How to design a 401(k) plan that's lawsuit-proof

High fees are a red flag, but prudence is the ultimate key to defeating a claim, according to advisers and attorneys

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Lawsuits targeting 401(k) plans have become commonplace over the past decade. It's no longer much of a surprise to hear that another plan sponsor has been sued over some aspect of its plan design, and speculation is that such legal action will continue for years.

While 401(k) advisers and legal experts say it may be impossible for employer clients to completely prevent litigation, there are steps retirement plan advisers can take to help reduce the threat of litigation and defeat claims that are brought.

"I don't think you can lawsuit-proof a plan, but you can make it very hard for a lawsuit to prevail," said Andrew Oringer, co-chair of the employee benefits and executive compensation group at Dechert, a law firm.

The vast majority of 401(k) lawsuits focus on an employer's breach of fiduciary duty under federal retirement law, the Employee Retirement Income Security Act of 1974. Fees for plan investments as well as record keeping and administration have been a focal point.

Often, plaintiffs allege fiduciary breach due to retention of an investment fund in a higher-cost, retail share class as opposed to a lower-cost, institutional share class, or because unmonitored use of revenue-sharing payments to a plan record keeper led administrative costs to become excessive. Retention of underperforming funds is also a typical claim.

Employers and advisers have become more fee-sensitive as a result. About 83% of employers assessed their defined-contribution-plan fees in 2017, according to Callan, a consulting firm. More than 40% of those employers reduced their overall fees as a result, up around 10 percentage points over the prior year.

But advisers and attorneys are quick to point out that high fees aren't necessarily bad; they become legally problematic if an employer isn't able to demonstrate it engaged in a prudent decision-making process to show why a particular fund or share class was justified.

"I think it's a fairly reasonable bet that if you have high fees on your funds, you're probably in trouble, in the sense that you probably don't have a prudent process," said Philip Chao, principal and chief investment officer at Chao & Co.

"Nobody said the fund that cost 30 basis points is imprudent. But people can say you have no process to determine if a 30 basis-point fee is prudent or not, because you don't have a methodology," Mr. Chao added.

In other words, prudence — and the documentation of it — is the key ingredient for advisers and their clients. Prudence involves making informed and reasoned decisions based on data, Mr. Chao said.

ERISA isn't about "20/20 hindsight," said Jeffrey Lieberman, executive compensation and benefits counsel at the law firm Skadden, Arps, Slate, Meagher & Flom. "It's not that you were absolutely right. You've shown there's careful consideration."

So, have a client think about fees and the cost that would be considered reasonable for a particular fund or service. Advisers can do a request for information or a request for proposal to get pricing data from vendors, or complete a fee-benchmarking exercise on a regular basis as part of a prudent process, Mr. Chao said. Demographics of the plan — age distribution and average income, for example — should also guide specific decisions about the investment menu, he added.

Consistently operating the plan in accordance with the 401(k) plan document is an important fiduciary duty, advisers said.

"The place where these claims win is when it can be shown the fiduciary was unaware of the issue or otherwise didn't look at it or understand it," Mr. Oringer said. "The adviser should be in there explaining to the committee, what are the areas about which they should be concerned."

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