Will 401(k) shortfalls precipitate wave of lawsuits?

By Robert Powell

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BOSTON (MarketWatch) -- Millions of Americans will set out to retire over the next few decades only to discover they don't have enough in their nest egg to fund their golden years.

And when that happens, many Americans will look to blame someone for their misfortune. In fact, odds are high that Americans -- being the lawsuit-happy lot they are -- will start suing everyone and anyone, including former employers, plan sponsors and perhaps even 401(k) plan providers.

Consider, for instance, how far away Americans are from being able to enjoy a comfortable retirement today. The typical working American household is on track to replace only 59% of projected preretirement income in retirement, according to Fidelity Investments research. That's about 20 percentage points to perhaps as high as 40 percentage points below what some experts say they might need.

Or consider the math on how little money the average American retiree should prudently withdraw from their 401(k) plan, or what is technically called a defined-contribution plan. Experts say investors should not withdraw much more than 4% per year from their investment accounts once in retirement. Given that Americans now have on average $61,000 in their 401(k), that means they should take out not much more than $2,400 per year in today's dollars. Hardly enough green to make the retirement years golden.

"The likelihood of class-action lawsuits is high," says Brad Gilliam, chief marketing officer for Rollover Systems in Charlotte, N.C. "Part of the problem is that employers and employees get a false sense of security having a 401(k) plan."

Others agree. "We see litigation, especially on the issue of plan participants not getting a good enough return," says Bruce Ashton, a partner with Reish Luftman Reicher & Cohen in Los Angeles.

Americans will indeed sue. But some experts say odds are low that Americans will win such suits, or at least not those that focus on issues where participants didn't save enough or invest wisely enough.

"It is important to understand that the benefit of a defined-contribution plan is the total of contributions and earnings thereon," says David Wray, president of Profit Sharing/401(k) Council of America. "No company makes any promises or guarantees beyond that. There is no legal responsibility for anything else. Defined-contribution plans are not defined-benefit plans and it is inaccurate to equate the two even though some who are critical of defined-contribution plans attempt to do so. We have had defined-contribution-plan-only companies since 1900 and none has been sued because the final account balance was inadequate."

Wray is not alone in his opinion. "401(k) plans are voluntary," says Christine Fahlund, a senior financial planner with T. Rowe Price. "Companies don't have to offer these plans to employees. They are not required to provide funding. They don't have to provide a match. If a person is participating in a plan it's their choice and plans make that clear."

But in a world in which most Americans participating in 401(k) plans remain in the dark about rules and regulations, lawsuits are a sure bet. And settlements that favor plan participants may be soon be a 50/50 bet, even in cases where participants accuse employers of not doing enough to help them save more or invest more wisely.

"I could see courts going both ways," says Ashton. Some courts, he says, will take a "laissez-faire" approach, ruling that it was the plan participant's responsibility to sock away enough money or to generate a return high enough to fund retirement. But other courts, he says, may take a more "paternalistic" approach, ruling that the laws that govern retirement plans require "affirmative action" by fiduciaries.

Some courts may rule that it was the fiduciary's job to make sure the plan participant has retirement benefits, that enough money was deferred and that assets were properly invested. "It's not a reach, in the wake of Enron, to say that a fiduciary's responsibility extends to making sure assets are properly invested," says Ashton.

Today, Americans -- whether they know it or not -- can sue their employers and the people charged with overseeing a 401(k) plan, the fiduciaries, for failing to act for the exclusive benefit of the participant. Employees can sue (and likely win) when fiduciaries don't have a process in place for identifying, selecting and monitoring investments in a 401(k). They can sue and likely win when a company misrepresents what a plan can do for participants.

For instance, Williams Cos., the largest U.S. natural-gas pipeline owner, this week agreed to pay $55 million to settle a lawsuit filed by workers who said they were misled into investing in company stock for their retirement accounts.

But most Americans don't know the difference between the laws that govern defined-benefit pension plans, the traditional pension plan in which a monthly benefit or dollar amount is defined and guaranteed by the employer, and a defined-contribution plan, in which the employee defines the contribution and there are no guarantees about benefits.

They don't know, for instance, that a company is under no obligation to provide education or that a company is under no obligation to provide advice. In fact, under current law and despite efforts to change it, employers are liable for any advice they do give participants. See related story on "safe harbor" proposals for employers.

And therein lies part of the problem. Americans don't have a clear sense of where the lines on the field are. They don't know where their job as investor ends and where that of the 401(k) plan fiduciary or employer begins.

In fact, such is the state of things that Invesmart, a retirement-planning firm, this week called for a retirement-plan participant bill of rights, under which 401(k) investors would have "the right to know the size of the retirement savings they will need in retirement to live in financial security and the right to know on a regular basis whether they are on track to building the appropriate retirement savings, or failing that, the steps to get on track."

Sadly, most, if not all, plan providers don't print 401(k) quarterly statements that reveal whether a plan participant is on track or not to reach their goals. Sadly, plan providers don't print statements that reveal to participants how much of their preretirement income their 401(k) could produce.

So it's not a reach to say that millions of Americans will retire someday to misfortune, not with fortune.