

Are Your Retirement Plans (And Your Officers, Directors And Plan Trustees) At Risk?

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The Enron scandal and its aftermath have resulted in a host of regulatory and administrative changes having a substantial impact on 401(k)s, ESOPs and other types of retirement plans. Plan sponsors, their boards of directors, management and plan trustees have been targeted by the Internal Revenue Service (IRS), the Department of Labor (DOL), and plaintiff class action lawyers like never before. The IRS has established special audit programs; the DOL is focusing attention on the actions of plan fiduciaries; Congress has enacted the Sarbanes-Oxley Act which severely increases penalties associated with fiduciary breaches; and the courts are refusing to dismiss class action lawsuits filed against fiduciaries of retirement plans.

Increased Risks Of IRS And DOL Audits

There have been relatively few IRS and DOL audits of retirement plans in recent years. As a result, abusive tax shelter schemes and promotions involving S corporation ESOPs, life insurance policies owned by retirement plans, and accelerated deductions for 401(k) plans have proliferated. The IRS has recently taken notice. It has provided a list of abusive transactions on its Web site and put the public on notice that it will be vigorously targeting promoters involved in "listed" transactions. The IRS has also initiated an aggressive audit program focusing on issues involving corporate 401(k) plans and the plans of unions and tax exempt entities.

The IRS has allocated significant resources to its Employee Plan Team Audit (EPTA) program, which will put large companies at a higher risk of audit. The EPTA focuses on large, single employer qualified defined benefit and defined contribution plans having at least 2,500 participants. The EPTA is a very intensive review of a retirement plan in form and in operation to determine whether the plan's language meets all legal requirements and whether the plan operates in accordance with its provisions and all relevant regulations.

As part of its audit program, the IRS has implemented a pilot program of "focus audits," audits limited to only four issues. If the agent begins a focus audit and finds that the plan is non-compliant in the identified area, the audit may be expanded. Focus audits will involve "internal control interviews" and the IRS has prepared "internal control checklists" for agents to use in the audit.

The Employee Benefits Security Administration (EBSA), a branch of the DOL, has primary responsibility for administering and enforcing Title I of ERISA, which pertains to issues involving fiduciary responsibility (including prohibited transactions) and reporting and disclosure. The EBSA has historically been faced with a shortage of fund-



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ing for its audit programs and has had to carefully allocate its resources. As a result, its audits have been few and very selective. Many times, in order to more effectively utilize its resources, rather than bring an action against a plan sponsor or fiduciary, it would file an amicus curiae brief in a lawsuit brought by class action attorneys. The criminal penalties imposed on persons who willfully violate the fiduciary responsibility provisions of ERISA have been substantially increased. The maximum penalty for individual violators is now 10 years of imprisonment and \$100,000 in fines. The maximum fine for corporate violators is now \$500,000. The EBSA has recently announced major audit programs focusing on ESOPs and service provider arrangements.

Increased Risks Of Litigation

As a result of recent accounting and financial scandals, plan fiduciaries are increasingly under scrutiny from both the DOL and plan participants. Plan fiduciaries are generally those persons who can or do exercise authority or control over the management of a plan and its assets, such as plan sponsors, plan administrators and trustees. Plan fiduciaries are generally required to (1) discharge their duties solely in the interest of plan participants and beneficiaries, (2) administer the plan in accordance with the plan document and governing instruments, (3) act as a prudent person would under similar circumstances, and (4) diversify investments to minimize risks of large losses.

Courts often have restricted fiduciary liability to only those who actually had decision-making authority over the plan or caused decisions to be made. Both the DOL and plaintiff's class action attorneys have been aggressively seeking to expand "fiduciary" to include executives and members of the boards of directors who are not directly responsible for administering the plans or investing the assets, but who appoint the fiduciaries who carry out these responsibilities. The DOL, in an amicus curiae brief filed in the case of *Tittle v. Enron Corp.* (D. Tex., Civil Action No. H-01-3913), argued that the officers and directors of Enron were fiduciaries, even though they were not directly involved in the operations of the plan, because they had duties to (1) make sure their appointees perform their fidu-

ciary duties, (2) take corrective action if they are not performing those duties properly, and (3) provide accurate information regarding the plan sponsor. No decision has yet been issued in the Enron case, but it gives a clear indication of the DOL's position.

In addition to the risks of the plan sponsor and other fiduciaries being sued by the EBSA, there is a small, but growing, number of plaintiff's lawyers whose clients are the employees of failed companies, such as Enron Corp., WorldCom, Inc., and Tyco International, Inc., who lost substantial retirement benefits as a result of financial and accounting scandals. These attorneys have filed class-action lawsuits alleging fiduciary breaches and ERISA violations such as providing materially misleading information to participants and third parties, conflicts of interest, and failure to monitor plan investments. The cases raise issues as to who the fiduciary is, what information must be disclosed to plan participants and the fiduciary's duty to diversify investments. The law in this area is unsettled and evolving. The courts ultimately will define who has fiduciary duties and what those duties are.

The reporting and disclosure requirements of the Sarbanes-Oxley Act, which was signed into law on July 30, 2002, also may promote increased litigation against corporate officers, directors and fiduciaries. For example, when an auditor prepares a certified financial statement of a pension, 401(k) or other qualified retirement plan, the auditor usually requires the plan sponsors to represent that the plan is operated pursuant to its terms and applicable law. Absent proper internal control procedures to enable the plan sponsor to properly monitor the administration of the plan, this representation may be inaccurate.

Assessing The Risks

It is important to get a handle on potential retirement plan compliance violations quickly and to act proactively to limit exposures and risks. The plan sponsor should undertake a careful and thorough review of its retirement plans. The review should be a "self-audit" of plan documents, operations, procedures and transactions. The audit should include the review of existing internal controls to identify and correct ERISA and IRS violations and the development of practices and procedures to prevent discovered violations from reoccurring. Careful attention should be paid to identifying and correcting potential fiduciary issues, including making sure that all fiduciary decisions are properly documented. It should be noted that when applying the fiduciary prudent man standard, courts have stated good faith is not sufficient - "a pure heart and an empty head is not enough."

Prior to conducting the self-audit, careful consideration should be given to protecting the attorney-client privilege. This can be accomplished by having the audit done by either in-house or outside counsel. Protection of the attorney-client privilege is especially important if breaches of fiduciary duty are discovered in the course of the self-audit. Absent the

attorney-client privilege, the results of the self-audit may be discoverable by the IRS, EBSA or attorneys for plan participants.

If violations are discovered, consideration should be given to utilizing the programs established by the IRS and EBSA which encourage plan sponsors to discover and correct violations. Violations which are self-corrected generally can be done with little or no fees being assessed against the plan sponsor. If serious violations are discovered on audit by the IRS or EBSA, the violations can cause disqualification of the plan. Generally, however, the IRS or EBSA will enter into an agreement with the plan sponsor whereby the violations are corrected and the plan sponsor pays a sanction for the violations. The amount of the sanction is determined based on facts and circumstances, but is significantly higher than the costs associated with self-correction. One of the factors the IRS considers when determining the amount of the sanction is the steps taken by the plan sponsor to identify and correct the violation and the installation of internal controls to prevent the violation from happening again. Self-correction under the IRS and EBSA programs generally is not available for breaches of fiduciary duty, such as providing misleading information, conflicts of interest and failure to properly monitor investments.

The IRS's self-correction program, the Employee Plans Compliance Resolution System (EPCRS), is set forth in Revenue Procedure 2003-44 and consists of three levels of corrections, depending on the seriousness and type of the violations. The Self Correction Program (SCP) applies to insignificant operational failures and significant operational failures that are corrected within two years after the plan year in which the failure is discovered. If the violation qualifies for the SCP, the correction will not require IRS approval or the payment of any fees or sanctions. The Voluntary Correction Program (VCP) is for non-operational failures and for operational failures that don't qualify for SCP. It is available for plans that are not under audit and that voluntarily submit their failures to the IRS for correction. Corrections under VCP require IRS approval and the payment of a fee based on the size of the plan. The Audit Closing Agreement Program (Audit CAP) applies to violations discovered in a plan audit. The closing agreement and sanctions are negotiated as part of the examination process.

The EBSA has established the Voluntary Fiduciary Correction (VFC) program and the Delinquent Filer Voluntary Compliance (DFVC) program. The VFC program contains a list of violations which may be self-corrected without penalty. The DFVC program provides reduced penalties for late filing or non-filing of Form 5500. Explanations of the VFC and DFVC programs are contained on EBSA's Web site: www.dol.gov/ebsa.

Act now! Conduct a self-audit of your retirement plans and determine what your risks are. Once you receive an audit letter from the IRS or EBSA, it is too late to take advantage of their self-correction programs.

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