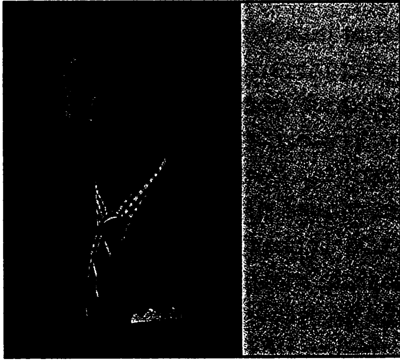

Fiduciary Lessons for ESOPs from the Enron (and other) Debacles

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Introduction

ESOPs maintained by public companies have been much in the news lately. Most of that attention was engendered by the spectacular collapse of several large public companies and has focused on the fiduciary questions surrounding the investment of plan assets in employer stock. But the issues are not new.

> "It's important for fiduciaries not to become complacent.... In-house fiduciaries must be sensitive to company-related events that can cause their fiduciary duties to conflict with their role in the company. Also, any downturn following a bull market may cause problems. It may be advisable for fiduciaries to consider in advance what their responses would be to such contingencies."
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> Powell, Lanoff and Terry, "The Mature ESOP," *Journal of Accountancy,* March, 2000.

That was not written with the help of a crystal ball. It is standard advice. Since that time, though, experiences with employer securities in pubic companies such as Enron, WorldCom, Global Crossing, Lucent, Providian, SBC, EDS, Williams and others too numerous to mention have certainly reinforced it. A lot of ink has been and will continue to be spilled on what the Enron and WorldCom plan fiduciaries, in particular, did or did not do as their share prices collapsed, and the litigation over those plans will further develop the body of knowledge on ERISA fiduciary duties, particularly the duties of those who appoint fiduciaries, the liability of officers and directors, and the duties of directed trustees.

The final story on the major stock collapses of recent years has not been written—most of the cases have been at the motion to dismiss stages, while few decisions have been on the merits—but it is possible to learn some lessons which can be applied now. If some of these lessons are not new, at least they serve as object lessons in what happens when they are ignored.

Fiduciary Lessons

Lesson #1: *There are fiduciaries with respect to employer stock in an ESOP.* It is important to know exactly who they are. Case law continues to draw a distinction that, while an ESOP is designed to invest primarily in employer securities by definition, that does not mean that plan fiduciaries can sit idly by as its value drops. And it is important to remember that someone is a fiduciary with respect to all plan investments, including employer stock. But who are those fiduciaries? A close look at plan and trust documents will usually indicate who at least some of those fiduciaries are. For many companies, public and private, a committee or committees will be the principal fiduciary for plan investments, including employer stock, under the plan and trust documents.

But someone can also become a fiduciary *in fact* by exercising discretionary authority and control over the management of the plan or the investment of plan assets. In other words, those actually "calling the shots" on the investment of plan assets or the administration of the plan may be fiduciaries as well as the people or committees named in the plan and trust documents. As several of the recent cases involving employer securities have pointed out, a person or entity appointing a fiduciary can be a fiduciary as well, with

respect to the act of making such appointments.

Another question arises when the plan or trust simply names the "company" as the fiduciary. That is whether such a designation makes the company's board members or officers fiduciaries as well. The answer is murky, because case law has tended to focus on whether the individual in question was functioning as a fiduciary *in fact,* i.e., was actually making fiduciary decisions, even if on behalf of the company, rather than on the person's title. The lack of clarity in determining who may be a fiduciary *in fact* when the company is named, and the prospect for second-guessing by courts, is currently leading plan sponsors away from designating the company as a fiduciary and towards more specific designations, such as the relevant committee, specific officers and so on.

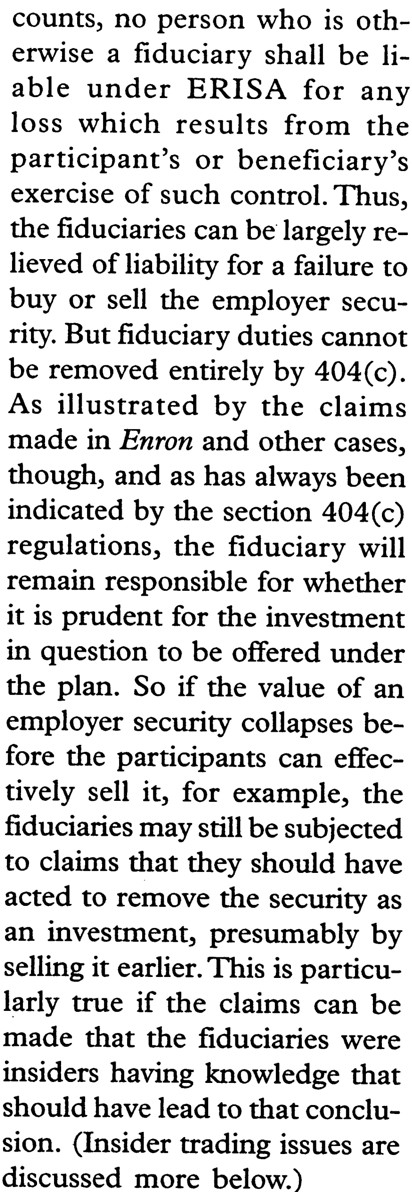
Lesson #2. *Once you know who your fiduciaries are, consider who they should be.* As noted above, even if not named as a fiduciary in the plan and trust documents, a person can become a fiduciary simply by exercising fiduciary duties *in fact.* We suggest that it is likely to result in better fiduciary decision-making if the company has deliberately determined who should be making fiduciary decisions regarding a plan, clearly designated them as fiduciaries, and make certain those individuals in turn understand their fiduciary duties. It is also better for the company to decide who should be making decisions as a fiduciary than to let the court tell them who was a fiduciary after the fact.

Lesson #3: *Monitor employer securities as an investment.* There is little support for taking the position that employer stock is a completely "hands off" investment. But it is not entirely clear what the standard of fiduciary duty is with respect to employer stock in an ESOP. This is an area that is evolving in the litigation, but perhaps the best current view, and a useful one for fiduciaries trying to come to grips with what they should be doing, derives from a decision from the Third Circuit in 1995, *Moench v. Robertsen. Moench* essentially stands for the proposition that there is a "presumption" that it is prudent for an ESOP to invest in employer securities. However, that is a rebuttable presumption, and the fiduciaries might, under some circumstances, be forced to conclude that employer securities are an imprudent investment. So, under *Moench,* an ESOP fiduciary may be able to hold into employer securities and not sell them under circumstances when, for any other type of plan investments, the fiduciary might conclude it should be sold. Recently, the Seventh Circuit and Ninth Circuits have adopted reasoning similar to *Moench.* However, by the same token, there are some circumstance under which an ESOP fiduciary should sell no matter that the plan and trust say that the plan shall be invested in employer stock.

Accordingly, many practitioners have concluded that the appropriate fiduciaries for the investment in employer stock (once it has been determined who they are) should monitor its performance, not unlike what it does with other investments, and maintain records of their deliberations. How the fiduciary acts upon that information with respect to employer securities may, however, then be different than what it would do with respect to other investments because of the Moench presumption.

Lesson #4. For public companies, consider expanding employee diversification rights. In a typical public company ESOP, the employee may direct the investment of that part of the employee's account derived from his or her own salary reduction contributions into and out of employer securities much like he or she does with other plan investments, such as mutual funds. At the same time, employer stock allocated as the employer match or nonelective profit-sharing contributions under the ESOP are usually required to remain invested in employer securities until distribution from the plan, usually upon termination from employment or retirement, and often subject only to the diversification rules of Code section 401(a)(28) (which generally permit employees age 55 or over with 10 years of participation to diversify up to 50 percent of their ESOP account).

Expanding the rights of participants to diversify their ESOP accounts, however, may have the benefit of putting less pressure on the plan fiduciaries to make the proper decision as to when to buy, sell or hold the security by shifting that responsibility to the participant. This is particularly true to the extent that the ESOP holding publicly traded securities becomes subject to ERISA section 404(c) which provides that if a plan provides for individual accounts and permits the participants and beneficiaries to exercise the investment control over their ac-



counts, no person who is otherwise a fiduciary shall be liable under ERISA for any loss which results from the participant's or beneficiary's exercise of such control. Thus, the fiduciaries can be largely relieved of liability for a failure to buy or sell the employer security. But fiduciary duties cannot be removed entirely by 404(c). As illustrated by the claims made in *Enron* and other cases, though, and as has always been indicated by the section 404(c) regulations, the fiduciary will remain responsible for whether it is prudent for the investment in question to be offered under the plan. So if the value of an employer security collapses before the participants can effectively sell it, for example, the fiduciaries may still be subjected to claims that they should have acted to remove the security as an investment, presumably by selling it earlier. This is particularly true if the claims can be made that the fiduciaries were insiders having knowledge that should have lead to that conclusion. (Insider trading issues are discussed more below.)

Nevertheless, the trend has been to allow greater employee diversification rights. There are potential downsides to be considered—reductions in shares held may result in less dividends to repay exempt loans and could create an issue of satisfying the requirement that ESOPs be "primarily invested" in employer securities.

Lesson #5. *Communicate better with employees.* ESOP summary plan descriptions are getting a fresh look in light of the ESOP fiduciary litigation. In particular, disclosures concerning the risks of employer securities, the importance of diversification when planning for retirement, and, where applicable, how unit accounting works, are being beefed up.

Lesson # 6 *For public companies—don't forget securities law and insider trading issues.* Following not far behind the fiduciary issues being litigated in *Enron* are the securities law issues affecting public company ESOPs. To greatly oversimplify matters, these issues have arisen because officers and insiders of companies who allegedly knew of wrongdoing either gave out false information, or at least failed to give out truthful information. This impacts ERISA fiduciary duties in at least two major ways; first, there is a question of whether those persons have a duty to provide information to the plan fiduciaries to act upon, and second, there is a question of what a fiduciary should do when he or she possesses nonpublic information. The principal concern of a plan fiduciary will often be this second concern. Reconciling securities law issues and ERISA fiduciary issues can be very difficult. One early case, *Hull v. Policy Systems* (D.S.C. 2001) generally held that ERISA did not impose a duty to violate securities law, and that fiduciary committee members were not obligated to trade based in insider information they possessed. But the answer may turn out to be more complicated. In its amicus brief in the *Enron* case, the Department of Labor has suggested a harder analysis, which might be characterized as that a fiduciary must satisfy both ERISA and the securities laws. In their brief in that case, the Department has argued that the officers of Enron who were also plan fiduciaries and who held nonpublic information could have (1) disclosed the poor financial condition of Enron to all the shareholders (plan and public), (2) eliminated Enron stock as a plan investment at the time questions about Enron's financial condition were initially raised or (3) reported to the SEC or DOL that potential misinformation was being provided. Obviously, the application of the DOL's analysis will be a very difficult one for fiduciaries in some situations. The response will depend upon the facts of each case, and in some cases, it may become advisable to seek the further guidance of the DOL.

Another practical concern is whether the selection of plan fiduciaries may exacerbate insider trading concerns. First, we would observe that it is the possession of insider information, not the title of the individual, which gives rise to insider trading concerns. And second, trying to rid a fiduciary committee of anyone who might at some point possess insider information might lead to an opposite problem of duties being delegated to individuals whose knowledge or junior level is such that it may make them more prone to claims that they were not making prudent decisions then would be the case of more senior employees were holding those positions. However, it may be advisable to review who sits on plan fiduciary committees involving investment of employer securities to determine whether some corporate positions will routinely raise insider trading concerns.

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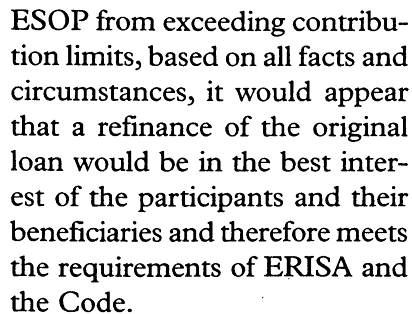

ESOP from exceeding contribution limits, based on all facts and circumstances, it would appear that a refinance of the original loan would be in the best interest of the participants and their beneficiaries and therefore meets the requirements of ERISA and the Code.

For the next analysis, we will take a company that has no decrease in payroll and therefore no issues with the maximum contribution limits of Code Section 404 and debt service. In addition, the trustee along with the employer sponsor, has considered that the company has consistently realized a sizeable increase in per share value and has no issues with cash flow. As shares are released on an annual basis and revalued each year, the committee has realized that, with the sizeable increase in per share value, the value allocated to the participants' accounts over the years were by far in excess of the committee's original intent. In effect, the committee concluded that the participants were being overcompensated and, as such, decided to refinance the original securities acquisition loan, which had a 10 year term, by extending the loan by another 5 years. Given these facts and circumstances, it appears that the decision to refinance would not be in the best interest of participants and their beneficiaries since the party that benefits is the company. As the general nature of employee ownership involves the risk of per share value decrease, simply making the decision to refinance the loan because the per share value has increased dramatically would not fall within the guidelines of ERISA or the Code. The DOL has examined situations like this and found that the Trustee could not demonstrate, given the facts and circumstances involved, that the transaction was for the primary benefit of the participants.

The DOL released Field Assistance Bulletin 2002-1 on September 26, 2002 in an attempt to clarify the issues surrounding fiduciary obligations under Sections 404(a) and 408(b)(3) of ERISA. The bulletin generally directs DOL agents to examine all issues surrounding security acquisition loan refinance to ensure that the refinance is in the best interest of the participants and their beneficiaries and consider all facts and circumstances surrounding the refinance of the loan. The bulletin also gives guidance and examples for fiduciaries to consider when contemplating a decision to refinance. Although there are indeed administrative issues surrounding loan refinance, fiduciaries should consider all facts and circumstances associated with the loan refinance to determine compliance with the ERISA and the Code. The Field Assistance Bulletin can be found at the DOL's website at the following link: http://www.dol.gov/ebsa/regs/fab_2002-1.html. ⊜

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Conclusion

Enron, WorldCom and similar cases will continue to shine the spotlight on a number of interesting and difficult fiduciary questions for ESOPs for years. Plan sponsors should monitor developments in those cases, but already are being provided some valuable indications of how some of those issues may be avoided in their own plans. As suggested in the Journal of Accountancy years ago, for ESOPs, where potential liabilities can be great, an ounce of prevention is worth a pound of cure. ⊜

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