FIDUCIARY ISSUES

IN

ERISA-COVERED PLANS

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I. FIDUCIARY STATUS

A. DEFINITION OF A "FIDUCIARY"

1. Employee Retirement Income Security Act of 1974 ("ERISA") includes a code of conduct for individuals known as fiduciaries. The primary purpose for identifying fiduciaries is to determine who has responsibility and liability for each aspect of plan administration and management. Under ERISA § 3(21), a fiduciary includes any person who -

   a. Exercises discretionary authority or control with respect to the management of a plan,

   b. Exercises any authority or control respecting management or disposition of plan assets,

   c. Has discretionary authority or responsibility in the administration of the plan, or

   d. Provides investment advice for a direct or indirect fee with respect to money or property of the plan. 29 C.F.R. 2510.3-21(c).

2. <u>Named Fiduciaries</u>: Every plan must have at least one "named fiduciary" and a plan administrator. The named fiduciary is a person designated in the plan document as having the "authority to control and manage the operation and administration of the plan." ERISA § 402(a)(1). Those plans subject to ERISA's trust requirement must also have a trustee. ERISA § 403(a).

3. <u>Investment Managers</u>: It is in the interest of the fiduciary Committee to appoint managers who qualify as "investment managers" under ERISA. If the Committee appoints an "investment manager," it is no longer responsible for the management of the assets and is not liable for the manager's breaches. The Committee does retain the duty to monitor the manager. ERISA §§ 3(38), 402(c)(3), 405(d)(1).

   a. Make sure that the manager acknowledges in writing that it is a fiduciary.

   b. To qualify as an "investment manager," a manager must be a bank, insurance company or registered investment adviser.

c. Make sure that the entity appointed as investment manager is the entity actually managing the assets -- to preserve the Committee's delegation of responsibility and to preserve the Qualified Professional Asset Manager exemption.

4. Functional Fiduciaries: While the named fiduciary, plan administrator and trustee are clearly fiduciary roles, any other person who exercises the authority or responsibility described in the fiduciary definition will be a fiduciary, whether or not he knowingly accepts that responsibility.

5. Fiduciary Role in Participant-Directed Plans: It is the Department of Labor's ("DOL") view that the selection of the plan's investment options, including employer stock (whether or not identified in the plan document) is a fiduciary act. Preamble to DOL Reg. § 2550.404c-1, 57 Fed.Reg. 46906, 46924, note 27.

6. Investment Advice vs. Education Advice: A person is considered a fiduciary with respect to a plan to the extent that person "renders investment advice for a fee or other compensation" with respect to the plan's assets. ERISA § 3(21)(A)(ii).

a. Under DOL regulations, a person will be deemed to be providing "investment advice" if (a) he renders advice to the plan as to the value of securities or other property or makes recommendations as the advisability of investing in, purchasing, or selling securities or other property, (b) the advice is individualized, (c) the advice is provided on a regular basis, (d) pursuant to a mutual agreement, arrangement or understanding that such services will serve as the primary basis for investment decisions, and (e) for direct or indirect compensation. Interpretive Bulletin 96-1 ("IB") provides guidance on when certain types of investment education will constitute investment advice. 29 C.F.R. § 2510.3-21(c).

b. The IB says a plan fiduciary/sponsor can provide or arrange for participant education and neither advisor nor employer will be a fiduciary. Furnishing of the following categories of information does not constitute rendering of "investment advice":

i. plan information (including information on investment alternatives under the plan, descriptions of investment objectives, risk and return characteristics, historical return information, etc.);

ii. general financial and investment information;

iii. asset allocation models available to all plan participants; and

iv. interactive investment materials (such as questionnaires, worksheets, software that helps participants to estimate future retirement income needs and assess the impact of different asset allocations on retirement income).

c. The IB indicates that the designation of an educator or advisor for a plan is the selection of a service provider, subject to fiduciary rules and co-fiduciary liability. IB 96-1.

d. Where a participant chooses the provider without limitation by the plan or employer, the employer/fiduciary is not responsible or liable for the provider selection or advice, so long as the employer does not "endorse" the provider or "otherwise make arrangement with the [provider] to provide the services." IB 96-1.

B. "PLAN ASSETS"

1. A fiduciary's liability under ERISA generally flows from his responsibility with respect to plan assets (or administration). DOL has indicated that when a plan invests in the following entities, the plan's assets include its interest in the entity (e.g., a share or a unit) but not the underlying assets owned by the entity:

a. a registered investment company (e.g., mutual fund shares), ERISA § 401(b)(1);

b. a "guaranteed benefit policy" issued by an insurance company, ERISA § 401(b)(2);

c. a registered security that is widely held and freely transferable, 29 C.F.R. § 2510.3-101(a)(2);

d. an entity in which "benefit plan investors" hold less than 25% of the equity interests, id.;

e. an "operating company" engaged in the production or sale of a product or service other than the investment of capital, id.;

f. a "real estate operating company" or REOC (which actively manages and develops real estate in accordance with DOL regs), id.;

g. a "venture capital operating company" or VCOC (which activity manages "venture capital investments" in accordance with DOL regs), id.

2. Where the plan invests in an entity that does not hold plan assets, the decision to invest in the entity will be subject to the fiduciary rules, but the transactions of the entity generally will not be. For example, if a plan invests in a partnership that is a real estate operating company, the partnership may buy property from parties in interest and pay incentive compensation to the general partner, transactions that might violate ERISA if they involved plan assets.

II. GENERAL FIDUCIARY DUTIES

A. DUTY OF LOYALTY

1. A fiduciary must discharge his duties "solely in the interest of the plan's participants and beneficiaries" and "for the exclusive purpose" of providing benefits and defraying reasonable expenses of administration. ERISA § 404(a)(1)(A). This rule is based on the common law trust duty of undivided loyalty.

2. A fiduciary does not violate this duty of loyalty if his actions incidentally benefit the fiduciary or another party so long as the actions are taken solely with the interests of the participants and beneficiaries in mind. Donovan v. Bierwirth, 680 F.2d 263 (2d Cir. 1982), cert. denied 459 U.S. 1069 (1982).

B. DUTY OF PRUDENCE

1. Prudent Professional Standard: A fiduciary must discharge his 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 in the conduct of an enterprise of a like character and with like aims." ERISA § 404(a)(1)(B).

a. The investing fiduciary will be held to the standard not of a prudent layman, but of a prudent investment professional. Whitfield v. Cohen, 682 F.Supp. 188, 194 (S.D.N.Y. 1988); Marshall v. Snyder, 1 EBC 1878 (E.D.N.Y. 1979).

b. "A pure heart and an empty head are not an acceptable substitute for proper analysis." Donovan v. Cunningham, 716 F.2d 1445 (5th Cir. 1987).

2. Consideration of Relevant Facts: In the investment context, the prudence requirement is satisfied if the fiduciary has given "appropriate consideration" to facts and circumstances that the fiduciary knows, or should know, are relevant to the particular investment or investment course of action, including the role that the investment plays in the plan's investment portfolio, and has acted accordingly. 29 C.F.R. § 2550.404a1(b)(1).

   a. "Appropriate consideration" by a fiduciary requires him to determine that an investment is reasonably designed, as part of the plan's portfolio, to further the purposes of the plan, taking into consideration the risk of loss, the opportunity for gain, the extent of the portfolio's diversification, the portfolio's liquidity and the investment's projected return. 29 C.F.R. § 2550.404a-1(b)(2).

   b. No particular investment or course of investment is per se imprudent under ERISA. Preamble to ERISA Section 404 Regulation, 44 Fed. Reg. 37221, 37225 (June 26, 1979). Prudence is determined based on an analysis of all the facts and circumstances, including the role that the investment plays in the portfolio. An investment will not be deemed imprudent merely because, standing alone, it has a relatively high degree of risk. Preamble at 37244.

3. No Guarantee of Success Required: The fiduciary is not the "guarantor" of the success of his investments. Whether it has any liability for investment losses will depend on whether it has employed appropriate methods to investigate the merits of the investment. Donovan v. Mazzola, 4 EBC 1865 (9th Cir. 1983); Donovan v. Cunningham, 716 F.2d 1455 (5th Cir. 1983). To establish that he has acted prudently in making an investment decision, a fiduciary should take AND DOCUMENT such steps as:

   a. Conducting an impartial study of the advantages and disadvantages of the transaction;

   b. Exercising due diligence in researching all aspects of the transaction;

c. Utilizing industry standards in retaining qualified experts and consultants;[1] and

d. Relying on complete and up-to-date information.

4. Prudent Selection of Investment Funds: The selection of investment funds offered under a participant-directed plan is likely to be a fiduciary act, subject to all of the fiduciary duties, including prudence. See Preamble to DOL Regs. 29 C.F.R. 2550, 57 FR 46906, 46924 n. 27.

5. Investment Policy Statements: While a statement of investment policy is not specifically required by ERISA, DOL believes that these statements serve a legitimate purpose by helping to ensure that investments are made in a rational manner and are designed to further the purposes of the plan and its funding policy.[2] The investment policy should take into account the plan's liquidity, funding policy and diversification. By including a proxy voting policy in the policy statement, the plan fiduciary can help ensure that proxy voting decisions are consistent with other aspects of the investment policy. DOL Interpretive Bulletin 94-2 (July 9, 1994).

C. DUTY OF DIVERSIFICATION

1. A fiduciary must diversify the plan's investments "so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so." ERISA § 404(a)(1)(C).

2. ERISA's legislative history indicates that a fiduciary should not invest an "unreasonably large percentage" of plan assets in a "single security," in "one type of security," or in "various types of securities that are dependent upon success of one enterprise or upon conditions in one locality." ERISA Conference Report at 304.

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[1] The trend in fiduciary investing is to encourage, if not require, fiduciaries to seek sophisticated expert advice. Under ERISA, if fiduciaries of a plan do not possess skills necessary to conduct adequate investigation of particular investments or investment courses of action, they are required to seek outside assistance. In light of the development of a variety of sophisticated and innovative investments, ERISA's encouragement of reliance on expert advice has promoted responsible fiduciary practices. See e.g., Liss v. Smith, 991 F.Supp. 278, 297 (S.D.N.Y. 1998); Harley v. Minnesota Mining and Manufacturing Co., 42 F.Supp.2d 898, 907 (D.Minn. 1999); Bevel, III v. Higginbottom, 2001 WL 1352896, *16-17 (E.D.Okla. 2001).

[2] Every plan must have a funding policy to enable plan fiduciaries to determine the plan's short- and long-term financial needs and communicate these to appropriate persons. ERISA § 402(b)(1).

3. Some courts have found non-diversification to be "clearly prudent" under certain circumstances.

   Reich v. King: Plan's investment of 70% of its assets in residential mortgages in a single county was "clearly prudent" because banker with knowledge of local real estate market testified as expert that mortgages were low risk, had 5 year balloon features and were marketable. 18 EBC 2799 (D. Md. 1994).

4. Diversification and Employee Stock Ownership Plans ("ESOPs"): Fiduciaries of ESOPs are exempt from the duty to diversify. 29 U.S.C. § 1104(a)(2); Moench v. Robertson, 62 F.3d 553, 568 (3rd Cir. 1995).

5. Diversification & Participant-Directed Plans: Although the fiduciary of a 404(c) plan will not be liable for a participant's decisions with respect to diversification, to qualify as a 404(c) plan, a plan must allow participants to choose from at least three diversified categories of investments. The self-directed investment choices must allow participants to sufficiently diversify his or her account to minimize investment losses. See discussion in sections IV. A, B.

D. DUTY TO FOLLOW THE PLAN DOCUMENTS

1. A fiduciary must discharge his duties "in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions" of ERISA. ERISA § 406(a)(1)(D).

   a. These documents include the plan's investment management agreements and any investment guidelines. Dardaganis v. Grace Capital, Inc., 8 EBC 1939 (S.D.N.Y. 1987) affd, 11 EBC 2081 (2d Cir. 1989).

   b. A fiduciary must decline to follow the plan document if the direction contained in the document is inconsistent with ERISA. A trustee can insure that directions are proper and not contrary to ERISA if (1) it follows procedures to ensure that the plan's provisions are fairly implemented, that participants have not been subjected to coercion or undue pressure in making their decisions, that necessary information is provided to participants, that clearly false information is not disseminated, and (2) it determines that following the direction would not violate ERISA. See DOL Info. Ltr. to Ian D. Lanoff (Sept. 28, 1995).

2. The plan sponsor must ensure that plan and trust documents accurately reflect current investment practices.

a. If the plan and not the plan sponsor will pay the expenses of managing plan assets, e.g., investment management and transaction fees, the plan document should authorize (or at least not prohibit) the plan's payment of expenses generally.

III. PROHIBITED TRANSACTIONS

A. PARTY IN INTEREST TRANSACTIONS

1. ERISA § 406(a) absolutely prohibits certain categories of transactions between a plan and a "party in interest."

    a. If a plan engages in a prohibited transaction, the fiduciary causing the plan to engage in the transaction will be liable to the plan for any losses. The transaction may also be rescinded and any profits of the fiduciary disgorged. ERISA § 409.

    b. If the plan is a qualified plan, the party in interest will be liable for excise taxes under IRC § 4975.[3] Parties in interest involved in transactions with welfare plans are subject to a similar civil penalty under ERISA § 502(i). The existence of these penalties create an incentive for parties in interest to confirm ERISA compliance.

2. Parties in Interest: Include any employer of or union representing covered employees, any service provider to the plan (e.g., recordkeepers, attorneys, actuaries, brokers), any fiduciary to the plan (e.g., investment managers, trustees, plan administrator), as well as a broad range of affiliates of each of these entities. ERISA § 3(14).

3. Prohibited Transactions: Absent an exemption, the following transactions are absolutely prohibited under ERISA § 406(a):

    a. A sale, exchange or lease of property between a plan and a party in interest.

[3] The excise tax is self-enforcing. If a party in interest determines that a prohibited transaction with respect to a pension plan has occurred, the tax is due without any assessment by the IRS. While the calculation of the excise tax can be complex, in general, the tax is 15% of the amount involved per year until the transaction is "corrected." Where the prohibited transaction involves services or other use of plan assets, the tax "pyramids," resulting in significantly higher taxes. IRC § 4975.

Example: The plan's purchase of stock from the employer in a private (non-exchange) transaction.[4]

b. A loan or other extension of credit between a plan and a party in interest.

Example: The plan recordkeeper's advance to a plan in order to affect daily securities transactions.[5]

Example: The plan's purchase of a bond issued by a provider of services to the plan or by the plan sponsor. A bond (even a publicly traded one) is considered an ongoing loan by the owner of the bond to the issuer.

c. The provision of services, goods or facilities between the plan and a party in interest.

Example: The plan's renewal of its contract with its recordkeeper is a prohibited provision of services by a party in interest. (Once the recordkeeper begins to provide services, it becomes a "party in interest." Thus, any renewal of a contract is the provision of services by a party in interest.)

d. The transfer of plan assets to a party in interest.

Example: The Plan makes a gratuitous payment to a plan service provider.

e. The use of plan assets by or for the benefit of a party in interest.

Example: The plan fiduciary causes the plan to purchase the plan sponsor's stock from an unrelated party in order to assist the plan sponsor in blocking a takeover attempt.

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[4] DOL has recognized that the purchase and sale of securities through an exchange (NYSE, etc.) should not involve a prohibited sale so long as the transaction is a "blind transaction," that is, because the transaction is through an exchange, the buyer and seller of the security are not aware of the identity of the other party. DOL Adv. Op. 92-23A (Oct. 27, 1992).

[5] A bank's provision of overdraft protection services to a plan may be exempt from the prohibited transaction rules, provided the bank complies with requirements of the DOL Advisory Opinion 2003-02A (Feb. 10, 2003).

B. PROHIBITED CONFLICTS OF INTEREST

In addition to transactions between the plan and "parties in interest," ERISA also prohibits self-dealing and other conflicts of interest by plan fiduciaries.

1. Self-Dealing: A fiduciary may not deal with the plan's assets in his own interest or for his own account. ERISA § 406(b)(1).

   a. DOL believes that a fiduciary should not even act in any transaction in which he has an interest that could affect his best judgment as a fiduciary. 29 C.F.R. § 2550.408b-2(e)(1).

      Example: Plan sponsor fiduciary chooses a custodian bank for the plan because the bank will provide, in exchange, advantageous banking arrangements for the sponsor's assets.

      Example: Sponsor fiduciary continues to offer employer stock as a plan option after it is no longer prudent to do so, in order to avoid negative publicity for the sponsor or to influence the stock price.

   b. Section 406(b)(1) also prohibits a fiduciary from exercising any discretion to affect the amount or timing of his fees. 29 C.F.R. § 2550.408b-2(e).

      Example: Bank custodian provides "sweep services" to the plan's employer stock fund. It transfers the fund's daily cash into a short term vehicle managed by the bank. If the bank has discretion to determine when the cash is swept, it can affect the amount of fees it receives for management of the short term income funds. DOL Adv. Op. 88-2 (Feb. 2, 1988).

   c. A fiduciary (such as the plan sponsor) may not hire itself or its affiliate to provide services to the plan UNLESS -

      i. it charges no fee, and any payment it receives is limited to reimbursement of its "direct expenses" in providing the service, ERISA § 408(c)(2), or

      ii. another exemption permitting a fee is available, e.g., ERISA §§ 408(b)(8), 408(b)(6).

2. Representing an Adverse Party: A fiduciary may not represent an adverse party in a transaction involving the plan.

Example: Absent an exemption, the plan sponsor may not represent both the corporation and the plan in negotiating an asset sale between the corporation and the plan. (Section 408(e) exempts certain transactions in employer securities.)

Example: An investment manager may not represent both the plan and another party in a "cross trade" between them.

3. Kickbacks: A fiduciary may not receive any consideration for his personal account from any party dealing with the plan in a transaction involving plan assets.

   Example: A consultant to a plan recommends that the plan invest in an insurance contract or mutual fund and, as a result, receives a commission from the insurance company or fund company.

   Example: A plan sponsor who invests plan assets with an investment manager may not receive a discount from that manager on other services provided to the company.

C. EMPLOYER SECURITIES AND REAL PROPERTY

ERISA §§ 406(a)(2) and 407 prohibit a plan from holding "employer securities" or "employer real property"[6] unless the securities and real property are "qualifying."[7] If the plan is not an individual account plan, no more than 10% of the plan assets are invested in employer securities and employer real property. (Most participant-directed plans are individual account plans and are therefore not subject to the 10% limit.). In addition, a plan may not purchase employer securities or real property from a party in interest, such as the employer, absent an exemption.

An exemption is provided by ERISA § 408(e) for a plan's purchase or sale of qualifying employer securities or qualifying employer real property if (a) no commission is charged, (b) the compensation is adequate, and (c) in the case of non-individual account plans, the 10% limit is observed.

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6 "Employer real property" is real property leased to the plan sponsor or an affiliate. Employer securities are securities issued by the plan sponsor or an affiliate. ERISA §§ 407(d)(1), (2).

7 "Qualifying employer securities" include stock, marketable obligations and certain limited partnership interests if immediately following the acquisition no more than 25% of the stock is held by the plan and at least 50% of the outstanding stock is held by persons independent of the issuer. "Qualifying real property" must be dispersed geographically and suitable for more than one use.

D. COMMON EXEMPTIONS

The following statutory or class exemptions issued by DOL provide relief for some common investment transactions of participant-directed defined contribution plans.[8] It is important to review each exemption carefully to determine whether it provides relief for Section 406(a), 406(b) violations, or both.

1. Provision of Services by a Party in Interest: A party in interest may provide (and be paid for) services to a plan if (i) the services are necessary for the operation of the plan, (ii) they are supplied under a reasonable arrangement (which includes the plan's right to terminate without penalty on reasonably short notice), and (iii) the plan pays no more than reasonable compensation. ERISA § 408(b)(2). This exemption does not provide relief for self-dealing (e.g., it does not allow a fiduciary to cause the plan to pay itself additional fees).

2. Interest-Free Loans: Prohibited Transaction Exemption 80-26 permits a party in interest, such as the plan sponsor, to make an interest-free, unsecured loan to (or guarantee the debt of) a plan. The loan proceeds may be used only for (i) payment of the ordinary operating expenses of the plan (including benefit payments), or (ii) for a term of three days, for purposes incidental to the operation of the plan.

3. Qualified Professional Asset Managers ("QPAM"): PTE 84-14, the QPAM exemption, generally permits most party in interest transactions that would otherwise be prohibited if, among other conditions, the assets involved in the transaction are managed by a QPAM. A QPAM is a bank, S&L or insurer meeting minimum capitalization requirements or a registered investment advisor with minimum capital and assets under management. This exemption provides no relief for self-dealing violations of § 406(b).

   "QPAM for a Day": The QPAM PTE is available only for those transactions that the QPAM negotiates and authorizes on behalf of the plan. A transaction negotiated by another fiduciary and merely approved by the QPAM may not be exempt.

4. Bank Collective Funds or Pooled Separate Accounts:

   a. Investment IN the Fund: ERISA § 408(b)(8) allows a plan to purchase units in a bank collective fund or pooled separate

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[8] DOL is authorized to promulgate both individual and "class" exemptions to the prohibited transaction rules of ERISA § 406.

account maintained by a party in interest bank or insurance company if certain conditions are met.

b. Investments BY the Fund: An insurance company pooled separate account or a bank collective fund in which plans invest is deemed to hold plan assets. Thus, in order to engage in transactions with parties in interest with respect to any investing plan, the account or fund must comply with PTE 90-1 or PTE 91-38. These PTEs do not exempt self-dealing violations by the managers of the account or fund.

5. Insurance Agents, Consultants and Mutual Fund Underwriters: PTE 84-24 provides relief for certain transactions with insurance companies, mutual fund underwriters, insurance agents and consultants. This exemption allows fiduciary salespersons to provide investment advice to plans and receive commissions on plan transactions if certain conditions are met. It also authorizes sales of insurance or mutual fund shares to plans by party in interest insurers or underwriters.

6. Investment Companies: PTE 77-4 provides relief for purchases and sales by a plan of shares of a registered, open-end investment company when a fiduciary with respect to the plan is also the investment adviser for the investment company (but is not an employer of employees covered by the plan), provided certain condition are met.

IV. SPECIAL ISSUES FOR PARTICIPANT-DIRECTED PLANS

A. SECTION 404(c)

1. Compliance with regulations under ERISA § 404(c) will relieve a plan fiduciary of responsibility for most of the investment decisions of plan participants who exercise control over assets in their defined contribution plan accounts.

2. In order to satisfy the requirements of Section 404(c), a plan must –

a. Offer a broad range of investment alternatives, including at least three alternatives that have different risk and return characteristics ("Core Alternatives");[9]

[9] Certain types of investment vehicles that restrict or prohibit direct transfers to Core Alternatives cannot themselves qualify as Core Alternatives. For example, if a group annuity contract ("GAC") were to preclude transfers from the GAC to a particular Core Alternative, the GAC could not serve as a Core Alternative, although it could be offered in addition to the three Core Alternatives.

b. Allow participants meaningful control over their accounts, including the right to direct transfers between Core Alternatives at least once per quarter;

c. Provide certain information to participants automatically, such as a description of the investment alternatives and any transaction fees, and copies of prospectuses; and

d. Provide other information upon request of the participant.

3. The fiduciary is not completely relieved of liability under a Section 404(c) plan.

a. The fiduciary is fully responsible and liable for prudent selection of the investment alternatives offered to plan participants;

b. Relief is not provided for certain participant transactions including:

i. any transaction inconsistent with the governing plan documents,

ii. any transaction that could jeopardize the tax status of the plan, and

iii. certain transactions with the plan sponsor.

B. EMPLOYER STOCK LITIGATION

1. A participant-directed plan may offer employer securities as one of the investment alternatives under the plan. In addition, the plan may provide for employer contributions to be made or invested in the employer securities (matching contributions, profit-sharing contributions, etc.).

2. Potential Claims Against Fiduciaries: Over the last several years, there has been increased litigation over losses suffered by participants who have invested in employer securities through their plans.[10] The claims made in these cases include the following:

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[10] To name a few: In re Worldcom, Inc., 354 F. Supp. 2d 423 (Feb. 1, 2005)(directed trustee summary judgment decision); Tittle v. Enron Corp., 284 F. Supp. 2d 511 (S.D.Tex. 2003); In re WorldCom, Inc., 263 F.Supp. 2d 745 (S.D.N.Y. 2003)(motion to dismiss decision); Rankin v. Rots, 278 F. Supp. 2d 853 (E.D. Mich. 2003) (Kmart); In re Williams, 271 F. Supp. 2d 1328 (N.D. Okla. 2003); Lalonde v. Textron, 369 F.3d 1 (1st Cir. 2004); Wright v. Oregon Metallurgical Corp., 360 F.3d

a. the fiduciaries knew or should have known of the company's problems before the stock price decline either by virtue of being corporate insiders or by conducting an investigation, and

b. the fiduciaries should have acted on that information by: (1) eliminating employer stock as an investment alternative; (2) disclosing truthful information about the company's condition to plan participants (even though such disclosures may be in violation of the insider trading prohibitions); (3) ceasing any stock contributions to the plan; or (4) divesting the plan of the employer stock.

3. Status of Cases: Some cases have settled or are in the process of being settled; many have survived on motions to dismiss. We should see some decisions on motions for summary judgment and trial decisions in the near future.

4. Lessons and Issues from the Employer Stock Cases:

a. Fiduciary duty to divest: Most employer stock cases have not yet focused on the important substantive issue – of when a fiduciary must terminate participant-directed plan's investment in employer stock. Cases suggest that even in the ESOP context holding of employer stock may no longer be presumed reasonable under some circumstances.

b. Procedural prudence vs. substantive prudence: In all the employer stock cases this far, the facts included fiduciaries who failed to take any action with respect to continued investment in the employer stock. The dicta in some cases suggests that procedural prudence - at least undertaking an investigation into the prudence of continued holding of the employer stock - may have minimized fiduciaries' exposure.

c. Significance of identifying fiduciaries and delineating fiduciary functions: When the plan document designates an investment fiduciary, the court is more likely to dismiss investment-related claims against the parties with no investment-related responsibilities under the documents or in practice.

1090 (9th Cir. 2004); Nelson v. IPALCO Enterprises, Inc., 2003 WL 402253 (S.D. Ind. 2003); In re Sprint Corp. ERISA Litigation, 2004 WL 1179371 (D. Kan. 2004); Hill v. BellSouth Corp., 313 F. Supp. 2d 1361 (N.D. Ga. 2004); Beauchem v. Rockford Products, 2003 WL 1562561 (N.D. Ill. 2003); In re Xcel Energy, Inc., Securities, Derivative & "ERISA" Litigation, 312 F. Supp. 2d 1165 (D.Minn. 2004).

Example: The plan authorizes the Board to appoint, retain, or remove members of the fiduciary administrative committee, which exercises investment authority. If there is no evidence that the Board exercised any authority beyond the allocated appointment responsibilities, the court is likely to dismiss the Board from the investment-based ERISA action (except if the complaint alleges a failure to monitor by the appointing fiduciaries).

d. Responsibilities of "appointing" fiduciaries. Historically, appointing fiduciaries have not been viewed as having substantial fiduciary exposure so long as they make appropriate appointments. However, many courts refused to dismiss appointing fiduciaries from the employer stock cases. The future court decisions are likely to provide more guidance on the duties of appointing fiduciaries.

e. General company statements to the public vs. company statements made to participants (including via distribution of SEC materials): When the plan documents incorporate SEC filings that contain misleading statements about the company's financial status, plan fiduciaries may be committing a fiduciary breach by distributing such information to participants. In re Worldcom, 263 F. Supp. 2d 745 (S.D.N.Y. June 17, 2003).

f. Insider trading securities laws vs. ERISA fiduciary obligations: Plaintiffs have alleged that fiduciaries who know of the company's true condition by virtue of being corporate insiders must divest the plan of any employer stock and must either eliminate the employer stock as an investment alternative or disclose such information to participants to discourage them from continued investment in the employer stock. The courts recognized that the proposed actions, even though they may be required by ERISA may violate the insider trading prohibitions of the securities laws. The courts have not yet resolved the conflict.

g. Individual liability: Members of the plan's administrative committee may be personally liable for their actions while on the committee.

h. Loss of 404(c) as a defense: A plan fiduciary cannot rely on section 404(c) as a defense when participants lack sufficient information about the company's financials.

i. <u>Following the terms of the plan as a defense</u>: Reliance on the terms of the plan mandating investment in the employer stock is not an absolute defense.

C. BLACKOUT PERIOD AND NOTICE REQUIREMENTS

1. Plan administrators must provide participants with at least 30 days written notice before a blackout period. ERISA section 101(i) (as amended by the Sarbanes-Oxley Act of 2002). Failure to provide the notice may result in up to $100 per day penalty for each participant. The DOL regulations contain a model notice for the plans' use.

2. <u>Blackout Period Defined</u>: any period for which the ability of a participant to direct assets, obtain distributions, or obtain loans, "which is otherwise available under the terms of such plan," is temporarily suspended for more than 3 consecutive business days.

3. The DOL regulations identify a number of situations which are not "blackout" periods requiring a notice, such as regularly scheduled suspensions, permanent restrictions, suspensions occurring by reason of a QDRO, etc.

4. Less than 30 day's notice may be provided: (a) if the deferral of the blackout period would result in a violation of the exclusive purpose and prudence rules in ERISA section 404(a); (b) if there exist unforeseeable events that are beyond the plan administrator's "reasonable control," or (c) for certain mergers and acquisitions. <u>Note</u>: In all three of these exceptions, notice of the blackout period still must be furnished as soon as reasonably possible under the circumstances, but no notice is required if providing notice before the termination of the blackout period would be impracticable.

5. In the event of changes to the blackout period, the plan administrator must provide participants with an updated notice identifying all material changes in the information in the original notice. The updated notice must be provided as soon as reasonably possible.

D. BROKERAGE OR MUTUAL FUND WINDOWS

1. All participant-directed plans permit participants to choose among a group of investment options selected by the plan fiduciary. Some plans also offer brokerage or mutual fund "windows" through which participants may invest in individual securities or other investments.

a. Brokerage account: a brokerage account established for each participant who may direct the broker to invest in any or almost any publicly traded security.

b. Mutual fund windows: an option under which a participant may invest in a select universe of mutual funds (as few as 20 or as many as thousands).

2. "Designated Investments" Issue: Under section 404(c), designated investments require a higher level of disclosure than non-designated investments (e.g., automatic description of investment risks and returns and diversification of portfolio, etc.). In addition, the plan fiduciary may be responsible for ensuring that each Designated Investment is a prudent option to offer under the Plan. Thus, whether a particular investment is characterized as a Designated Investment is very significant. It is not clear whether the investments available through "windows" will be considered Designated Investments.

   Example: The plan permits investment in all publicly traded securities. DOL has indicated that, in this case, none of the securities would be Designated Investments.

   Example: The window does not permit investment in any security, but offers a large (3000) or small (30) group of mutual funds. Here, it is harder to argue that each of these mutual funds is not a Designated Investment (particularly when the number offered is smaller), making disclosure difficult, and the fiduciary's due diligence almost impossible.

3. Direction to Identified Fiduciary: Section 404(c) requires that the participant be permitted to give investment "directions" to an identified fiduciary. In the Windows, participants will normally direct a broker. Thus, the broker should be appointed an "agent" of the identified fiduciary.

4. Duty to Monitor Investments: Some investments in a Window are not covered by 404(c), so the fiduciary must structure the Windows and monitor them to ensure that the section 404(c) restrictions are observed. See 29 C.F.R. § 2550.404c-1(d)(2).

5. Duty to Select and Monitor the Window Provider: The selection of investments is a fiduciary act. The fiduciary must ensure that the Window provider enforces investment restrictions, provides reporting and required disclosures and holds assets in trust.

E. PROXY VOTING FOR SELF-DIRECTED ACCOUNTS WITH EMPLOYER STOCK

1. A participant-directed plan may hold employer securities. From time to time, the plan, as a shareholder, will be asked to vote proxies on those securities.

2. To obtain 404(c) protection for voting and with respect to any transaction involving employer securities, including the acquisition, holding and sale of the employer securities by participants who self-direct their investments, voting and similar rights must be passed through to participants. 29 C.F.R. 2550.404c-1(d)(2)(ii)(E)(4). If proxies are passed through, the § 404(c) requirements themselves must be met with respect to proxy voting (e.g., participants receive notice of their proxy voting and other rights; there is no employer influence on the voting, and confidentiality requirements are satisfied).

3. If a participant of a section 404(c) plan affirmatively exercises his or her voting rights, fiduciaries are fully protected from any claims for losses that may result from such exercise. When participants have the opportunity to vote the employer securities but the trustee does not receive any directions from such participants, the trustee generally has no obligation to vote securities held in the accounts of such participants. See Preamble to DOL. Regs. 29 C.F.R. 2550, 57 FR 46906, 46927 (Oct. 13, 1992).

4. Even, if participants are permitted to vote the proxies for the employer stock allocated to their accounts, questions remain regarding any ESOP stock not yet allocated to participant accounts ("Unallocated Shares") or stock that participants failed to vote ("Unvoted Shares"). Among the options in this situation are (1) accepting the participant's failure to vote allocated shares as an affirmative direction to not vote those shares, (2) requiring an independent trustee or investment manager to vote the Unallocated and Unvoted Shares, (3) requiring the named fiduciary to vote these shares, and (4) voting the Unvoted and Unallocated Shares in the same proportion as participants actually voted their allocated shares ("mirror voting").

5. Each of these options has potential risks and benefits for the fiduciary, plan sponsor and trustee. For example, where the trustee votes the Unvoted or Unallocated Shares, it will have full fiduciary responsibility and liability, and when the plan provides for voting direction by the plan sponsor or under a mirror voting rule, the

trustee may follow that direction only if it would not violate ERISA.[11] Mirror voting could also be challenged because it permits a potentially small group of participants to determine how the plan's shares should be voted. Lastly, a plan sponsor who votes proxies will be subject to potential conflicts of interest.

6. The proxy voting in the ESOP context contains additional rules. For guidance, see Herman v. NationsBank Trust Co., 126 F.3d 1354 (11th Cir. 1997), reh'g denied 135 F.3d 1409 (11 th Cir. 1998), cert. denied 119 S.Ct. 54 (1998).

F. ALLOCATION OF PLAN EXPENSES AMONG PARTICIPANT ACCOUNTS

DOL has indicated that plan sponsors and fiduciaries have considerable discretion in determining how plan expenses will be allocated among participant accounts in a defined contribution plan. DOL Field Assistance Bulletin 2003-3 (May 19, 2003).

1. Plan Documents: If an allocation method is specified in plan documents, the fiduciaries must follow the specified method.

2. Administration Practice: If the plan documents are silent or ambiguous with respect to the allocation method, the fiduciary must select an allocation method prudently and solely in the interests of participants and beneficiaries.

3. Pro Rata Method vs. Per Capita Method: Either method of allocating expenses may be reasonable depending on the circumstances.

    a. Pro rata method (allocation based on the assets in each individual account): This method may be reasonable where fees or charges to the plan are determined on the basis of account balances (e.g., investment management fees).

    b. Per capita method (expenses charged equally to each account, without regard to the assets in each individual account): This may be a reasonable method of allocating certain fixed administrative expenses of the plan (e.g.,

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[11] The trustee must adhere to a plan document's mirror-voting procedure for any shares for which it did not receive the directions unless the trustee after investigation determines based on a well-founded rationale that following the mirror voting procedure would violate ERISA. DOL Info. Ltr. to Ian D. Lanoff (Sept. 28, 1995). Note: In this case, 404(c) protection would cease to apply and the trustee would be subject to standard duties of prudence and loyalty. See 57 Fed. Reg. at 46928.

recordkeeping, legal, auditing, annual reporting, claims processing).

4. Individual Account Assessments: It may be permissible to allocate certain expenses to the accounts of the individuals to whom the expenses relate. These may include: (a) hardship withdrawals; (b) calculation of benefits payable under different plan distribution options; (c) benefit distributions; (d) administrative expenses charged to separated vested participants; and (e) QDROS- and QMCSOs-related determinations.

G. FLOAT

A service provider's compensation may contain earnings ("float") on the plan's short-term funds transferred to the provider's general account for distribution or until the receipt of investment instructions regarding the funds, etc., provided a service provider makes sufficient disclosures to the fiduciary and has no discretion in affecting the amount of compensation it receives from the float. Fiduciary duties with respect to the float include reviewing sufficient information to enable the fiduciary to evaluate the float, reviewing comparable providers and service arrangements (e.g., quality and costs) and circumstances under which float may be earned by the service provider. In addition, a plan fiduciary must periodically monitor compliance by the service provider with the agreement and the reasonableness of compensation under the agreement. DOL Field Assistance Bulletin 2002-3.