The Thing You Have To Fear As A 401(k) Plan Sponsor

By Ary Rosenbaum, Esq.

In his inauguration speech, Franklin Delano Roosevelt said that "the only thing we have to fear is fear itself." 401(k) plan sponsors have more to fear than fear itself except the problem is that they're unaware that they have anything to fear. If you think you have nothing to fear and do something wrong as a plan sponsor, you may land in trouble. This article is about what 401(k) plan sponsors have to fear and it's certainly more than fear itself.

The times have changed

I have been an ERISA attorney for almost 27 years and so many times over those first few years, I was told that rarely do 401(k) plan sponsors land into trouble because most plan sponsors are too small to register any big problems. That's assuming that the only thing that plan sponsors have to fear is a big class action lawsuit. The nature of class action litigation is that law firms front the expenses of this litigation, with the hope of a favorable settlement. Honestly, they have bigger fish to fry than a $5 million 401(k) plan. The fact is that a class action lawsuit is only one thing to fear, there are more things to fear that could happen if you have a small to medium-sized 401(k) plan.

Fearing Current Employees

The idea behind setting up a 401(k) plan initially was to provide a benefit for employees and like I always say, the road to hell is paved with good intentions. A 401(k) plan can be an excellent benefit for current and potential employees as a recruiting and/or retention tool. Whether it can be an excellent benefit is whether the plan sponsor can prudently administer the plan, A 401(k) plan that is rife with administrative errors, poor-performing investment options, and/or high fees is going to get current employees upset. While most people would claim that most employees wouldn't even notice, there only needs to be one employee who understands and gets disgusted. It only takes one employee to fight back for a poorly run 401(k) plan. While people again will claim that their company is so small and average account balances for plan participants are minuscule, current employees don't have to sue to get even. They just would have to call the Department of Labor (DOL) to complain. I was an aggrieved employee once too and I can tell you stories on what aggrieved employees can accomplish and it's not a pretty sight for employers.

Fearing Former Employees

While plan sponsors may scoff at current employees for complaining because of fears over their employment status, former employees no longer have that attachment. Former employees are usually angry when their termination is involuntary on their part and some former employees try to get a measure of revenge many unlike me, don't limit that revenge to articles, blog posts, and a couple of books (still available on Amazon.com). Some employees want that measure of revenge even if they are fired for a good reason because many people can't see the errors of their ways and a poorly run 401(k) plan is an easy way for a former participant to get their pound of flesh. Many years ago, I worked with a plan administrator who was confrontational with his bosses and ended up getting terminated because he lied about the hours and days he worked. Rather than accept his mistake, he sued my employer for religious discrimination. There have been numerous lawsuits against that employer and many had merit, this one did not. This administrator ended up getting a quick $4,000 settlement that I do not believe he was entitled to. So rather than worry about some lawsuit by a former employee, a plan sponsor should be more concerned about that former employee just threatening- ing litigation to get a quick four or five-figure settlement and a poorly run 401(k) plan is just one thing that a former employee and their counsel can easily cite as a good way to threaten to sue. From experience, I always know that you should never let anyone have the power to put you down for the count, so a poorly run 401(k) plan is just a billboard for a former employee to use against the plan sponsor even if that former employee was the second coming of Homer Simpson in terms of competent employees. A plan sponsor should never let a 401(k) plan become a loose end that a former employee could use as leverage to extract money from the employer. Taking care of the plan by hiring good plan providers and having the plan reviewed regularly will go a long way in avoiding former employees coming to the door and asking for money.

Fear from the IRS

Plan sponsors don't understand that qualified 401(k) plans are a bargain that is made with the government. Plan participants don't recognize 401(k) plan income until distribution and plan sponsors get a tax deduction as long as the plan sponsors abide by the rules outlined in the Internal Revenue Code. So if a plan sponsor doesn't follow the rules of the Code, they run the risk of losing that pretty good bargain. The job of the Internal Revenue Service (IRS) is to ensure that taxpayers follow the rules by voluntarily complying. Since men and women are not angels, the IRS set processes in place to check whether taxpayers comply. One method is the use of an audit. So since 401(k) plans that comply with ERISA have to file a Form 5500 annual tax return, the IRS will audit plans to make sure they comply. Audits can be random or they can be based on information received by the IRS (again revenge-minded form employees?) or because of errors on Form 5500. Whatever the reason, the IRS will use that audit to make sure the plan sponsor is administering the plan according to the Internal Revenue. Plan sponsors may have errors in their plan document or the administration in the Plan. The problem with getting caught in an audit with mistakes is that the IRS agents are less forgiving than if the plan sponsors used a voluntary compliance program to correct their glaring plan errors. Plan sponsors who know they have such problems as a plan document that has not been updated in 7 years or plan loan or testing failures should use the IRS voluntary compliance programs to clear up major issues at nominal fees rather than being at the mercy of an IRS agent who is conducting a plan audit. Penalties from audits can be huge (they are not tax deductible) and there is always a threat of plan disqualification which would have plan participants immediately recognize 401(k) plan income and the disallowance of prior contribution deductions made by the plan sponsor.

Fear from the DOL

While the IRS is concerned about the tax qualification of a 401(k) plan, the Department of Labor (DOL) is concerned about plan participant rights since the DOL enforces ERISA (which is the Employee Retirement Income Security Act) that employer-sponsored qualified plans must comply with. DOL audits can be random and based on a plan participant or former participant complaint. The DOL is there to ensure that plan participants are treated fairly and that the plan sponsor is exercising their duties as a plan fiduciary in a prudent manner. I have been indirectly involved with DOL audits where plan sponsors have gone to jail for embezzlement and I have been directly involved in an audit where a plan sponsor was sued for millions of dollars. The DOL are serious about their duties and have been more diligent in their duties in the last 15 years. They certainly started with fee disclosure regulations being implemented in 2012. Getting a call from a DOL agent is not something to look forward to. It might be nothing or something, but it's something to fear. Quite honestly, the only things I fear are heights, drowning, and a DOL audit.

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