DrinkerBiddle®

Bruce L. Ashton
(310) 203-4048
Bruce.Ashton@dbr.com

Participant Loan Leakage: Protecting Participant Accounts and Reducing Fiduciary Risks

Disclosure Isn't the Answer.

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BRUCE ASHTON

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Introduction

Plan sponsors may have a false sense of security when it comes to the fiduciary risk related to 401(k) loans. What they may not recognize is that participant loans are plan investments and must be managed with the same prudence and oversight required for any plan investment.[1] The risk is heighted by several factors: the increased focus on 401(k) plans as a source of litigation; an alarming rate of loan defaults, as reflected in academic and industry studies; and a misguided belief that disclosure provides adequate protection. This paper explores these issues.

The Cost of Loan Defaults

In addition to risk mitigation, there is a strong argument that preventing loan defaults is simply the right thing to do. For example, a 2018 Deloitte study concluded that at the current rate, defaults will eliminate $2.5 trillion dollars from borrowers' retirement accounts over the next decade.[2] Other research shows that participants default at significant rates, and almost all—86%—default following job loss.[3] If you consider that participants taking loans tend to be the most financially vulnerable, the impact of a default is even more severe.

Plan loans are often emergency funds disproportionally made to lower-paid employees, for whom defaults spell short and long-term trouble. In the situation where a participant loses his or her job – especially as a result of layoff – they are not in a position to continue to make payments on the loan. The loan becomes a taxable distribution, including in most cases a 10% penalty. While the median loan is just $4,600,[4] defaulting on a $4,600 loan results in taxes and penalties of over $1,500, which the borrower—already in financial distress—likely doesn't have. This often forces the participant to cash out his or her entire remaining plan balance to cover these costs. In the long term, the average (vs. median) defaulting borrower, who has an outstanding loan balance of about $7,000, could miss out on approximately $300,000 of retirement assets once the cascading effects of a loan default are considered.[5]

The Fiduciary Jeopardy

Participant loans are a popular feature of 401(k) plans. What often remains unrecognized is that loans were established as plan investments early in the history of 401(k) programs[6]. As such – and contrary to what many believe – they fall under ERISA's prudence standard, which requires that fiduciaries

> "discharge their duties with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use."[7]

According to a key DOL advisory opinion[8], participant loan programs should only be allowed where they are maintained in the interest of the plan participants. The DOL explained the fiduciary obligation as follows:

> "The responsible Plan Fiduciaries must act prudently and solely in the interest of the participants and beneficiaries in deciding whether to enter into [a loan program described in the opinion], and in negotiating the terms and conditions of the Program. In this regard, it should be emphasized that the purpose of [the prohibited transaction exemption under] section 408(b)(1) and the regulations thereunder is not to encourage borrowing from retirement plans, but rather to ***permit it in circumstances that are not likely to diminish the borrower's retirement income or cause loss to the plan.*** Thus, plan fiduciaries must ***assess and monitor loan programs***, in particular loan programs like the one at issue which are designed to facilitate borrowing, ***to ensure the programs continue to be in the interest of the participants and beneficiaries of the plan and otherwise in compliance with Title I of ERISA***. [Emphasis added.]

Given the prevalence of loan defaults, this language raises a serious question: can a plan sponsor prudently offer a loan program if losses are virtually guaranteed after separation from employment?

The ERISA and Internal Revenue Code provisions that permit participant loans require that a plan receive adequate security for the loan. This generally means using the participant's account balance as collateral to protect the plan against loss in the event of a default. While adequate security is a requirement of a loan program, the requirement may protect the plan, but does nothing to protect the borrowing participant's account. In fact, the requirement in the long run will harm a participant who has no choice but to default as a result of job loss.

The Disclosure "Safeguard"

Industry practitioners may point to education and disclosure as the mechanisms for addressing the fiduciary risks[9] related to loan payments. They maintain that the risks of loan defaults are disclosed to participants before they borrow, and that this practice satisfies the provisions in ERISA related to loans. This view is apparently based on the disclosure requirements under the prohibited transaction exemption that permits participant loans if various conditions are satisfied and disclosures are made.[10]

That fiduciaries would feel comfortable with this *laissez-faire* approach is surprising given the ever-increasing frequency of 401(k) plan litigation. Numerous court rulings and out-of-court settlements have exposed the limitations of disclosure as a defense when the actions, or inaction, of the plan sponsor can be shown to have diminished the value of participant retirement accounts. That is, simply telling the participants the cost of an investment doesn't insulate fiduciaries from liability for an imprudent investment selection. This raises another question for plan sponsors: does disclosure satisfy a fiduciary's obligation under ERISA to "preserve assets in the event of a (loan) default"?[11] The answer is clearly no.

Plan sponsors have been living under the specter of increasing litigation for some time now, and high profile excessive fee suits have driven many plan sponsors to re-evaluate their plans and evolve their investment lineups. It isn't hard to imagine that 401(k) loans could be the next target. Consider, for example, the class action suit recently brought against plan provider TIAA for its loan practices.[12]

Litigation in the 2000s related to investment expenses may be instructive in anticipating where this trend could go. For decades, retirement plans offered retail priced mutual funds, often affiliated with plan service providers. Then participants began a series of cases arguing that plan sponsors had better choices available to them – take, for example, the *Edison* case,[13] where the court said that failure to select the lowest cost share class available to the plan was a fiduciary breach – which has opened a whole new era of fiduciary concern and oversight.

Institutionally priced mutual funds and passively managed index funds with strong performance records became available at significantly reduced cost. The prudence bar was raised, and plan sponsors became accountable for keeping up.

Even though investment costs and fund performance are clearly spelled out—in mutual fund prospectuses, annual reports, participant statements, web sites, and summary plan documents—disclosing those costs was not enough to meet a fiduciary standard of protecting the interests of participants when it became important for fiduciaries to consider the availability of lower cost options. As Fred Reish has noted, fiduciaries "need a periscope and a microscope."[14] That is, they need to be able to accurately assess the present, but also "scan the horizon . . . to see the issues that should be looked at, but aren't on the agenda."[15]

Another Light on the Problem

The new Form 1099-R will shine another light on the loan default problem. Until this year, plan sponsors have only been required to report loan defaults for active employees who received a "deemed distribution." These defaults only represent about 8% of the total. Loan defaults by terminated participants, which represent the other 92% of the total, are reported as actual distributions and are lumped in for reporting purposes with the other distributions by the plan. This masks the magnitude of the problem almost entirely.[16] Going forward, the updated 2019 Form 1099-R will require plan sponsors to report *all* loan defaults, *i.e.*, defaults by continuing employees and those by terminated employees that result in a loan offset.

Some practitioners speculate that the IRS will use this new data to target plan audits—the higher the number of defaults, the higher the probability of audit. And even though the Form 1099-R is a confidential tax form, some even wonder whether this data could be "discovered" in litigation.

Now consider the increased risks with a workforce reduction. Employers looking to cut costs can eliminate positions they consider unnecessary. However, wearing its fiduciary hat, an employer that eliminates a participant's job after approving a plan loan is virtually guaranteeing that participant will default on the loan. It doesn't help that lower paid workers are often disproportionally impacted by workforce reductions, leading to a higher concentration of defaults, a lower rate of return on a plan investment, and ultimately reduced retirement benefits for this vulnerable group of employees.

Possible Solutions

Despite increased awareness of the high incidence of default at job separation, plan sponsor and provider practices remain largely unchanged. Some practitioners have suggested doing away with loan programs altogether. Others suggest increasing the cost of obtaining a loan to discourage participants from taking them. Some plan sponsors are amending their loan policies to allow continuation of loan payments for separated employees, with Alight[17] reporting as many as two-thirds of sponsors now allowing this practice. Others are adding ACH from a personal checking/savings account as a mechanism for such a continuation of payments; but the observed usage of ACH to date is not encouraging.[18]

In fact, none of these or other approaches, including structural changes to limit the number of loans, limiting borrowing to only employee contributions, or offering out-of-plan consumer lending facilities, have been able to demonstrate evidence of mitigating loan defaults. And in the end, many of these "solutions" have the unfortunate effect of hurting the group of employees who need loans the most.

Applying the Lessons Learned

Loan programs are a plan investment and must be viewed in a similar light. The risks of loan default may be disclosed to participants during the borrowing process and included in readily available documents such as the loan policy. But is there a more effective solution available for loans…one that will prevent loan defaults and materially reduce fiduciary exposure at the same time?

It is becoming apparent that loan insurance could become the catalyst in the next ten years that index funds and institutionally priced funds were during the last decade. Loan insurance automatically repays the loan of any participant losing his or her job, preventing the taxes, penalties and lost earnings that, as described at the beginning of this paper, can quickly exceed many times the original loan amount. Generally, participants pay a small premium, in addition to their regular principal and interest payments, outside of plan assets, for the benefit of this coverage.

This last point, the incremental fee for loan insurance coverage, could raise a concern. As always, plan fiduciaries must exercise prudence in their selection and monitoring of any new service and service provider. But how does it serve the interests of participants and fulfill fiduciary responsibility by actually *raising* the cost of the loan? There is a straightforward answer to this question. Fiduciaries are not required to offer programs, services or investments at the lowest possible cost.[19] Rather, they must determine whether the cost is reasonable in relation to the value being obtained.

From a plan fiduciary standpoint, the incremental cost of loan insurance offers a significant value to participants. When the price is reasonable, the value the coverage delivers by protecting borrowers from the negative consequences of a loan default is clear.

One last point about cost: even if a participant doesn't lose his or her job before the loan is repaid, loan insurance still has a value. Lenders require home buyers to obtain fire insurance, even though both the lender and the homeowner hope it will never be needed. And the prudent homeowner wouldn't consider not carrying such insurance even if it weren't required. It offers a certain level of comfort, knowing that they are covered in the event of disaster. The same can be said when the plan, as the actual lender, obtains loan insurance. More importantly, it will enable the plan fiduciaries to fulfill their duty to act in the best interest of the participants and take steps to create "circumstances that are not likely to diminish the borrower's retirement income."

Conclusion

Courts have allowed investment fee complaints to move forward even though costs were disclosed to participants in advance, holding the actions of the plan fiduciary to a higher standard. Employers have settled these cases by paying their participants millions of dollars. It doesn't require too much imagination to think that a new class of defaulting borrowers might seek compensation for loan-related losses.

The risk certainly exists. Participants may have little recourse other than through lawsuits and the court system to challenge the administration of 401(k) plans. A recent academic study by the Boston College Center for Retirement Research suggests that litigation shows no signs of slowing down.[20] A changing business environment will undoubtedly increase the odds that more loans are issued to participants that end up losing their jobs. The resulting financial impact isn't hard to anticipate—unless something changes.

Reflecting on the recent past, a reliance on disclosure alone hasn't proven to be a valid defense when plan sponsor action or inaction has been shown to diminish the value of participant retirement accounts. Given the risk, plan sponsors may want to take the "prudent" approach and obtain loan insurance to prevent 401(k) loan defaults, particularly in cases involving involuntary termination.

Endnotes

1. *See* Schmidt, William A. and White, George L., "The Inconvenient Truth of Fiduciary Loan Regulation," Tax Management Compensation Planning Journal (2018).
2. Deloitte, "Loan leakage: How can we keep loan defaults from draining $2 trillion from America's 401(k) accounts?" (2018) (the "Deloitte Study").
3. The Pension Research Council, "Borrowing from the Future: 401(k) Plan Loans and Loan Defaults," 2015.
4. *Ibid.*
5. The Deloitte Study.
6. 54 Fed. Reg. 30,520 (July 20, 1989).
7. ERISA Section 402(a)(1)(B).
8. DOL Advisory Opinion 95-17A.
9. The Pension Research Council, "Borrowing from the Future: 401(k) Plan Loans and Loan Defaults," 2015.
10. ERISA Section 408(b)-1 and related regulations at 29 CFR Section 2550.408b-1.
11. ERISA Regulation 29 CFR Section 2550.408b-1(d)(vii).
12. *See* Wille, Jaclyn, "TIAA Can't Escape $50M Lawsuit Over Retirement Plan Loans," *Bloomberg BNA* (2018)
13. *Tibble v. Edison International*, The district court "concludes that defendants are liable for breaching their fiduciary obligations and are liable beginning on August 16, 2001—or for three funds the later date institutional share classes become available—for the actual loss in excessive fees paid and for the lost investment opportunity of this breach." *See* https://www.plansponsor.com/tibble-vs-edison-plaintiffs-win-the-latest-decision-in-district-court/
14. Fred Reish, "Plan Committees Need a Periscope and Microscope," Drinker Biddle & Reath LLP Client Alert, May 2017.
15. *Ibid.*
16. The Pension Research Council, "Borrowing from the Future: 401(k) Plan Loans and Loan Defaults," 2015.
17. Alight, 2019 Hot Topics in Retirement and Financial Wellbeing.
18. *Ibid.*
19. ERISA Section 404(a)(1)(A)(ii) regarding duty to incur reasonable fees.
20. Mellman, George S. and Sanzenbacher, Geoffrey T., "401(k) Lawsuits: What Are the Causes and Consequences?" Boston College Center for Retirement Research, May 2018.

The law and analysis contained in this white paper are current as of April 2019, are general in nature, and do not constitute a legal opinion that may be relied on by third parties. Readers should consult their own legal counsel for information on how these issues apply to their individual circumstances and to determine if there have been any relevant developments since the date of this paper.