

Employer Stock Litigation: The Tension Between ERISA Fiduciary Obligations and Employee Stock Ownership

Introduction

The bankruptcies of Enron Corporation and WorldCom, Inc. and other highly-publicized corporate scandals have resulted in many class actions brought under Title I of the Employee Retirement Income Security Act of 1974, as amended ("ERISA").¹ These lawsuits arise from a widespread feature of U.S. corporate retirement programs — the investment of plan assets in the sponsoring employer's stock. Litigation challenging the investment of plan funds in plan sponsors' stock has drawn the attention of legal commentators,² practitioners,³ insurers,⁴ employers and the courts.

Employee investments in company stock are typically made through participant-directed accounts in plans that permit employee contributions under section 401(k) of the Internal

¹ 29 U.S.C.A. §§ 1001–1461 (West 2004).

² See Susan J. Stabile, *I Believed My Employer and Didn't Sell My Company Stock: Is There an ERISA (or '34 Act) Remedy for Me?*, 34 Conn. L. Rev. 385 (Winter 2004); Mike Prame, Anna Driggs, & Jennifer Eller, *Liability for Employer Stock Holdings: Litigation Update*, in PENSION & BENEFITS REP., Vol. 30, No. 45, at 2549–2553 (Nov 18, 2003); Proceedings of the 2003 Annual Meeting, Assn. of American Law Schools Section on Employee Benefits, *Employee Stock Ownership After Enron*, 7 EMPLOYEE RTS. & EMP. POL'Y J. 213 (2003); Lorraine Schmall, *Defined Contribution Plans After Enron*, 41 BRANDEIS L. J. 891 (2003); H. Douglas Hinson & Patrick C. DiCarlo, *Fiduciary Duties and Investments in Employer Securities*, 29:1 J. PENSION, PLANNING & COMPLIANCE 20 (2003); Brian T. Ortelere, *Enron-Lite Suits: A Curmudgeon's View*, PENSION & BENEFITS WEEK, Feb. 10, 2003, at 5–8; H. Douglas Hinson & Patrick C. DiCarlo, *Hybrid Claims Under ERISA and the Securities Laws*, 27 SEC. LIT. FORMS & ANALYSIS § 1:5 (updated Aug. 2002); Bill Bois, Nancy G. Ross & Amy Doehring, *401(k) Litigation Over Company Stock Fund Performance: It's Only Just Begun*, 15 BENEFITS LAW J. No. 4 at 33–54 (2002); Susan J. Stabile, *Enron, Global Crossing, and Beyond: Implications For Workers*, 76 ST. JOHN'S L. REV. 815 (2002); Sharon Reece, *Enron: The Final Straw & How To Build Pensions Of Brick*, 41 DUQ. L. REV. 69 (2002); Colleen E. Medill, *Stock Market Volatility and 401(k) Plans*, 34 U. Mich. J. L. Reform 469 (2000-2001).

³ See William L. Belanger, *Employer Stock in Defined Contribution Plans: ERISA Fiduciary Requirements*, 33 Tax Mgmt. Comp. Plan. J. 311 (2005); David M. Gische & Jo Ann Abramson, *The New Wave Of Corporate Fiduciary Claims*, 33 AMERICAN BAR ASSN. — SPRING BRIEF 45 (2004); Alan J. Hawksley & Thomas Asmar, *Duty of Disclosure for Corporate Officers and Directors under ERISA*, 31:5 TAX MANAGEMENT AND COMPENSATION PLANNING J. 163 (2003).

⁴ See Robert N. Eccles & David Gordon, *The Perils of Holding Company Stock in Sponsored Plans* (Chubb Group of Insurance Companies 2005).

Revenue Code of 1986, as amended (the “Code”) (“401(k) plans”). Where participants are permitted to direct the investment of their accounts, the U.S. Department of Labor (“DOL”) offers plan fiduciaries some relief from liability for participants’ investment decisions if safe harbors, which include offering a range of different investment options, are satisfied.⁵ Although not required to do so, employers often add their own stock funds to this menu. Employee stock ownership plans (“ESOPs”), which are designed to invest primarily in employer stock, are similarly authorized under ERISA and the Code, and do not require that a range of investment options be offered.⁶

The proliferation of both ESOPs and company stock funds as a matching or participant-directed option in 401(k) plans contributed to an overall decrease in plan investment diversification during the 1990s, as many employees’ investment portfolios became more concentrated in employer stock. Some portion of the decrease in diversification also resulted from the value of employer stock rising more rapidly than the value of other investments in a participant’s portfolio.⁷ The risks caused by this lack of diversification was largely overlooked during the mid-1990s, when the equity markets generally were robust and, where employer stocks kept pace with the markets, plan participants were earning double-digit returns on paper.

⁵ 29 C.F.R. § 2550.404c-1 (2004). Pursuant to the DOL regulations there is a safe harbor relieving company fiduciaries and institutional fiduciaries from liabilities resulting from participants’ own investment decisions pursuant to Section 404(c)(1) of ERISA.

⁶ See ERISA § 407(d)(6)(A), 29 U.S.C.A. § 1107(d)(6)(A).

⁷ For example, if a participant allocated \$50 to the company stock fund and \$50 to other equity funds (a 50 percent allocation), and in a particular time period achieved 200 percent returns on the company stock and a mere 20 percent on the other funds (not unheard-of in the late 1990s), she would end up with \$150 in the company stock fund and \$60 in the other funds, resulting in a 71.4 percent allocation to company stock – a jump of more than twenty percent, occurring without any conscious decision to increase the allocation of investments in company stock.

Thus, beginning around 2000 when the U.S. economy cooled off, participants in many of these retirement plans experienced significant losses in the value of their plan accounts.⁸

ERISA was enacted in part to ensure that the administration of retirement plans was monitored, and that funds placed in trust for employees' future retirement were protected.⁹ To achieve those interrelated goals, ERISA incorporated the trust-law doctrine of fiduciary duty, which includes duties of loyalty, prudence, diversification and adherence to plan documents.¹⁰

A person is a "fiduciary" with respect to a plan under ERISA to the extent the person exercises authority or control over plan assets, exercises discretionary authority or discretionary control over the management of the plan, or has discretionary authority or discretionary responsibility in plan administration.¹¹ The statutory fiduciary duties include: (i) a duty of loyalty, which includes the obligation to act "solely in the interest of the participants and beneficiaries" for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable administration expenses; (ii) a duty of prudence, which includes the obligation to act with the skill, care and diligence that a prudent person in such capacity would use; (iii) a duty to diversify the plan's assets so as to minimize the risk of large losses ("unless under the circumstances it is clearly prudent not to do so"); and (iv) a duty to

⁸ NASD, INVESTOR ALERT: PUTTING TOO MUCH STOCK IN YOUR COMPANY — A 401(K) PROBLEM (Feb. 15, 2005), available at <http://www.nasd.com> (last visited Feb. 23, 2005) (hereinafter "NASD Investor Alert").

⁹ See H.R. Rep. No. 533, 93d Cong., 2d Sess. 1, reprinted in 1974 U.S.C.C.A.N. 4639, 4639 ("The primary purpose of [ERISA] is the protection of individual pension rights....").

¹⁰ *Varity Corp. v. Howe*, 516 U.S. 489, 496 (1996) ("rather than explicitly enumerating all of the powers and duties of trustees and other fiduciaries, Congress invoked the common law of trusts to define the general scope of their authority and responsibility").

¹¹ See ERISA § 3(21)(a); 29 U.S.C.A. § 1002(21)(a); see also *Mertens v. Hewitt Assocs.*, 508 U.S. 248, 261 (1993) (ERISA defines fiduciaries "in functional terms of control and authority over the plan") (emphasis is the Court's).

comply with the plan documents, “insofar as such documents and instruments are consistent with the provisions of [ERISA].”¹²

The fiduciaries of eligible individual account plans (“EIAPs”), a category that includes both ESOPs and 401(k) plans, are statutorily exempt from the duty of diversification to the extent that the plans require or permit investment in employer stock. The fiduciaries of such plans are similarly exempt from the duty of prudence, but “only to the extent that it requires diversification.”¹³ ERISA does not excuse EIAP fiduciaries from the general obligation to act prudently and for the exclusive benefit of plan participants.¹⁴

In particular, the prevalence of 401(k) defined contribution plans—many of which include employer stock as a participant-directed investment option and/or a way to satisfy the plan sponsor’s matching contribution obligations—highlights a tension between ERISA’s emphasis on protecting retirement assets and the specific exception from ERISA’s diversification duty granted to EIAPs. The growth in the number of employers who make EIAPs (including an employer stock option) the only available employer-sponsored retirement vehicle may in some instances run counter to the original perspective and views of ERISA’s drafters, but is consistent with the law’s encouragement of employee stock ownership.¹⁵ Retirement plans are created to accumulate a fund over the employee’s working life and to distribute that fund in retirement to

¹² See ERISA § 404(a)(1), 29 U.S.C.A. § 1104(a)(1).

¹³ ERISA § 404(a)(2), 29 U.S.C.A. § 1104(a)(2); see also 29 U.S.C.A. § 1107(d)(6)(A); *Kuper v. Iovenko*, 66 F.3d 1447, 1457–58 (6th Cir. 1995); *Moench v. Robertson*, 62 F.3d 553, 568–59 (3d Cir. 1995).

¹⁴ Compare ERISA § 404(a)(1)(B), 29 U.S.C.A. § 1104(a)(1)(B) with ERISA § 404(a)(2), 29 U.S.C.A. § 1104(a)(2).

¹⁵ This tension may be absent in certain individual account tax-qualified plans, such as stock bonus plans, that are excluded from ERISA’s coverage. Section 401(a)(1) of the Code requires that an employer’s stock bonus, pension or profit-sharing plan be established for the exclusive benefit of the employees or beneficiaries. 26 U.S.C.A. § 401(a). Pre-ERISA revenue rulings suggest that these plans may be subject to duties of prudence, but not duties as rigorous as ERISA’s fiduciary duties. In contrast to ERISA’s policy objective of safeguarding retirement wealth, stock bonus plans preceded ERISA’s enactment and were permitted to incur greater risk (and thus reap greater rewards).

supplement Social Security and private savings. Some employees, however, may regard their EIAP investments as a vehicle for speculating in employer stock. Depending on the employee's age and circumstances, this could have severe consequences.

A class action under the securities laws,¹⁶ brought by purchasers or sellers of stock, typically alleges that the issuer made material misstatements and omissions to the investing public, which caused the plaintiff to incur losses in the purchase or sale of securities. Employer stock litigation, brought under ERISA based on the same circumstances, adds a new layer of claims on behalf of company employees, former employees and beneficiaries who invested in company stock. Such cases contend that the corporate insiders responsible for overseeing the plan, and sometimes the plan's directed trustee, breached ERISA's fiduciary duties by allowing the plan participants to buy and hold company stock when the insiders knew or should have known that such investments were imprudent or were not solely in the interests of the plan participants and beneficiaries.

The recent litigation involving employer stock held in EIAPs raise numerous issues for courts, plan sponsors, plan fiduciaries and anyone with a personal or professional interest in U.S. employee benefits policy. These issues include:

- Should the holding of employer stock in employee benefit plans be subject to the same fiduciary standards as other plan investments, to the standards set forth in the securities laws, or to some other standards? Are additional protections under ERISA advisable?
- If an EIAP mandates investment in company stock, when (if at all) should fiduciaries be required to ignore or override such mandate?
- Should the standard model of plan governance, in which the plan is overseen by a committee composed solely of corporate officers, be changed?
- Does, or should, ERISA impose any special duty on a plan fiduciary who obtains non-public information about a company's prospects in his or her role as a corporate officer?

¹⁶ See 15 U.S.C.A. § 78j(b); 17 C.F.R. § 240.10b-5 (2004).

- How can institutional trustees be encouraged to remain in the business of overseeing employee retirement plans, consistent with ERISA’s allocations of fiduciary responsibility among plan trustees, investment managers or advisors, “named fiduciaries,” and (in the case of plans falling under ERISA section 404(c)) plan participants?

These issues are vitally important to plan sponsors and insurers, as well as plan fiduciaries, participants and beneficiaries. Employer stock cases have recently generated settlements with significant cash components, typically funded by the plan sponsor and its fiduciary insurance.¹⁷

The Committee recognizes that the law in this area is developing. To date, no federal appellate court has spoken to the substance of the above questions, or other related issues, in the context of the recent wave of employer stock litigation.¹⁸ Decisions in the district courts have depended largely upon the facts and circumstances alleged in each particular case.¹⁹ The Committee therefore has not sought to derive from existing law a rigid set of directives that will apply to fiduciaries in every case. Rather, this Report offers for consideration suggestions and recommendations that are based on its members' experience in this field, as applied to general issues raised by the recent decisions.

¹⁷ Significant settlements, and their cash components, include WorldCom, Inc. (partial settlement of \$47.5-51.5 million approved October 18, 2004); Lucent Technologies (\$69 million; approved March 15, 2004); Global Crossing, Ltd. (\$79 million; approved November 24, 2004); and Household International, Inc. (\$30.75 million; approved November 22, 2004). *See also* *In re Electronic Data Systems Corp. “ERISA” Litig.*, 2005 WL 1875545 (E.D. Tex. June 30, 2005) (denying unopposed motion for preliminary approval of \$16.5 million settlement, as “not in the best interests of the proposed class members”).

¹⁸ *In Lalonde v. Textron, Inc.*, 369 F.3d 1 (1st Cir. 2004), as discussed below, the First Circuit deferred such issues to discovery. In *In re Schering-Plough Corp. ERISA Litig.*, No. 04-3073, 2005 U.S. App. LEXIS 17613, 2005 WL 1993990 (3d Cir. Aug. 19, 2005), the Third Circuit simply ruled that a subset of plan participants have standing under ERISA to seek damages, on behalf of the plan, for losses due to breaches of fiduciary duty; other issues were deferred to the District Court on remand.

¹⁹ At least four of the District Court cases have been decided by judges in the Southern District of New York: *In re WorldCom, Inc. ERISA Litig.*, 263 F.Supp.2d 745 (S.D.N.Y. June 17, 2003) (Cote, J), which has generated multiple opinions; *In re Polaroid ERISA Litig.*, 362 F.Supp.2d 461 (S.D.N.Y. Mar. 31, 2005) (Pauley, J.); *In re AOL Time Warner, Inc. Securities and “ERISA” Litig.*, No. 02 CV 8853, 2005 U.S. Dist. LEXIS 3715, 2005 WL 563166 (S.D.N.Y. Mar. 10, 2005) (Kram, J.); and *Fisher v. J.P. Morgan Chase & Co.*, No. 03 CV 3252, 2005 U.S. Dist. LEXIS 18274, 2005 WL 2063813 (S.D.N.Y. Aug. 26, 2005) (Stein, J.). *See also In re Global Crossing Securities and ERISA Litig.*, 225 F.R.D. 436 (S.D.N.Y. Nov. 24, 2004) (Lynch, J.) (approving partial settlement).

EIAPs and ESOPs as Retirement Investment Vehicles

Practically all major public corporations in America provide their employees with a retirement plan, and many of those plans are EIAPs.²⁰ Some of these corporations also provide employees with a defined benefit plan; others do not. EIAPs are standard defined contribution plans: employees may contribute amounts to the plan, but no fixed benefit is promised.²¹ In contrast, a defined benefit plan promises the employee a fixed stream of income on retirement, and the plan sponsor is required to fund the plan to the level actuarially necessary to pay those benefits. ERISA limits the amount of employer stock that a defined benefit plan may hold to 10% of the plan assets.²² However, ERISA imposes no similar explicit limit on investment in company stock through EIAPs or ESOPs. Because ESOPs and other EIAPs are not designed to guarantee a sum certain, they may place employee retirement assets at a greater risk than defined benefit plans.²³ Where the risk results from investment choices made by the employee, ERISA assigns the consequences to the employee if certain safe-harbor requirements are satisfied.²⁴

In adopting ERISA and modifying the excise tax provisions of Code section 4975, Congress recognized that employee stock ownership through EIAPs could be a means of providing rank-and-file employees with a stake in their employers' success.²⁵ ERISA permitted

²⁰ About 13 percent of 401(k) plans offer company stock as an investment choice or include a matching option. However, since these plans are maintained by America's largest corporations, the number of employees affected is significant — over 23 million. Ass'n. of American Law Schools Section on Employee Benefits, *Employee Stock Ownership After Enron: Proceedings of the 2003 Annual Meeting*, 7 EMPLOYEE RIGHTS & EMP. POL'Y J. 213, 215–16 (2003) (hereinafter "Annual Meeting").

²¹ See *Hughes Aircraft Co. v. Jacobson*, 525 U.S. 432, 439 (1999).

²² ERISA § 407; 29 U.S.C.A. § 1107.

²³ See *Moench v. Robertson*, 62 F.3d 553, 568 (3d Cir. 1995).

²⁴ See ERISA § 404(c), 29 U.S.C.A. § 1104(c), and the associated DOL regulations, 29 C.F.R. § 2550.404c-1 (2004).

²⁵ See *Ershick v. United Missouri Bank of Kansas City, N.A.*, 1990 U.S. Dist. LEXIS 11929 (D. Kan. 1990) ("intended purpose" of ESOPs is "to build equity ownership of shares of the employer corporation for its employees"), citing H.R. Rep. No. 1280, 93d Cong., 2d Sess. 313, reprinted in 1974 U.S.C.C.A.N. 5038, 5093; but see *In re Schering-Plough Corp. ERISA Litig.*, No. 04-3073, 2005 U.S. App. LEXIS 17613, 2005 WL 1993990, **4-6 (3d Cir. Aug. 19, 2005) (distinguishing ESOPs from other savings and investment plans).

EIAPs to invest in “qualifying employer securities”²⁶ without the 10% limit imposed upon defined benefit plans, thereby causing EIAPs to function “as both an employee retirement benefit plan and a technique of corporate finance that... [encourages] employee ownership of a company.”²⁷

Corporations have promoted employee investment in company stock funds through various mechanisms. Most notably, many companies have “matched” 401(k) plan employee contributions with additional contributions paid in company stock rather than cash contributions. In some cases, plans require that those matching contributions remain in the company stock fund. Under such circumstances, participants have only limited ability to shift those assets into other investments prior to retirement or the attainment of certain age and service criteria.

During the mid- to late 1990s, when the proliferation of 401(k) plans was coupled with a record bull market, employees' retirement investments became increasingly concentrated in company stock. For example, by 2000, 62% of Enron Corporation's 401(k) plan funds were invested in Enron stock.²⁸ Enron was not unusual in that respect: other plans that became highly concentrated in employer stock included Sherwin-Williams (almost 92% of the plan's assets were invested in company stock); Procter & Gamble (almost 95%); Coca-Cola (81%); McDonalds (81%); Abbott Laboratories (almost 91%); and Pfizer (85.5%).²⁹

²⁶ ERISA § 407(b)(1), 29 U.S.C.A. 1107(b)(1).

²⁷ *Kuper v. Iovenko*, 66 F.3d 1447, 1457 (6th Cir. 1995); *accord Martin v. Feilen*, 965 F.2d 660, 664 (8th Cir. 1992).

²⁸ Annual Meeting, *supra* note 20, at 213. *See also* NASD Investor Alert, *supra* note 8 (in 2001 “57.73% of Enron employees' 401(k) assets were invested in Enron stock as it fell 98.8% in value”).

²⁹ Annual Meeting, *supra* note 20, at 213–14; *Enron Hearings: Prepared Statement of Professor Susan J. Stabile, Testimony Before the Senate Comm. on Governmental Affairs*, Feb. 5, 2002, available at www.senate.gov/~gov_affairs/020502stabile.htm (citing a Wall Street Journal article reporting that the 401(k) plan assets of one in five companies were at least 50% invested in the company's own stock). The data reflect the plans as of 2001–2002.

The growth of plan investments in company stock was further fueled by tax benefits and other structural incentives. For example, dividends that are paid by a company to an ESOP may be deducted by the company under certain conditions, as well as paid to participating employees outside of the plan itself.³⁰ ESOPs have also been used as a "tax-favored" corporate finance vehicle.³¹ ESOPs have also been used by management to settle strikes and to offset across-the-board cash pay reductions,³² and to stave off hostile tenders.³³ Depending upon a stock's liquidity, the purchase of securities by an ESOP or 401(k) plan could positively influence the value of the stock. Moreover, stock ownership provides employees with a stake in the fortunes of the company, which under certain circumstances appears to promote employee loyalty and productivity.

The resulting diminution in the diversification of EIAP participants' investments subjected them to increased market volatility. Because the value of any single stock or bond is tied to the fortunes of one company, holding a single kind of stock or bond necessarily involves a higher measure of risk than holding a diversified mix of stocks or bonds, or holding investments (such as mutual funds) which pool that risk.³⁴ Persons who hold a diverse portfolio of stocks and bonds face less risk,³⁵ because they have only a small stake in each company and exposure that is balanced among economic sectors. When stock prices were rising across the board,

³⁰ Annual Meeting, *supra* note 20, at 237 (citing to IRC § 404(k)).

³¹ *Id.* at 238 (discussing that a company could use ESOPs to deduct the cost of repaying its funded debt while providing benefits to employees in the form of ownership).

³² *Id.*

³³ *Id.* at 238–39.

³⁴ See NASD Investor Alert, *supra* note 8 (“diversification spreads your risk”).

³⁵ Steinman v. Hicks, 352 F.3d 1101, 1104 (7th Cir. 2003) (Posner, J.), citing N. Gregory Mankiw, PRINCIPLES OF ECONOMICS 546 (1998).

employees, plan sponsors, advisors and the government expressed little concern over this risk.³⁶ But, when the bubble created by overvalued technology stocks burst in 2000 and the markets were rocked by a series of high-profile corporate accounting scandals, many 401(k) plans and ESOP participants experienced significant losses. When companies such as Enron, Global Crossing and WorldCom sought bankruptcy protection, employee retirement assets in the distressed companies' shares became virtually worthless.

Legal Theories in Employer Stock Litigation

In the recent wave of employer stock litigation, plaintiffs typically have named as defendants the plan sponsor, the 401(k) plan's administrative and investment committees, the individual committee members and sometimes the institutional directed trustees. Claims have also been made against the companies' chief executive officers, their boards of directors, and other individuals with varying degrees of responsibility for corporate management or plan operations. Although plaintiffs' counsel have styled these cases as class actions, the employer stock lawsuits need not be brought on behalf of a class. The class cannot recover directly, because ERISA makes fiduciaries personally liable only *to the plan* for damages caused by a breach of fiduciary duty.³⁷ Rather, ERISA empowers the U.S. Department of Labor or any "participant, beneficiary or fiduciary" to seek damages under ERISA section 409,³⁸ authorizing what in effect is a derivative suit on behalf of the plan.

³⁶ *But see* Susan J. Stabile, *Pension Plan Investment in Employer Securities: More Is Not Always Better*, 15 YALE J. ON REG. 61 (1998) (arguing for greater regulation of pension plans, especially 401(k) plans, since excessive accumulation of corporate stock will lead to inadequate diversification).

³⁷ ERISA §409, 29 U.S.C.A. §1109.

³⁸ ERISA §502(a)(2), 29 U.S.C.A. §1132(a)(2); *see* *In re Schering-Plough Corp. ERISA Litig.*, No. 04-3073, 2005 U.S. App. LEXIS 17613, 2005 WL 1993990, **3-10 (3d Cir. Aug. 19, 2005).

Plan participants in the recent employer stock cases have asserted four major types of claims for breach of fiduciary duty: (i) “prudence” claims, (ii) “disclosure” claims, (iii) “monitoring” claims, and (iv) “conflict-of-interest” or “loyalty” claims.

Prudence claims in employer stock litigation usually have asserted that plan fiduciaries violated their duty of prudence by maintaining company stock as an investment option after it became imprudent to do so; failing to initiate steps that would stop further plan investment in the company's stock; or failing to investigate the suitability of continued investment in company stock.

Disclosure claims in employer stock cases have asserted that the plan sponsor breached its duties by disseminating misleading information to plan participants regarding the company's financial condition or by failing to disclose material information to participants.

Monitoring claims relating to employer stock have asserted that the plan sponsor and its directors failed to oversee and monitor the activity of the plan fiduciaries, or failed to provide the fiduciaries with information necessary to perform their duties.

Loyalty or conflict-of-interest claims in employer stock litigation have asserted that the plan fiduciaries failed to act solely in the interest of plan participants and beneficiaries. Fiduciaries subject to such claims are alleged to have breached their duty of loyalty, in part, by acting under a conflict of interest. Such conflicts have been claimed to arise from the fiduciaries' involvement in corporate misconduct aimed at inflating the employer's share prices, or from the plan sponsor's executive compensation policies tying the fiduciaries' pay to the company's share price.

In response, the defendants in these cases have made various arguments, including the following:

If the terms of the plan require investment in employer stock, the named fiduciaries lacked discretion to change those terms, and were not required by ERISA's fiduciary duties to ignore them.

Selling off the plan's employer stock would breach the plan's provisions, and thereby would defeat the participants' expectations about the investment of their plan accounts.

If required to invest in employer stock by the plan, fiduciaries should be permitted to maintain such investments unless the company is headed for collapse or bankruptcy.

The defendants who are not members of the plan committee were not fiduciaries under ERISA, and thus were not required to adhere to ERISA's fiduciary standards with respect to the EIAP.

The duty to monitor appointed fiduciaries is limited and need not result in automatic liability for the persons who appointed fiduciaries, when the appointed fiduciaries have breached their duties.

Plan participants directed their own investments and thus bore the risks of their decisions because the safe harbor requirements in ERISA section 404(c) were satisfied.

Any allegedly misleading statements in SEC filings or company press releases were not made by the defendant while acting in a plan fiduciary capacity.

Actions by plan fiduciaries to sell off the plan's holdings of company stock based on nonpublic information would violate the federal securities laws against insider trading.

Plan participants also have made claims against the "directed" trustees of 401(k) plans, *i.e.*, persons who have custody of plan assets but no discretionary authority over the disposition or management of those assets. Both ERISA and the Code require that a plan's assets be held in trust or a trust equivalent (such as a group annuity contract or an insurance contract). The DOL has specified in regulations that trustees "by the very nature of [the] position, have 'discretionary authority or discretionary responsibility in the administration'" of the plan, making them fiduciaries under ERISA.³⁹ However, a trustee's fiduciary liability may be limited to the extent that either (i) the plan expressly provides that the trustee be subject to the direction of a named fiduciary who is not a trustee, or (ii) the authority to manage, acquire or dispose of the plan's

³⁹ See 29 C.F.R. §2509-75-8, Q&A D-3.

assets is delegated to one or more investment managers under ERISA.⁴⁰ “Directed” trustees typically are financial institutions.

Plaintiffs have asserted that the directed trustees, as fiduciaries under ERISA, breached their fiduciary duties by failing to override the participants’ directions to invest in company stock and by maintaining plan assets invested in company stock. Such allegations sometimes have been accompanied by assertions that the directed trustees had knowledge from some other source that the company’s financial statements were inaccurate. In response, the directed trustees have challenged the extent to which ERISA’s fiduciary duties apply to them. The directed trustees have further contended that any fiduciary exposure on their part should be limited to liability resulting from their failures to follow “proper directions.”⁴¹ The directed trustees take the position that they were assigned the limited role of holding the 401(k) plan assets and implementing the participants’ investment directions and their responsibilities accordingly were limited under ERISA section 403(a).⁴²

Issues Raised by Employer Stock Litigation

Many courts have denied motions to dismiss in employer-stock cases, concluding that the plaintiffs should have the opportunity to develop their case through discovery.⁴³ By deferring discussion of the merits of the plan participants’ legal theories to a later stage of the litigation,

⁴⁰ See ERISA §§403(a)(1) and (a)(2), 29 U.S.C.A. §§1103(a)(1) and (a)(2).

⁴¹ See ERISA § 403(a)(1), 29 U.S.C.A. § 1103(a)(1).

⁴² 29 U.S.C.A. §1103(a).

⁴³ See, e.g., *Lalonde v Textron, Inc.*, 369 F.3d 1 (1st Cir. 2004); *Lively v. Dynegy, Inc.*, No. 05-cv-0063-MJR, slip op. at 5-6 (S.D. Ill. Feb. 15, 2006) (holding that arguments against fiduciary claims were “premature” on motion to dismiss; “Discovery will tell the tale.”); *Falk v. Amerada Hess Corp.*, Civ. No. 03-2491, slip op. (D.N.J. May 10, 2004); *In re CMS Energy ERISA Litig.*, 312 F. Supp. 2d 898 (E.D. Mich. 2004); *In re Xcel Energy, Inc. Sec., Deriv. & “ERISA” Litig.*, 312 F. Supp. 2d 1165 (D. Minn. 2004); *In re Electronic Data Systems Corp. “ERISA” Litig.*, 305 F. Supp. 2d 658 (E.D. Tex. 2004); *In re Ikon Office Solutions, Inc. Sec. Litig.*, 86 F. Supp. 2d 481 (E.D. Pa. 2000); *In re AEP ERISA Litig.*, 327 F. Supp. 2d 812, 2004 WL 1776001, *6-7 (S.D. Ohio Aug. 10, 2004).

however, courts to date have left plan sponsors and participants with little guidance on these important issues.

The Committee's views on some of the novel issues presented by the recent employer stock litigation are set forth below.

A. Limits on Investment in Employer Stock

Recent employer stock litigation has exposed a significant structural tension between statutory provisions in ERISA and the Code that are intended to promote employee stock ownership, and fiduciary duties that are intended to protect the pension benefits of plan participants and beneficiaries. Portfolio theory has established that concentrating investments in a single security is generally riskier than diversifying a portfolio, yet ERISA makes significant accommodations for plans that concentrate their investments in employer stock.

The Committee generally believes that, consistent with the Congress's expressed intent and the business needs of employers, pension plan investment in employer stock should be allowed. However, the Committee also recognizes that the concentration of plan investments in employer stock can significantly increase the plans' aggregate exposure and participants' individual exposure to market volatility.

Legislation proposed in the 108th Congress evidenced sentiment for greater diversification of EIAPs.⁴⁴ At a minimum, the Committee believes that Congress should extend the diversification rules for ESOPs under the Internal Revenue Code to include any EIAPs

⁴⁴ See, e.g., S. 2424, 108th Cong. 2d Sess. § 101 (2004) (would amend Internal Revenue Code and ERISA to require a defined contribution plan holding publicly traded securities to provide employees with (i) the opportunity to divest employer securities, and (ii) at least three investment options other than employer securities); H.R. 1000, 108th Cong. § 104 (2003) (would amend the Internal Revenue Code and ERISA to require EIAPs that permit investments in employer securities to allow participants to divest such securities and reinvest in other options if (i) the benefit is based on three years of service as an employee, or (ii) with respect to an allocation during the plan year, not more than three years after the end of that plan year; would also require some plans to offer at least three investment options and quarterly opportunities to elect among options).

holding employer stock, so as to minimize the financial risks to participants inherent to investment in such arrangements.⁴⁵ In considering such measures, however, Congress should not unduly restrain the ability of employers to design plans that meet their desires, and not unduly restrict the upside opportunity for employees who wish to invest in their own company. For example, Congress might consider requiring plans to offer protective features, without requiring plan administrators or other fiduciaries to force participant investment in a particular manner. To that end, Congress might give participants a right to dispose of employer securities, and/or require increased disclosures, warnings and education for plan participants about the risks of concentrated investment in employer stock – measures that some plan sponsors have already adopted on their own.

B. Proposed Changes to Plan Governance Model

Recent employer stock class litigation has placed in question the traditional model of benefit plan governance for single-employer plans. Like other employee benefit plans, EIAPs are typically overseen either by a single plan committee or by an “investment” committee and an “administrative” committee. The plan committees may be appointed by, and typically report to, the plan sponsor's board of directors (or other governing body). The committees’ members typically include corporate insiders, such as the plan sponsor's chief financial officer, treasurer and director of human resources.

Complaints in employer stock litigation frequently allege that these insider fiduciaries knew material adverse information about the company from their work as corporate officers, and

⁴⁵ See 26 U.S.C.A. § 401(a)(28) (an employee who has participated in a qualified ESOP for at least 10 years and is at least 55 years old may elect to direct the investment of up to 25 percent, or up to 50 percent in the final year of election, of the assets in the employee’s account).

were involved in concealing this information from the public and the plan participants.⁴⁶ The plaintiffs contend that the insider fiduciaries should have precluded further participant investment in company stock, should have diversified existing plan holdings based on their alleged knowledge that the company's public statements were false, or should have done both.⁴⁷ In some cases — most notably Enron — the company officers are alleged to have actively, and fraudulently, promoted investment in company stock through the EIAP, and to have done nothing to steer the plan away from retaining or expanding company stock holdings within the EIAP, even as it became clear to them that the company was headed for disaster. The alleged conduct would violate the duties of a fiduciary to protect participants' plan benefits.

Corporations usually view employee benefits as a component of running their business — an aspect of employee compensation or an incentive device. Unlike the common law of trusts, therefore, ERISA allows corporate officers to wear "two hats" and serve simultaneously as plan fiduciary and as company functionary.⁴⁸ Thus, under ERISA, corporate officers of the plan sponsor may be involved in the governance and administration of benefit plans. In the Committee's view, the "best practices" for plan governance should include (a) having company insiders clearly identify the official role they are playing with respect to any particular plan transaction; (b) having the plan committee, as a regular part of its operations, obtain the advice of legal counsel on the interpretation of applicable ERISA legal standards; and (c) with respect to

⁴⁶ See, e.g., *In re WorldCom, Inc. ERISA Litig.*, 263 F. Supp. 2d 745 (S.D.N.Y. Jun. 17, 2003); *Hull v. Policy Management Systems Corp.*, No. 3:00-778-17, 2001 U.S. Dist. LEXIS 22343, 2001 WL 1836286 (D.S.C. Feb. 9, 2001); *Pennsylvania Federation v. Norfolk Southern Corp. Thoroughbred Retirement Investment Plan*, No. 02-9049, 2004 U.S. Dist. LEXIS 1987, 2004 WL 228685 (E.D. Pa. Feb. 4, 2004); *In re Sears, Roebuck & Co. ERISA Litig.*, No. 02 C 8324, 2004 U.S. Dist. LEXIS 3241, 2004 WL 407007 (N.D. Ill. Mar. 3, 2004).

⁴⁷ See, e.g., *Howell v. Motorola, Inc.*, 337 F. Supp. 2d 1079, 1099-1100 (N.D. Ill. 2004) (court allowed claims against corporate vice president who held the title "Director-Global Rewards-Benefits" and signed certain SEC filings, but noted that it "finds Plaintiffs' conclusory response" that he acted as a fiduciary when he made misrepresentations to the plan participants to be "unsatisfying").

⁴⁸ See *Pegram v. Herdrich*, 530 U.S. 211, 225 (2000).

decisions involving the plan's continued investment in company stock, having the plan committee obtain, on a regular basis and otherwise as needed, the views of independent advisors who are not officers, directors or employees of the plan sponsor.

The Committee is aware of Congressional interest in imposing additional rules pertaining to plan governance. In formulating plan governance measures, legislators should be mindful of the practicality and feasibility issues that such requirements may pose for smaller plan sponsors.

C. Determination of Fiduciary Status and Fiduciary Duties

Fiduciary status under ERISA is governed by a functional statutory definition; persons are plan fiduciaries *to the extent* that they exercise authority or control over plan assets, exercise discretionary authority or discretionary control over the management of the plan, or have discretionary authority or discretionary responsibility in the administration of the plan.⁴⁹ Because fiduciary responsibility and liability depends upon the underlying facts, the courts considering employer stock complaints frequently have been reluctant to determine such questions on motions to dismiss.⁵⁰ The first federal appellate court to consider an employer stock class action — the First Circuit in *Lalonde v. Textron, Inc.*⁵¹ — reached a similar conclusion in reversing the grant of a motion to dismiss, thereby avoiding deciding numerous important, substantive issues. The First Circuit remanded the case to the district judge for

⁴⁹ *Mertens v. Hewitt Assocs.*, 508 U.S. 248, 261 (1993); *see* ERISA § 3(21)(A), 29 U.S.C.A. § 1002(21)(A).

⁵⁰ *See, e.g.*, *In re Xcel Energy, Inc., Sec., Deriv. & "ERISA" Litig.*, MDL No. 1511 (D. Minn. Mar. 10, 2004); *Pennsylvania Federation v. Norfolk Southern Corp. Thoroughbred Retirement Investment Plan*, No. 02-9049, 2004 U.S. Dist. LEXIS 1987, 2004 WL 228685 (E.D. Pa. Feb. 4, 2004); *Cokenour v. Household Int'l.*, 2004 U.S. Dist. LEXIS 5286 (N.D. Ill. Mar. 30, 2004); *In re CMS Energy ERISA Litig.*, 312 F. Supp. 2d 898 (E.D. Mich. Mar. 31, 2004); *Rankin v. Rots*, 278 F. Supp. 2d 853 (E.D. Mich. Aug. 20, 2003); *In re AEP ERISA Litig.*, 327 F. Supp. 2d 812, , 2004 WL 1776001, *10 (S.D. Ohio Aug. 10, 2004).

⁵¹ *Lalonde v. Textron, Inc.*, 369 F.3d 1 (1st Cir. 2004).

"further record development — and particularly input from those with expertise in the arcane area of the law where ERISA's ESOP provisions intersect with its fiduciary duty requirements."⁵²

The Committee questions the *Lalonde* court's notion that expert testimony is necessary to determine whether a fiduciary breach has been adequately pleaded. Fiduciary duties under ERISA are "the highest known to the law."⁵³ To survive a motion to dismiss, plaintiffs should not be permitted simply to "parrot" ERISA's definition of fiduciary as the sole support for such status.⁵⁴ Even under liberal federal pleading standards,⁵⁵ the complaint must give the defendants fair notice of what the plaintiff's claims against them are, and the grounds upon which those claims rest. The factual elements of fiduciary status and breach of fiduciary duty should be discernible from the face of a complaint. Plaintiffs in employer stock cases thus should be required to plead specific facts that support the fiduciary status of named defendants – for example, that the individual had a role that was "fiduciary" in nature under the terms of the plan (*e.g.*, serving on the plan's investment committee), or acted to control plan investments or administration – and state how the individual violated ERISA's duties in performing those actions.

D. The Duty to Monitor

Monitoring claims have been a principal mechanism used by plan participants to extend fiduciary liability beyond the plan committee (or other fiduciaries actually charged with making

⁵² *Id.* at 12–13.

⁵³ *Donovan v. Bierwirth*, 680 F.2d 263, 272 n.8 (2d Cir. 1982) (Friendly, J.).

⁵⁴ *In re Sprint Corp. ERISA Litig.*, 2004 U.S. Dist. LEXIS 19125, *32–33 (D. Kan. Sept. 24, 2004) (granting Sprint's motion to dismiss the plaintiffs' co-fiduciary claim against the other Sprint defendants); *but see In re ADC Telecommunications, Inc. ERISA Litig.*, No. 03-2989, 2004 U.S. Dist. LEXIS 14383, 2004 WL 1683144, at *5 (D. Minn. July 26, 2004) (to plead *de facto* fiduciary status, it is sufficient to survive a motion to dismiss if the complaint "merely parrots the language of ERISA without much factual elaboration"); *In re WorldCom, Inc. ERISA Litig.*, 263 F.Supp.2d 745, 759 (S.D.N.Y. 2003) (allegations against president and chief executive officer stated fiduciary claim, even though complaint "d[id] little more than track the statutory definition of a fiduciary").

⁵⁵ *See Swierkiewicz v. Sorema, N.A.*, 534 U.S. 506, 512 (2002); *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957).

plan investment decisions). According to the DOL, "the performance of trustees and other fiduciaries should be reviewed by the appointing fiduciary in such a manner as may be reasonably expected to ensure their performance has been in compliance with the terms of the plan and statutory standards."⁵⁶ In some cases, plan participants have contended that the employer's board of directors had a duty to prevent the alleged fiduciary breaches by monitoring the plan committee's activities.

The contours of the duty to monitor, however, remain unclear. While one can point to egregious examples,⁵⁷ the cases give scant direction on what level of monitoring is required or sufficient in the ordinary situation. As matters stand, corporate directors have no explicit regulatory guidance on what must be done to "monitor" plan fiduciaries, how frequently the monitoring must be undertaken, when to take action if the monitoring discloses a problem, and what sort of action to take. The Committee believes that the DOL should promulgate standards of conduct that are both flexible and comprehensible, so that corporate directors acting in good faith can be reasonably confident that they have discharged their duty to monitor the performance of fiduciaries.⁵⁸ In the Committee's view, a company's board of directors should be able to delegate effectively the task of day-to-day plan management, without having to review every fiduciary decision *de novo* and without bearing vicarious liability for every act or omission of the plan committee.

Pending the development of such standards, as a matter of "best practices," the Committee suggests that plan sponsors consider the following steps to monitor and guide the actions of plan committees:

⁵⁶ 29 C.F.R. § 2509.75-8 at FR-17 (2004).

⁵⁷ *See, e.g.*, In re WorldCom, Inc. ERISA Litig., 263 F.Supp.2d 745, 754 (S.D.N.Y. 2003).

⁵⁸ One example of guidelines that seek to achieve this goal is the model Investment Policy Statement promulgated by the Profit Sharing/401(k) Council of America, available at http://www.pzca.org/ips_model.asp.

- A plan sponsor, through binding action of its board of directors or other governing body, should establish a charter for the plan committee that generally describes its duties, powers and responsibilities.
- A plan sponsor, through its delegates and with independent professional assistance, should require the plan committee to keep formal written minutes of its actions and transmit those minutes to the company for actual (not perfunctory) periodic review. These minutes should be reviewed for compliance with policy and legal requirements.
- A plan sponsor should review plan documents and service provider agreements regularly to ensure that the agreements identify the individuals or groups who set policy, implement policy, and monitor results and compliance with policy and legal requirements. Delegations of authority should be clearly stated in these documents.
- A plan sponsor should review investment manager agreements to ensure that the agreements identify permissible asset classes, investment disciplines used, benchmarks for evaluating performance, the frequency of regular performance reviews, and any limits on manager discretion.
- When the interests of the plan and the plan sponsor may diverge, plan fiduciaries should be encouraged by the plan sponsor to consider retaining independent counsel on behalf of the plan. The retention of independent counsel can lead to the retention of an independent fiduciary to review a proposed course of action when inherent conflicts of interest cannot otherwise be resolved.
- Plan sponsors should encourage plan fiduciaries to keep abreast of developments in employee benefits law through continuing training and education.⁵⁹
- Plan sponsors should verify that fiduciary liability insurance policies have been purchased and, if so, should review the policies to determine what claims would be covered.⁶⁰

⁵⁹ See Comment, *Keeping Employees' Trust: The Rocky Road Ahead for Pension Plan Trustees*, 37 J. MARSHALL L. REV. 903 (2004) (advocating that ERISA should require that trustees possess information regarding their duties as fiduciaries and should have minimal investment knowledge that would enable them to oversee plan assets and investment advisors).

⁶⁰ Plan sponsors should also review the plan documents to ensure that appropriate language providing for indemnification by the employer or a fiduciary liability insurer is included, to the extent permitted by ERISA. As a cautionary tale, it would appear prudent for plan sponsors to note the example of the proposed WorldCom settlement in which outside directors of the corporation would have settled for \$54 million, including \$18 million from their personal assets. See Gretchen Morgenson, *A WorldCom Settlement Falls Apart*, N.Y. TIMES, Feb. 3, 2005, at C1, available at 2005 WLNR 1474917; see also Jonathan Weil, *WorldCom's Directors Pony Up*, WALL ST. J., Jan. 6, 2005, at A3, available at 2005 WL-WSJ 59836981.

E. Overriding the Plan Documents

Fiduciaries are required to follow plan terms only “insofar as such documents and instruments are consistent with the provisions of [ERISA's fiduciary duties].”⁶¹ Thus, if a plan document would require action that is not solely in the interest of the plan participants and beneficiaries or that is imprudent, ERISA compels the fiduciary to ignore the requirement.

An ESOP's investment in employer stock is entitled to a presumption of prudence. That presumption may be rebutted by showing that the plan fiduciaries “could not have believed reasonably that continued adherence to the ESOP's direction was in keeping with the settlor's expectations of how a prudent trustee would operate.”⁶² To prevail on a fiduciary claim under that standard, a plan participant would have to establish that, under the circumstances, continued investment in employer stock constituted an “abuse of discretion.”⁶³

Recent employer stock litigation has challenged the courts — and plan sponsors and fiduciaries — to apply those standards in practice. The standards, however, are not readily susceptible to precise or practical application. Although some point exists after which it becomes imprudent to continue to invest in company stock, precisely where that point lies is unknown.

In the Committee's view, the present position of plan fiduciaries that oversee investments in company stock is untenable. According to the employer stock complaints and the *Moench* line of cases, fiduciaries must override the plan terms where it would be “imprudent” to follow them (with the precise boundaries of imprudence being difficult or impossible to determine

⁶¹ ERISA § 404(a)(1)(D); 29 U.S.C.A. § 1104(a)(1)(D).

⁶² See *Moench v. Robertson*, 62 F.3d 553, 571 (3d Cir. 1995).

⁶³ *Id.*; accord *Kuper v. Iovenko*, 66 F.3d 1447, 1459 (6th Cir. 1995); *In re AEP ERISA Litig.*, 327 F. Supp. 2d 812, 2004 WL 1776001, *9 (S.D. Ohio Aug. 10, 2004).

objectively).⁶⁴ Yet, ERISA fiduciaries may also be held liable for *failing* to follow the plan's terms.⁶⁵ For example, consider what would happen if the plan sponsor's stock price declines, the plan fiduciary does not invest in company stock as required, and then the company's share prices rebound. The fiduciary could be sued for having breached the plan's investment instructions, having failed to take advantage of the opportunity to obtain company stock at a low price, and having foregone the value of the subsequent increase in share prices.⁶⁶

The Committee believes that plan participants and beneficiaries would be better protected if plan fiduciaries were given clear judicial or regulatory clear standards for determining when it is necessary to override the plan's directions on investment in employer stock. In the case of ESOPs, such standards should be highly deferential to the continuation of plan investments in employer stock. In this connection, the Committee agrees with the suggestion of some courts that fiduciaries cannot be held liable for maintaining holdings in company stock when, as an objective matter, the company did not go bankrupt and the securities in question remained investment-worthy.⁶⁷ However, if the employer's securities are no longer investment-worthy

⁶⁴ See *Moench v. Robertson*, 62 F.3d 553, 567 (3d Cir. 1995); *In re McKesson HBOC, Inc. ERISA Litigation*, No. C00-20030, 2002 U.S. Dist. LEXIS 19473, 2002 WL 31431588, *4–6 (N.D. Cal. Sep 30, 2002); *In re Sprint Corp. ERISA Litigation*, 2004 U.S. Dist. LEXIS 19125, *10, (D. Kan. May 27, 2004); *In re Ikon Office Solutions, Inc. Securities Litigation*, 86 F.Supp.2d 481, 492 (E.D. Pa. Mar 01, 2000).

⁶⁵ ERISA §404(a)(1)(D), 29 U.S.C.A. §1104(a)(1)(D); see *Moench*, 62 F.3d at 571–72.

⁶⁶ See, e.g., *Tatum v. R.J. Reynolds Tobacco Co.*, 392 F.3d 636, 639–40 (4th Cir. 2004) (employee stated valid claim that plan fiduciaries breached standard of care under ERISA in sale of assets in predecessor fund); *Schoenholtz v. Doniger*, 657 F. Supp. 899, 909 (S.D.N.Y. 1987) (ERISA fiduciaries found liable for failure to invest 100 percent of plan funds in employer securities in accordance with provisions of the plan).

⁶⁷ *Lalonde v. Textron, Inc.*, 270 F. Supp. 2d 272, 280 (D. R.I. Jun. 24, 2003) (court found shares not "unsuitable for investment" as a matter of law), *rev'd*, 369 F.3d 1 (1st Cir. 2004); *In re Calpine Corp. ERISA Litig.*, No. C-03-1685, 2005 U.S. Dist. LEXIS 9719, *17, 2005 WL 1431506, *5 (N.D. Cal. Mar. 31, 2005) (company showed steady revenue and was profitable each year from 1998-2003; financial statements demonstrated that company "was a viable concern throughout the alleged class period and was not in the sort of deteriorating financial circumstances that must be pled to rebut the presumption of prudence"); *In re Duke Energy Corp. Securities & "ERISA" Litigation*, 281 F. Supp. 2d 786, 794–95 (W.D.N.C. Jun. 23, 2003) (company did not face "dire circumstances" or "impending collapse"); *Wright v. Oregon Metallurgical Corp.*, 360 F.3d 1090, 1099 (9th Cir. 2004) (company was "far from the sort of deteriorating financial circumstances involved in *Moench* and was, in fact, profitable and paying substantial dividends throughout that period"); *Steinman v. Hicks*, 252 F. Supp.2d 746,

(for example, due to bankruptcy), the plan fiduciaries may be liable for failing to prevent the loss of value to the plan by divesting the plan of employer stock.⁶⁸

F. Failure-to-Disclose Claims and the Securities Laws

Courts are divided over how to treat allegations that plan fiduciaries who also serve as corporate officers should have used inside information to sell, or at least not expand, the plan's holdings of employer stock, and should have disclosed the company's true circumstances to plan participants.⁶⁹

Some courts have held that the securities laws can be harmonized with ERISA's fiduciary duties. For example, in *Enron*, the court held that the two statutes should be construed together and that tension between the two may be resolved by eliminating employer stock from the plans or disclosing inside information to the public.⁷⁰ Other courts have held that ERISA does not

759 (C.D. Ill. 2003) (defendants showed company was “financially solid”); *but see* *Rogers v. Baxter International, Inc.*, ___ F. Supp. 2d ___, 2006 WL 488694, *11 (N.D. Ill. Feb. 22, 2006) (stating that “case authority running contrary to the defendants’ position [that recovery of stock value showed investment was not imprudent] is substantial”).

⁶⁸ *But see* *In re Reliant Energy ERISA Litig.*, 2006 WL 148898, *3 (S.D. Tex. Jan. 18, 2006) (granting summary judgment to defendants; holding that where plan left fiduciaries with “no discretion” by requiring that company stock fund be offered and limiting company stock fund’s cash reserve, fiduciaries could not have deleted company stock fund or shifted employer matching funds elsewhere); *compare* *DiFelice v. Fiduciary Counselors, Inc.*, 398 F. Supp. 2d 453, 488-89 (E.D. Va. 2005) (granting motion to dismiss; fiduciary acted prudently to mitigate risks to plan of potential bankruptcy filing by directing trustee to cease purchasing shares of plan sponsor on open market and by gradually increasing percentage of cash in company stock fund, even though company stock fund was retained as plan investment and plan sponsor ultimately filed for bankruptcy).

⁶⁹ *Compare, e.g.*, *In re McKesson HBOC ERISA Litig.*, No. C00-20030, 2002 U.S. Dist. LEXIS 19473, *20-24, 2002 WL 31431588, *6-8 (N.D. Cal. Sept. 30, 2002) (plan fiduciaries have no duty to violate securities laws by engaging in insider trading) *and* *Hull v. Policy Management Systems Corp.*, No. 3:00-778-17, 2001 U.S. Dist. LEXIS 22343, 2001 WL 1836286, *8-9 (D. S.C. Feb. 9, 2001) *with* *In re Enron Corp. Sec., Deriv. & "ERISA" Litig.*, 284 F. Supp. 2d 511, 559-67 (S.D. Tex. 2003) (non-disclosure of material, negative non-public information by fiduciary would breach duties under both ERISA and securities laws); *In re WorldCom, Inc. ERISA Litig.*, 263 F.Supp.2d 745, 765-66 (S.D.N.Y. 2003) (ERISA fiduciary may not knowingly present plan participants with false information, even when such information concerns company stock); *and* *Rogers*, 2006 WL 488694, at *12 (noting judicial criticism of *McKesson*); *see also* *Pennsylvania Federation v. Norfolk Southern Corp. Thoroughbred Retirement Investment Plan*, No. 02-9049, 2004 U.S. Dist. LEXIS 1987, *17, 2004 WL 228685, *5 (E.D. Pa. Feb. 4, 2004) (fiduciaries need not disclose non-public information based on their superior inside knowledge, unless this information concerns fraud).

⁷⁰ *In re Enron Corp. Sec., Deriv. & "ERISA" Litig.*, 284 F. Supp. 2d 511 (S.D. Tex. Sept. 30, 2003); *see also* *In re Xcel Energy, Inc., Sec., Deriv. & "ERISA" Litig.*, MDL No. 1511 (D. Minn. Mar. 10, 2004) (citing *Enron*, the court stated that the securities laws do not shield from ERISA violations).

create a duty to use non-public information solely for the benefit of plan participants in violation of otherwise-applicable federal securities law restrictions on insider trading.⁷¹ With respect to the disclosure of inside information to the general public, some courts in the latter group have observed that such disclosures would not benefit the plan participants, since the share price would be swiftly corrected by the market.⁷²

These issues cannot be easily resolved. The Committee notes, however, that there has been a growing trend toward appointing, as ERISA plan committee members, corporate employees below the top executive level. These fiduciaries may be appointed individually, or they may be identified by title in plan documents (for example, “Assistant Vice President, Benefits”). By assigning ERISA fiduciary duties to lower-level employees, corporations can reduce the chance that fiduciaries will possess material non-public information. On the other hand, the plans sponsored by such companies may lose the vision, leadership and ability of higher-level employees because they “know too much” to be ERISA fiduciaries.

In certain instances, it may be appropriate for fiduciaries to recuse themselves or resign when faced with the possibility of obtaining material inside information from elsewhere in the company. Such fiduciaries should be permitted and encouraged to remove themselves promptly from a conflicted situation, without incurring potential liability as a result.

G. Directed Trustee Liability

As described above, a directed trustee generally is a person or entity who has custody of plan assets but has no discretionary authority over the disposition or management of those

⁷¹ See e.g., *In re McKesson HBOC ERISA Litig.*, No. C00-20030, 2002 U.S. Dist. LEXIS 19473, 2002 WL 31431588 (N.D. Cal. Sept. 30, 2002) (no duty to violate the securities laws by engaging in insider trading); *Hull v. Policy Management Systems Corp.*, No. 3:00-778-17, 2001 U.S. Dist. LEXIS 22343, 2001 WL 1836286, *8 (D. S.C. Feb. 9, 2001); *Pennsylvania Federation v. Norfolk Southern Corp. Thoroughbred Retirement Investment Plan*, No. 02-9049, 2004 U.S. Dist. LEXIS 1987, 2004 WL 228685 (E.D. Pa. Feb. 4, 2004) (fiduciaries need not disclose non-public information based on their superior inside knowledge, unless this information concerns fraud).

⁷² *See id.*

assets.⁷³ The directed trustee acts on the specific directions of a plan's fiduciary, or may be instructed by the fiduciary to follow the directions of others (such as plan participants). Directed trustees are ERISA fiduciaries.⁷⁴ Directed trustees are utilized to assist the named fiduciaries of a plan in carrying out their investment decisions in a manner that complies with the plan's requirements. For example, a brokerage firm as directed trustee will actually buy or sell the securities on behalf of the plans' beneficiaries as instructed by the plans' fiduciaries.

As noted above, in some employer stock cases, plan participants have sued directed trustees for failing to act on their own initiative to divest the plans of employer stock, even when such action would breach instructions previously received by the directed trustees. Under ERISA, directed trustees are not liable for actions performed pursuant to the named fiduciary's instructions if such instructions are "proper," "in accordance with the terms of the plan" and "not contrary to" ERISA.⁷⁵ Of course, an instruction to act in a way that the directed trustee knows or ought to know is imprudent would violate the trustee's fiduciary duties under ERISA.⁷⁶ Therefore, some federal courts have denied directed trustees' motions to dismiss the fiduciary claims against them. These courts reason that the directed trustees may have a responsibility to act without instructions, or contrary to instructions, if it appears that the plan's investment in company stock would violate ERISA's prudence standard.

In *Enron*,⁷⁷ plaintiffs were held to state a viable claim when they alleged, with factual support, "that the directed trustee knew or should have known from a number of significant waving red flags and/or regular reviews of the company's financial statements that the employer

⁷³ ERISA § 403(a)(1), 29 U.S.C. § 1103(a)(1).

⁷⁴ See *In re WorldCom, Inc. ERISA Litig.*, 263 F. Supp.2d 745, 761–62 (S.D.N.Y. 2003); *Wright v. Oregon Metallurgical Corp.*, 360 F.3d 1090, 11102 (9th Cir. 2004).

⁷⁵ ERISA § 404(a)(1), 29 U.S.C.A. § 1104(a)(1).

⁷⁶ *In re WorldCom, Inc. ERISA Litig.*, 354 F. Supp. 2d 423, 2005 WL 221263, *17 (S.D.N.Y. Feb. 1, 2005).

⁷⁷ *In re Enron Corp. Sec., Deriv. & "ERISA" Litig.*, 284 F. Supp. 2d 511 (S.D. Tex. 2003).

company was in financial danger and its stock greatly diminished in value, yet the named fiduciary, to which the plan allocated all control over investments by the plan, directed the trustee to continue purchasing the employer's stock."⁷⁸ According to the *Enron* court, depending on the facts, ERISA may impose on the directed trustee "a fiduciary duty ... to investigate the advisability of purchasing the company stock."⁷⁹

The *Enron* court rejected the argument of the American Bankers Association as *amicus*, which contended that, based on ERISA's legislative history, the directed trustee is required only to determine whether the directed action facially complies with the terms of the plan and ERISA.⁸⁰ Instead, the *Enron* court adopted the position of the DOL, also appearing as an *amicus*, that "[a] directed trustee should not follow the named fiduciary's directions if he 'knows or should know' that the directions violate ERISA's fiduciary duties of prudence."⁸¹

The DOL has issued a Field Assistance Bulletin discussing the fiduciary responsibilities of a directed trustee.⁸² According to the DOL Bulletin, a directed trustee should not follow instructions from the plan fiduciary that conflict with ERISA or the plan's terms.⁸³ Similar to any other fiduciary, a directed trustee must exercise its duties prudently and solely in the interest of the plan participants and beneficiaries. In the context of purchasing, selling or holding publicly traded securities, the trustee in most instances may follow the named fiduciary's order

⁷⁸ *Id.* at 601.

⁷⁹ *Id.* at 601–02.

⁸⁰ See H.R. Conf. Rep. No. 93-1280 (1973), reprinted in 1974 U.S.C.C.A.N. 5038, 5079; *Enron* at 585.

⁸¹ *Enron* at 600.

⁸² U.S. Dept. of Labor, Fiduciary Responsibilities of Directed Trustees, Field Assistance Bulletin No. 2004-3 (Dec. 17, 2004) available at <http://www.dol.gov/ebsa/pdf/fab-2004-3.pdf>.

⁸³ *Id.* at 3; see also *DiFelice v. US Airways, Inc.*, 397 F. Supp. 2d 735, 751-53 & n.25 (E.D. Va. 2005) (granting directed trustee's motion to dismiss and endorsing approach of DOL Field Assistance Bulletin).

without further inquiry.⁸⁴ Referring to the decisions in *Enron* and *WorldCom*, the DOL Bulletin states that violations may occur where a directed trustee: (1) buys an investment that is contrary to the plan's investment policy; (2) follows an order that causes the plan to engage in a recognized prohibited transaction; (3) buys the company's own stock despite being aware of non-public information indicating that the company's public financial statements contain material misrepresentations; or (4) buys the company's own stock despite SEC or bankruptcy filings that call the company's viability into serious question.⁸⁵

Other recent cases have held, in denying motions to dismiss, that the directed trustee may be liable for following directions to purchase or hold employer stock under the "knew or should have known" standard.⁸⁶ Granting summary judgment to a directed trustee, the federal district court in the *WorldCom* litigation adopted a "brink of collapse" standard: the directed trustee may be liable for breach of fiduciary duty if it fails to override directions to invest in employer stock at a time when it knows or ought to know of "reliable public information that calls into question the company's short term viability as a going concern."⁸⁷ Under that standard, for a "fiduciary duty of inquiry" to arise, a directed trustee's knowledge must encompass more than mere facts about declining stock prices and profits, a corporate restructuring, or a government investigation (including an investigation into the reliability of the plan sponsor's financial statements), or the filing of private lawsuits.⁸⁸ However, "[s]uch a duty *may* arise when formal civil or criminal

⁸⁴ *Id.* at 5.

⁸⁵ *Id.* at 3-6.

⁸⁶ See *Kling v. Fidelity Mgmt. Trust Co.*, 270 F. Supp. 2d 121, *modified on other grounds* 291 F. Supp. 2d 1 (D. Mass. 2003); *In re WorldCom, Inc. ERISA Litig.*, 263 F. Supp. 2d 745 (S.D.N.Y. 2003); *Beam v. HSBC Bank USA*, No. 02-CV-0682E(F), 2004 U.S. Dist. LEXIS 15744, 2003 WL 22087589 (W.D.N.Y. Aug. 19, 2003).

⁸⁷ *In re WorldCom, Inc. ERISA Litig.*, 354 F. Supp. 2d 423, 2005 WL 221263, at *23-24 (S.D.N.Y. Feb. 1, 2005).

⁸⁸ *Id.* at *23.

charges have been filed by government bodies, depending on the nature of the formal charges.”⁸⁹

Financial institutions that act as directed trustees have no clear and unified standard to apply under the evolving case law and DOL guidance. While the Committee believes that the *WorldCom* decision moves the law in a positive direction, the existing case law viewed as a whole imposes on directed trustees a monitoring obligation that is undefined and amorphous, and may increase the administrative costs of plans. When "should" directed trustees know that the plan sponsor is in financial trouble, and how can they tell if such trouble is transient or permanent? What steps "should" they take to make such a determination? It seems unlikely that financial institutions will continue to perform the highly circumscribed role of directed trustee if it involves taking on such risks. The Committee believes that plans, participants and beneficiaries will all benefit from retaining reputable and responsible institutions to act as directed trustees. Therefore, the Committee believes that some legislative relief is warranted — either in the form of an express return to the "clear on its face" standard, or amendment of the "knew or should have known" standard to require actual knowledge as a condition of liability.

Conclusion

The employer stock litigation highlights a tension within ERISA: Can employee stock ownership be encouraged while simultaneously protecting the plan participants' retirement benefits? The tension is not easily resolved, but it may be reduced. The Committee believes that implementation of the "best practices" described in this Report, and the adoption of certain legislative and regulatory solutions identified herein, would resolve some of the difficult issues facing federal courts confronted with these lawsuits. More fundamentally, the Committee believes that legislators, as well as plan sponsors, fiduciaries and counsel, should adopt the

⁸⁹ *Id.* (emphasis added).

measures recommended above and similar initiatives to encourage the most qualified individuals to become involved in plan governance, to encourage the most qualified institutions to serve as directed trustees, and to encourage prudent investments in employer stock by EIAPs.

April 2006

**Dissent to Report of Employee Benefits Committee Entitled
Employer Stock Litigation: The Tension
Between ERISA Fiduciary Obligations
and Employee Stock Ownership**

The Report does an excellent job setting forth the tension between ERISA Fiduciary Obligations and Employee Stock Ownership by pension plans covered by ERISA. The Report also suggests a number of best practices, which if adopted by plan sponsors and fiduciaries will help the fiduciaries to improve plan operations and reduce much of this tension. My dissent is addressed to the proposed legal changes, which would reduce fiduciary responsibilities and thus the protections of ERISA pension benefits.

ERISA fiduciary responsibilities should continue to be based on what the fiduciaries should have known as well as what they actually knew. In general, “a pure heart and an empty head are not enough” to meet fiduciary responsibilities. Donovan v. Cunningham, 716 F.2d 1455 (5th Cir. 1983). Thus, ERISA and the regulations should continue to require institutions that wish to act as directed trustees for ERISA pension plans to decide prudently whether to follow instructions to purchase company stock. Prudent fiduciaries engage in sufficient due diligence to acquire the knowledge they need to fulfill their duties..

It is advisable for the Department of Labor to promulgate “standards of conduct that are both flexible and comprehensible” for (1) corporate directors to monitor the performance of the plan fiduciaries they name; (2) plan fiduciaries to monitor the plan investments in employer stock. Those standards should alert the fiduciaries to tools that they may use to determine the prudence of continuing such fiduciaries or such plan investments. Fiduciaries should not be relieved of the very demanding ERISA

requirement that they act prudently as the report proposes to do by suggesting that the new standards be safe harbors.