401(k) Investment Issues

The Duty to Remove Investments

It is commonly accepted that fiduciaries of participant-directed plans, such as 401(k) plans, have a duty to select, monitor, and remove investments prudently; however, there has been little analysis of that duty by either the courts or the Department of Labor (DOL). This article explores the legal responsibility to remove investments when they are no longer prudent and suitable for a participant-directed plan. In examining that duty, we first review the scope of the duty. We then briefly review the duties of fiduciaries generally, and close with an analysis of the investment issues.

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The threshold question is whether a fiduciary's duty to remove investments applies to individual investments or whether the decisions are judged only on the basis of the investments in the aggregate. At least one court, in *DeFelice v. US Airways, Inc.*, [436 F. Supp. 2d 756, (E.D. Va. 2006)] applied an aggregate test. The case involved the US Airways 401(k) Savings Plan. The plan offered company stock as an investment option in its plan. The participants complained that the plan committee breached its duty to act prudently because it retained the airline's stock as an investment option notwithstanding the company's severe financial difficulties. The court found that the committee members had not breached their fiduciary duty when they failed to remove the company stock.

Interestingly, there are facts surrounding US Airways' dealings with plan investments that the court did not consider, or at least failed to mention in the decision. For example, the investment committee did monitor the plan's other investments (which were mutual funds), used independent investment consultants for that purpose, and, in that process, made determinations about whether to replace or continue to hold the other investments. The investment committee also oversaw the investments for the company's defined benefit pension plan and used investment managers for that purpose. The job of those investment managers was to make buy, sell, and hold decisions about individual stocks and bonds, which is logically inconsistent with the committee's argument in the lawsuit (as well as the judge's decision) that investments are to be evaluated only in the aggregate.

Despite the fact that the company stock was a risky investment and that US Airways faced, and ultimately declared, bankruptcy during the period, the court reasoned that highly risky investments can contribute to the diversity of a plan's investment portfolio. In holding against the participants' claims, the court said:

> But plaintiff's theory of liability fails for the more fundamental reason that plaintiff views the prudence of an investment in the Company Stock Fund as an isolated investment instead of as a part of a portfolio of investments. . . . ERISA requires that the prudence of selecting a particular investment be viewed in light of its contribution to the risk and return of the entire portfolio, and not in light of its individual risk.

Based on this court's reasoning, other than in extreme cases, there is no need to remove an investment option regardless of its individual merits, as long as there is an adequate number of investment options to satisfy modern portfolio theory and to balance the risk and return characteristics of the portfolio. Put another way, if prudence is to be judged solely on the basis of the investment options in the aggregate, there is no need for a fiduciary to consider the prudence

of an individual investment. Taken to its logical conclusion, the court's ruling means that having a large variety of investment choices satisfies ERISA's prudence standard, without regard to whether some—or even all—of the investments are considered inferior by most measurement standards.

The court was wrong. The obligation of fiduciaries under ERISA is to prudently select, monitor, and remove individual investments, as well as to consider the performance of the portfolio as a whole. It is not an "either-or" scenario; both requirements must be satisfied.

Fiduciary Duties Generally

The fiduciary obligations imposed by Sections 404(a)(1)(A) and 404(a)(1)(B) of ERISA are "three different but overlapping standards." [*Donovan v. Bierwirth,* 680 F.2d 263, 271 (2d Cir. 1982)] These standards are (1) *the duty of loyalty to the plan participants,* (2) *the exclusive purpose requirement,* and (3) *the prudent man rule.* To summarize each of these:

1. *Duty of Loyalty*: The duty of loyalty provides that a fiduciary must act "solely in the interest" of the plan and its participants and beneficiaries. Thus, a fiduciary must act with an "eye single" to the interests of the participants and must not put the interests of a third party (for example, the interests of the plan sponsor) before those of the participants. As explained by the DOL in Interpretive Bulletin 94-1:

> The Department has construed the requirements that a fiduciary act solely in the interest of, and for the exclusive purpose of providing benefits to, participants and beneficiaries as prohibiting a fiduciary from subordinating the interests of participants and beneficiaries in their retirement income to unrelated objectives.

2. *Exclusive Purpose Requirement:* The exclusive purpose rule requires that fiduciaries act for the "exclusive purpose" of providing benefits for participants; thus, in a 401(k) plan, the focus is on fiduciary conduct designed to produce retirement income. In evaluating investments, ERISA requires that fiduciaries select, monitor, remove, and replace investments with the sole objective (*i.e.,* for the exclusive purpose) of providing retirement benefits.

   To meet this objective, fiduciaries must evaluate the potential for both (a) the return on investment, and (b) the preservation of capital; thus, fiduciaries must determine that an investment is competitive as compared to alternative investments with similar risks and costs that are available to the plan. As stated by the DOL in Advisory Opinion 88-16A:

> Because the investments you propose to recommend for the Plan would, if implemented, cause the Plan to forgo other investment opportunities, such investments would not be prudent if they provided a plan with less return, in comparison to risk, than comparable investments available to the plan, or if they involved a greater risk to the security of plan assets other than investments offering a similar return.

In other guidance, the DOL explained:

> Other facts and circumstances relevant to an investment or investment course of action would, in the view of the Department, include consideration of the expected return on alternative investments with similar risks available to the plan. [DOL Interpretive Bulletin 94-1]

As a result, fiduciaries cannot retain an investment in an ERISA plan unless it is at least comparable in terms of both return and risk to alternative choices.

3. *The Prudent Man Rule*: *The standard for measuring the fiduciaries' performance in implementing the exclusive purpose requirement is found in ERISA Section 404(a)(1)(B), the prudent man or prudent person rule. As one court noted, ERISA's prudence standard "is not that of a prudent layperson, but rather that of a prudent fiduciary with experience dealing with a similar enterprise." {*Marshall v. Snyder, *572 F.2d 894 (2d Cir. 1978)}*

> In evaluating the prudence of a fiduciary decision, courts look to the process in which the fiduciary has engaged, as well as the results of that process. In the context of investments, for a fiduciary to engage in a prudent process, he must perform an independent investigation of the merits of an investment. [*In re Unisys Savings Plan Litig.,* 74 F.3d 420, 435 (3d Cir. 1996)] This requires that fiduciaries understand and apply generally accepted investment theories and evaluate the investments using prevailing practices in the investment industry. [*National Pension Fund v. Northern Trust Quantitative Advisers, Inc.*, 173 F.3d 313 (5th Cir. 1999)]

As a part of a prudent process for investment selection and monitoring, a fiduciary must give:

> appropriate consideration to those facts and circumstances that . . . the fiduciary *knows or should know* are relevant to the particular investment or investment course of action involved, including the role the investment or investment course of action plays in that portion of the plan's investment portfolio with respect to which the fiduciary has investment duties; and (B) has acted accordingly. (Emphasis added.) [DOL Reg. § 2550.404a-1]

This regulation contains a number of important elements:

- The fiduciary must know what information is relevant to the decision, *i.e.*, the information that needs to be evaluated to make a prudent and informed decision.
- By implication, the fiduciary must accumulate the information relevant to making the specific decision.
- The fiduciary must evaluate and make appropriate judgments about the "relevant" information.

Applying those principles to the monitoring of investment options for participant-directed plans, the DOL made it abundantly clear in the preamble to the final regulations to ERISA Section 404(a) that the prudent selection of an investment incorporates both a consideration of the individual performance of each investment and the performance of the portfolio in the aggregate.

> The regulation, however, is not intended to suggest either that any relevant or material attributes of a contemplated investment may properly be ignored or disregarded, or that a particular plan investment should be deemed to be prudent solely by reason of the propriety of the aggregate risk/return characteristics of the plan's portfolio. Rather, it is the Department's view that an investment reasonably designed—as part of the portfolio—to further the purposes of the plan, and that is made upon appropriate consideration of the surrounding facts and circumstances, should not be deemed to be imprudent merely because the investment, standing alone, would have, for example, a relatively high degree of risk. The Department also believes that appropriate consideration of an investment to further the purposes of the plan must include consideration of the characteristics of the investment itself. (Emphasis added.) [Preamble to ERISA § 404(a) Regulation, 44 Fed. Reg. 37,225 (June 26, 1979)]

Investment Duties

The specific criteria that a fiduciary should employ to evaluate any investment is in the province of investment experts. From a legal perspective, the fiduciaries must:

- Make their decision with a focus on providing retirement benefits (*i.e.*, the exclusive purpose rule);
- Determine, gather, and examine the relevant facts and circumstances;
- Employ generally accepted investment theories and prevailing investment industry practices; and
- Make independent and informed decisions.

The decision may be to affirm an investment, to remove it, to place it on a "watch list," or to gather additional information before making a decision. In taking these steps, the fiduciaries' performance will be measured by the high standard of the hypothetical careful, skillful, prudent, and diligent person contemplated by the prudent man rule.

To appreciate fully the importance of the DOL guidance in this area, consider the unique characteristics of participant-directed plans. Although participants can decide which offered investment to use, they cannot decide which investments are offered—that job belongs to the fiduciaries. In fulfilling that responsibility, ERISA requires, in effect, that the fiduciaries make a legal "promise" to the participants that each of the investment options is prudently selected and monitored (and removed, if it is no longer a prudent choice) and that the lineup of options offered to the participants is prudent in the aggregate—all for the exclusive purpose of providing retirement benefits.

Why is this the case? Unless a participant's account is professionally managed, the participant must assemble a portfolio that is allocated among different asset classes to create a suitable blend of risk and return. If the investment choices are not prudent in the aggregate (*e.g.,* if the investments do not constitute a broad range that allows participants to balance risk and reward by allocating among them), the participants could not construct portfolios according to their needs. On the other hand, if some or even all of the investments were individually imprudent, then even a well-constructed portfolio would likely underperform. As a result, each investment must be prudent and suitable

on a standalone basis, and the lineup of investments must be prudent in the aggregate.

As DOL guidance indicates, and as supported by prevailing investment industry practices, the offering of a large number of alternative investment choices cannot convert an imprudent or inferior option into a prudent or superior one. If the sole obligation of the fiduciaries was to review the investments in the aggregate, no investment (no matter how bad) would ever need to be removed from a plan that holds a number of other investments. That logic–or illogic–flies in the face of acknowledged high standards imposed on fiduciaries: the duty of loyalty to the participants, the duty to act for the exclusive purpose of providing retirement benefits, and the duty to act prudently.

Turning now to the duty to monitor, remove, and replace imprudent investments, the fiduciaries have an ongoing duty to periodically review the investments offered by an ERISA retirement plan and to decide whether their initial decisions remain valid in light of changed circumstances. In describing the obligations of fiduciaries, the courts have said that, "Once an investment has been made, a fiduciary has an ongoing duty to monitor investments with reasonable diligence and remove plan assets from an investment that is improper." [*Harley v. Minnesota Mining and Manufacturing Co.*, 42 F. Supp. 2d 898, 906 (D. Minn. 1999)] Another court noted, "The flaw in the trustees' argument is that it ignores the continuing nature of a trustee's duty under ERISA to review plan investments and eliminate imprudent ones." [*Martin v. Consultants & Administrators, Inc.,* 966 F.2d 1078, 1087–1088 (7th Cir. 1992)]

The DOL guidance echoes the concept that included in the duty to monitor is the duty to remove specific investments when, under a prudence standard, they should no longer continue to be available as investment options for participants. As noted earlier, the DOL said in the Preamble to the Section 404(a) Regulation:

> The regulation, however, is not intended to suggest either that any relevant or material attributes of a contemplated investment may properly be ignored or disregarded, *or that a particular plan investment should be deemed to be prudent solely by reason of the propriety of the aggregate risk/return characteristics of the plan's portfolio.* (Emphasis added.) [Preamble to ERISA § 404(a) Regulation, 44 *Fed. Reg.* 37, 225 (June 26, 1979)]

For the purpose of monitoring, fiduciaries must consider whether the investments in a plan are suitable and prudent for the express purpose of accumulating retirement benefits. Ultimately, the role of a fiduciary of a retirement plan in monitoring investments is different from that of a market-timer or market speculator who seeks to make short-term gains (but is willing to run the risk of severe losses on a particular investment). Instead, fiduciaries—who select investments for others—must protect the capital from permanent loss, while providing reasonable opportunities for long-term retirement gains.

Conclusion

Fiduciaries are obligated under ERISA to monitor prudently all of the investment choices and to evaluate their suitability and prudence for the exclusive purpose of providing retirement benefits. In effect, the law provides the equivalent of a promise to participants that each investment option has been prudently selected and monitored.

Given the fact that fiduciaries have the obligation to consider the suitability and prudence of individual investments, as well as the portfolio as a whole, and have the further obligation to review periodically their decisions to ensure that their choices continue to be prudent, it is also clear that fiduciaries have an obligation to change decisions that are no longer valid. In other words, the fiduciary obligation to monitor carries with it the obligation to remove investments that are not reasonably expected to perform adequately in the future and replace them with others that, after appropriate investigation and analysis, the fiduciary believes will perform adequately. ■