision—for the only class action fee case that has gone to trial, a federal district court found in favor of the participants:

“At that time [July 2002], both retail share classes and institutional share classes were available for all three funds. The only difference between the retail share classes and the institutional share classes was that the retail share classes charged higher fees to the Plan participants. Otherwise, the investments were identical.” [*Tibble v. Edison International*, 2010 WL 2757153 (C.D. Cal.), decided July 8, 2010.]

*continued . . .*



## Reasonableness of Expenses

“. . . a prudent fiduciary commonly would review all available share classes and the relative costs for each when selecting a mutual fund for a 401(k) Plan. Here, however, there is **no evidence** that Defendants even considered or evaluated the different share classes . . .”



# Disclosures: DOL Activity

## DOL activity:

- Point-of-sale disclosure to fiduciaries by advisers and providers (408(b)(2) regulation).
- Disclosure to participants under the 404a-5 regulation.

## 408(b)(2) Disclosures

- The regulation requires that covered service providers give plan fiduciaries the following information in writing:
  - the services provided.
  - the compensation—direct or indirect—to be received for those services.
  - the “status” of the service provider.



# Disclosures: Fiduciary Issues

## The fiduciary concerns:

- Is the compensation reasonable?
- Are the costs reasonable?
- Are there conflicts of interest?



B. S m a l l e r

*"If we take a late retirement and an early death, we'll just squeak by."*

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## The Future

The success of 401(k) plans will be evaluated by the results they produce . . . the measuring stick will be “benefit adequacy”--the ability of participants to retire.





"THE GOOD NEWS IS YOU CAN RETIRE AT 65. THE BAD NEWS IS THAT IT'S 2065."



# Benefit Adequacy and Lifetime Income

## Outcomes and Issues:

- DOL project on income projections
- Gap analysis.
- Emerging issue: Need for “solution.”



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