Chapter 35: Specific Corporate Compliance Challenges by Practice Area: ERISA*

Authors: Brian S. Cousin, Jonathan Evan Goldberg and Jose M. Jara
Editor: Carole Basri

---

* Re-printed with permission of Matthew Bender LexisNexis from the forthcoming *Corporate Compliance Practice Guide: The Next Generation.*

Chapter 35: Specific Corporate Compliance Challenges by Practice Area: ERISA

Brian S. Cousin
Jonathan Evan Goldberg
Jose M. Jara
Seyfarth Shaw LLP

PART I: OVERVIEW

35.01 Introduction to ERISA

Imagine that it is late in the day on December 11, 2008. You recently became a fiduciary of a publicly-traded company's pension plan and have just learned that Bernard Madoff, the founder and chairman of Bernard L. Madoff Investment Securities LLC ("BLMIS") and the former chairman of the NASDAQ stock exchange, has been arrested for operating a giant "Ponzi scheme" allegedly defrauding thousands of customers to the tune of billions of dollars. You initially thank your lucky stars that you had none of your own money invested with Mr. Madoff's firm but suddenly terror grips you. The pension plan for which you serve as a fiduciary might have had money invested with BLMIS (either directly or through a feeder fund). Questions begin to race through your mind. Was money invested with BLMIS? If so, how much money was invested, when was the money invested, who made the decision to invest, and are you subject to a lawsuit, either by the government or the plaintiff's bar?

[STATUTE] Although the above-described scenario implicates a number of legal areas -- including securities law, bankruptcy law, and insurance law -- it may also implicate the federal statute known as the Employee Retirement Income Security Act of 1974 ("ERISA"), 29 U.S.C. §§ 1001-1461. Congress enacted ERISA in response to the Studebaker Company's shut down of its South Bend, Indiana plant in December 1963 -- which left thousands of employees without any retirement savings -- to help avert (or minimize) similar occurrences. The primary purpose of ERISA is to protect interstate commerce and the retirement and other employee benefits of plan participants and beneficiaries by providing for disclosure and reporting to participants and beneficiaries, establishing standards of conduct, responsibility, and obligations for fiduciaries, and by providing for remedies, sanctions and ready access to the federal courts. *See* ERISA, § 2, 29 U.S.C. § 1001. Among other things, ERISA, its regulations, and case law interpreting the statute and its regulations, describe the special, heightened duties (known as "fiduciary duties") owed by those entrusted with protecting such benefits (known as "fiduciaries"). *See Massachusetts Mutual Life Insurance Co. v. Russell*, 473 U.S. 134 (1985) (discussing ERISA's legislative history). Further, the Employee Benefits Security Administration ("EBSA"), an agency of the United States Department of Labor ("DOL"), is charged with enforcing ERISA and ensuring that businesses and individuals are in compliance with the law and its regulations.

The investment of retirement monies with Mr. Madoff's firm -- or, indeed, with any individual or company -- will implicate ERISA if the pension plan is one covered by the ERISA statute.

In this Part I, we provide an introduction to ERISA to help you understand its applicability. In Part II, we discuss ERISA's fiduciary duties and prohibited transactions, and outline best practices for fiduciary compliance. In Part III, we discuss ERISA litigation and risk management, and in Part IV we discuss ERISA reporting and disclosure requirements. An understanding of these issues will help companies and their fiduciaries stay in compliance with ERISA and avoid potential liability. For further information, we recommend the DOL's website, www.dol.gov/ebsa/, which contains additional information to help businesses and individuals comply with the law. Additional resources are also contained at the end of this Chapter.

35.02 What is an ERISA Plan?

ERISA defines an employee pension benefit plan or pension plan as any plan, fund, or program which is established or maintained by an employer to provide retirement income to employees or results in employees deferring income for a period extending to termination of employment and beyond. ERISA § 3(2), 29 U.S.C. § 1002(2). There are two types of ERISA pension plans: (i) "defined benefit plans" and (ii) "individual account plans" (which are often also called "defined contribution plans"). Defined benefit plans provide employees with a fixed amount at retirement based on a certain formula and factors including compensation, age, and the length of service of the individual who is a "participant" in the plan. *See* ERISA § 3(35), 29 U.S.C. 1002(35). The risk of loss in these plans (for example, loss as a result of a fraudulent ponzi scheme) remains with the employer. By contrast, an "individual account plan" is defined as "a pension plan which provides for an individual account for each participant and for benefits based solely upon the amount contributed to the participant's account, and any income, expenses, gains and losses." ERISA § 3(34), 29 U.S.C. § 1002(34). In individual account plans, some risk of loss shifts over to the individual participants. ERISA requires that the benefits, requirements, and other characteristics of such pension plans be in writing and described in "plan documents," which may consist of one or more documents.

Pension plans are generally designed to encourage employees to save for their retirement and other long-term goals. The defined contribution plans permit employees to defer a percentage of their salary on a pre-tax basis and permit the employer to make a contribution (known as a "matching contribution"). *See Harzewski v. Guidant Corp.*, 489 F.3d 799 (7th Cir. 2007) (stating that an employee's retirement is the eventual value of her account based on contributions made by the employer and/or the employee). In addition, sometimes the "plan sponsor" -- the entity that establishes the pension plan -- makes discretionary "basic" contributions to participants' accounts. In contrast to traditional defined benefit pension plans, participants alone shoulder the investment risk in defined contribution plans. *See Hirt v. Equitable*, 533 F.3d 102, 105 (2d Cir. 2008) (explaining that defined benefit plans differ from defined contribution plans with respect to who bears the investment risk; defined benefit plans guarantee a specific benefit without regard to market performances, whereas in defined contribution plans the employee bears investment risks); *Register v. PNC*, 477 F.3d 56, 61-62 (3rd Cir. 2007) (same).

Participants in defined contribution plans are typically given several different investment options in which to invest their contributions and any employer matching contributions, including in the

employer's stock fund ("Stock Fund"). Some plans provide that up to 100% of its assets may be invested in the Stock Fund and sometimes there are restrictions on a participant's ability to transfer her money in and out of a Stock Fund. Moreover, some plans require its fiduciaries to invest in a Stock Fund only upon a participant's directions.

One popular type of defined contribution plan worth noting is an employee stock ownership plan ("ESOP"). Under ERISA, fiduciaries are generally required to "diversify" the investments of the plan. *See* ERISA § 404(a)(1)(C), 29 U.S.C. § 1104(a)(1)(C). By contrast, ESOP fiduciaries receive a waiver from this requirement with respect to investments in the employer's securities. *See* ERISA § 404(a)(2), 29 U.S.C. § 1104(a)(2).

[TRAP] ESOPs must be "designed to invest primarily in employer stock." *See* ERISA § 407(d)(6), 29 U.S.C. § 1107(d)(6). This requirement has not yet been interpreted by the IRS or the courts, but the phrase implies that in order for a plan, or a portion thereof, to qualify as an ESOP it must invest or hold the majority of its plan assets in employer securities. A DOL Advisory Opinion [83-6 (Jan. 24, 1983)] states that there is no fixed, quantitative standard for the "primarily invested" requirement and that the applicable requirements are flexible and vary according to the facts and circumstances. In light of this ambiguity, employers should be careful when designing an ESOP. As a result of the Pension Protection Act of 2006, participants are permitted to transfer their shares in employer stock in exchange for shares of equivalent value in other investment options offered by their plan. Pension Protection Act, § 901(b) (adding Internal Revenue Code § 401(a)(35) and ERISA 204(j)).

ERISA not only covers pension plans, but also "welfare benefit plans," which includes any plan, fund, or program established or maintained by an employer or by an employee organization, or by both, to the extent that such plan, fund, or program provides for its participants or their beneficiaries medical, surgical, or hospital care or benefits, or benefits in the event of sickness, accident, disability, death or unemployment, or vacation benefits, apprenticeship or other training programs, or day care centers, scholarship funds, or prepaid legal services, or any benefit described in the Labor Management Relations Act of 1947, § 302(c) (other than pensions on retirement or death, and insurance to provide such pensions). *See* ERISA § 3(1), 29 U.S.C. § 1002(1). Welfare benefit plans also must be operated in accordance with the fiduciary duties detailed below.

Further in connection with health care plans, ERISA has been amended by the Consolidated Omnibus Budget Reconciliation Act of 1985 ("COBRA") and the Health Insurance Portability and Accountability Act of 1996 ("HIPAA"). While welfare benefit plans and their related statutes involve issues that are beyond the scope of this chapter, recent legislation warrants mention. The recently enacted American Recovery and Reinvestment Act of 2009 ("ARRA") provides that eligible individuals will only have to pay 35% of their COBRA premiums and that the remaining 65% is to be reimbursed to the employer through a tax credit.

35.03 Is Your Plan Covered by ERISA?

How do you know whether your employee benefits plan is governed by ERISA? Essentially, "[i]f it Talks Like a Duck . . . and Walks Like a Duck . . . It is . . ." *possibly* an ERISA plan. *Donovan v. Mercer*, 747 F.2d 304, 305 (5th Cir. 1984). Indeed, while most such plans are

governed by ERISA, not every retirement or benefits plan is covered. For example, ERISA Section 4(b) specifically exempts from ERISA certain plans sponsored by governments, churches, and certain tax-exempt entities. 29 U.S.C. § 1003. The DOL has provided guidance as to what is a covered plan. *See* 29 C.F.R. § 2510.3-2(f). The primary focus of the DOL guidance is the degree to which the employer is involved in establishing and/or managing a plan. For example, the selection of service providers could be considered employer involvement, subjecting a plan to ERISA's requirements. Other actions by the employer, such as making contributions to the plan or negotiating special features with a service provider, could also make an arrangement subject to ERISA. *See DOL's Field Assistance Bulletin 2007-2 – Is Your Plan Subject to ERISA?*

35.04 Who is a Fiduciary?

A person is an ERISA "fiduciary":

> [w]ith respect to a plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan ... .

ERISA § 3(21), 29 U.S.C. § 1002(21)(A).

Plan documents must designate a "named fiduciary" who has the authority to control and manage the operations of the plan. ERISA § 402(a)(1), 29 U.S.C. § 1102(a)(1). ERISA defines a "named fiduciary" as "a fiduciary who is named in the plan instrument, or who, pursuant to a procedure specified in the plan, is identified as a fiduciary (A) by a person who is an employer or employee organization with respect to the plan or (B) by such an employer and such an employee organization acting jointly." ERISA § 402(a)(2), 29 U.S.C. § 1102(a)(2).

35.05 De Facto Fiduciary

The United States Supreme Court has articulated a functional test to determine whether an individual is a fiduciary, focusing not on the individual's formal designation, but rather on the person's actions or authority. *Mertens v. Hewitt Associates*, 508 U.S. 248, 262 (1993); *Hancock v. Harris Trust*, 510 U.S. 86, 95-96 (1993) (although ERISA's fiduciary provisions "are not mellifluous" (i.e., smooth and flowing), when "read as a whole," it is clear that "Congress commodiously imposed fiduciary standards on persons whose actions affect" a participant's retirement) (emphasis added). Accordingly, if a person exercises or has any discretionary authority or control over plan administration or assets, that person may be deemed to be an ERISA *de facto* fiduciary. This test is fact-intensive and, consistent with the goals of ERISA, is to be construed broadly. *See In re Pfizer ERISA Litigation*, 2009 WL 749545 (S.D.N.Y. Mar. 20, 2009); *Feigenbaum v. Summit Health Administrators, Inc.*, 2008 WL 2386168, *4 (D.N.J. June 9, 2008) (a determination on fiduciary status does not hinge on formal designation, but rather upon the functional test).

[WARNING] Appointing and removing plan fiduciaries are fiduciary functions. *Harris v. Koenig*, 602 F. Supp. 2d 39, 60 (D.D.C. 2009) ("The power to appoint and remove trustees carries with it the concomitant duty to monitor those trustees performance.")(*citing Liss v. Smith*, 991 F. Supp. 278, 311 (S.D.N.Y. 1998)). Having the power to appoint and remove gives rise to the duty to monitor. *See Ford Motor Company ERISA Litigation*, 590 F. Supp. 2d 883 (E.D. Mich. 2008). Accordingly, it is important for such persons (who are themselves fiduciaries) to monitor their fiduciary appointments.

Note that fiduciaries will *only* be a fiduciary with respect to those powers delegated to them. *Brant v. Grounds*, 687 F.2d 895, 897 (7th Cir. 1982) (bank that provided investment advice to a plan was fiduciary only with respect to such advice) (emphasis added). Thus, if a claim is brought against directors and/or officers ("D&Os") in connection with the loss of plan assets as a result of imprudent investments, and those D&Os only had the power to appoint other fiduciaries, the D&Os would likely be shielded from liability unless it can be established that a failure to monitor the appointees was the cause of the loss to the plan.

35.06 Directors and Officers as Fiduciaries

As mentioned above, D&Os -- who generally only have the power to select and remove others who administer the plan -- would be found to be fiduciaries under ERISA only with respect to such appointments. Further, DOL regulations provide that D&Os are fiduciaries under ERISA only to the extent that they have responsibility for the appointment and/or retention of other ERISA fiduciaries. 29 C.F.R. 2509.75-8 (2007).

Certain courts have held that D&Os are not ERISA fiduciaries in the absence of express individual authority for plan administration. For example, in *Confer v. Custom Eng'g Co.*, 952 F.2d 34 (3d Cir. 1991), where the plan document named the corporation as the named fiduciary of the plan, the court explained that "the officers who exercise discretion on behalf of that corporation are not fiduciaries … unless it can be shown that these officers have *individual* discretionary roles as to plan administration." *Id.* at 37. As such, if a corporation delegated some of its fiduciary responsibilities to an officer or designated the officer as the plan administrator, fiduciary status would be found.

By contrast, at least two Circuits have rejected the above analysis, holding instead that ERISA and its policy support a broader, functional fiduciary test and rejecting any attempt to limit the liability of D&Os who function as fiduciaries. *Kayes v. Pacific Lumber Company*, 51 F.3d 1449, 1461 (9th Cir. 1995); *Musmeci v. Schwegmann Giant Super Markets, Inc.*, 332 F.3d 339 (5th Cir. 2003) (using the same functional approach as *Kayes*); *see also Briscoe v. Fine*, 444 F.3d 478, 487 (6th Cir. 2006) (stating that the primary difference between *Confer* and *Kayes* is that *Confer* appears to begin with a rebuttable presumption against D&O fiduciary liability, whereas *Kayes* starts with no initial presumption)

The weight of authority appears to reject a per se rule of non-ERISA fiduciary liability for D&Os where the corporation alone is identified as the named fiduciary. Courts outside the Third Circuit appear to reject the *Confer* rationale and instead hold that D&Os could be ERISA fiduciaries if they have or exercise discretionary authority or control over the administration or assets of the plan, regardless of whether they are acting in an individual or corporate capacity.

35.07 The "Two Hats" Doctrine

The "two hats" doctrine provides that when an individual is acting in a corporate capacity on behalf of the company, ERISA's fiduciary duties are not implicated. *See Pegram v. Herdrich,* 530 U.S. 211, 225-226 (2000) (employer can switch between wearing its "fiduciary" and "employer" hats). An individual may be acting in a corporate capacity -- performing a "settlor" function -- by adopting, amending, or terminating a plan. *See In re Ullico Inc. Litigation,* 2009 WL 837655, *6 (D.D.C. Mar. 31, 2009) (citing to Supreme Court precedent). Accordingly, to trigger an individual's fiduciary duties, an individual must have been acting in a fiduciary capacity and not a corporate one. *See In re Citigroup ERISA Litigation,* 2009 WL 2762708 (S.D.N.Y. Aug. 31, 2009)(holding that the defendants were not acting in a fiduciary capacity with respect to offering employer stock as an investment option because they had no discretion under the plan document to eliminate the employer stock fund as an investment option). The Supreme Court has acknowledged this doctrine and has found that an individual may not be wearing both hats at the same time. *Varity Corp. v. Howe*, 516 U.S. 489 (1996).

35.08 Benefits Committee

"Best practices" dictate that employers who sponsor a benefits plan should establish a "benefits committee" to govern and administer the plan in accordance with ERISA. A benefits committee must be carefully comprised of experts within the company and should contain at least two subcommittees -- the investment committee and the administrative committee. The benefit committee's "Charter" should be designed to describe all the duties and responsibilities of the committees. The plan documents and investment policy statements should be reviewed to ensure the Charter is accurate. At a minimum, the Charter should detail the following:

- The Committee's Purpose (to ensure the plan's purpose (as detailed in the plan document) is met and in compliance with ERISA)

- Membership (which should de detailed by title, e.g., VP of Finance, with qualifications that include ERISA fiduciary duties and responsibilities).

- Authority and Responsibilities (including such information as the timing of review of the Charter; evaluation and approval of matters necessary to satisfy ERISA's fiduciary obligations; providing ERISA compliance report to the company's Board of Directors at least semi-annually; providing recommendations to the Board of Directors; evaluation, selection, retention, appointment, or termination of all the plan's service providers; decision making authority with respect to plan administration, design and policy; and investment review).

- ERISA Compliance (setting forth ERISA's fiduciary requirements as described below).

- Operations of the Committee (when and how meetings of the committee are conducted). Minutes should be taken at all fiduciary committee meetings.

- Authority of the Charter (for example, if there are conflicts between the plan and the charter, the terms of the charter should govern).

35.9 Administrative and Investment Sub-Committees

Benefits committees should be broken into at least two subcommittees, one for investment and the other for administration. The Chief Financial Officer and Treasurer usually are members of the Investment Committee, while the executives in charge of Human Resources, Compensation and Benefits, Legal, and Operations usually serve on the Administrative Committee.

35.10 Meeting with the Board of Directors

As provided in the Charter, the benefits committee should meet with the Board of Directors semi-annually. In addition, the Charter should provide the benefits committee with the discretion to hold a special meeting with the Board. At the meeting, aside from certain plan-related business decisions (referred to as "settlor functions") such as establishing the benefit plan, adopting plan documents and amendments, or whether to terminate a plan, the Board should receive a report regarding the fiduciaries' actions for the past year in order to review their performance.

32.11 Best Practices for the Board of Directors: Appointment and Monitoring of Fiduciaries

The Board of Directors is responsible for appointing and monitoring fiduciaries, which requires that delegation of authority be done prudently. With respect to the appointment process, the Board of Directors should, with counsel, engage in a thorough process as to the selection of fiduciaries, which process should include assessing the potential fiduciaries' experience and qualifications. This process should be documented clearly and in detail.

With respect to the monitoring of plan fiduciaries, the Board of Directors should be provided with a report by a third party of all the major fiduciary decisions that have been made in order to assist them in making a determination as to whether the fiduciaries are performing their responsibilities as required by ERISA. This process should also be described in the minutes and, if done properly, should help to insolate the Board of Directors from claims of breach of fiduciary duty for failure to monitor the plan's fiduciaries.

If the Board of Directors desires, they may eliminate the duty to appoint and monitor fiduciaries by delegating the authority to perform this function to certain company executives or officials. Alternatively, the plan document can be amended to automatically appoint fiduciaries by their title and function within the company (e.g., "the benefits committee shall be comprised of the Chief Financial Officer, the Treasurer, and the Vice President of Human Resources").

PART II -- ERISA FIDUCIARY DUTIES AND PROHIBITED TRANSACTIONS

35.12 Fiduciary Duties

When one hears the words "fiduciary duty," one is reminded of Judge Cardozo's oft-cited description of that duty: "[a] [fiduciary] is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior." *Meinhard v. Salmon*, 249 N.Y. 458 (1928). Under ERISA, fiduciaries are

required to: (i) act for the "exclusive purpose" of the plan, (ii) act with "prudence," (iii) "diversify" plan investments, and (iv) act in accordance with the "terms of the plan."

35.13 The Exclusive Purpose Rule

Under the "exclusive purpose" rule, plan assets must be used only: (i) to pay plan benefits, and (ii) to pay plan expenses that are reasonable and relate only to plan activities. ERISA § 404(a), 29 U.S.C. § 1104(a). Where fiduciaries follow the express terms of the plan, there should be no violation of the exclusive purpose rule as long as those terms are in accordance with ERISA. On the other hand, were a named fiduciary to personally profit from his service as a fiduciary at the expense of a plan -- by, for example, controlling a service provider that overcharges the plan for services for his own pecuniary interest -- a court would most likely remove that fiduciary or force him to resign.

This duty requires that fiduciaries, at a minimum, engage in a scrupulous independent investigation of their options to insure that they act in the best interests of the plan participants and beneficiaries. *See Donovan v. Bierwirth*, 538 F. Supp. 463, 470 (E.D.N.Y. 1981), *aff'd as modified*, 680 F.d 263, 272 (2d Cir.), *cert. denied*, 459 U.S. 1069 (1982). Accordingly, there are certain circumstances that require a fiduciary to recuse himself from a particular transaction due to a conflict of interest. Recusal, under the DOL's interpretation, means to abstain from any consideration of the transaction at issue and refrain from exercising any authority, control, or responsibility with respect to the transaction at issue. However, a fiduciary who recuses himself will still have the duty to disclose to the plan material information in his possession with respect to the particular transaction. *See Barry v. Iron Workers*, 404 F. Supp. 2d 145 (D.D.C. 2005).

In explaining this duty, the DOL uses the example of where a trustee of a plan also serves as the president of a bank that is proposing to provide administrative services to the plan for a fee. The DOL regulations state that no ERISA Section 406 violation occurs if the trustee/president "absents himself from all consideration of [the Bank's] proposal and does not otherwise exercise any of the authority, control or responsibility which makes the trustee/president a fiduciary to cause the plan to retain [the Bank]." 29 C.F.R. 2550.408b-2(f)(7). The DOL has issued several advisory opinions and information letters concerning this issue and, from time to time, has granted exemptions to permit the provision of services to the plan by an entity related to a fiduciary where the conflicted fiduciary has recused himself from the decision.

35.14 Prudence

Above all else, an ERISA fiduciary is required act with the "care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in like capacity and familiar with such matters would use in the conduct of an enterprise of like character with like aims." ERISA 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B). A court faced with the issue of whether a fiduciary has acted with prudence will consider what a comparable fiduciary would have done under similar circumstances. Prudence is not measured in hindsight, whether it accrues to the fiduciary's detriment or benefit. *DiFelice v. U.S. Airways, Inc.*, 497 F.3d 410, 424 (4th Cir. 2007); *Steinman v. Hicks*, 252 F. Supp. 2d 746, 759 (7th Cir. 2003) (citing Judge Scalia as stating "'I know of no case in which the trustee who has happened -- through prayer, astrology or just blind luck -- to make (or hold) objectively prudent investments (e.g., an investment in a

highly regarded 'blue chip' stock) has been held liable for losses from those investments because of his failure to investigate and evaluate beforehand.'"). The test is not what resulted, but what actions/process did the fiduciary undertake at the time. *DiFelice, supra; Bunch v. W.R. Grac*e, 555 F.3d 1 (1st Cir. 2009) (prudence requires considering the "totality of the circumstances").

Several courts in ERISA cases have adopted the "modern portfolio theory," which "teaches that an investment in a risky security as part of a diversified portfolio is, in fact, an appropriate means to increase return while minimizing risk." *DiFelice, supra*, 497 F.3d at 423. The prudence of investments or classes of investments must be reviewed individually and the plan fiduciary must prudently select and continuously monitor each investment option available in a plan. *Id*.

35.15 Diversify Investments

An ERISA fiduciary also has the duty to diversify the plan's investments to minimize the risk of loss. ERISA 404(a)(1)(C), 29 U.S.C. § 1104(a)(1)(C). However, investments need not be diversified when (i) it is clearly prudent not to do so, (ii) ownership of employer stock is a principal purpose of the plan, and when (iii) participants direct the investment of their own accounts. *See Nelson v. Hodowal*, 512 F.3d 347, 351 (7th Cir. 2008) ("Diversification is valuable even when each security is accurately priced by the stock market."); *Summers v. State Street*, 453 F.3d 404, 409 (7th Cir. 2006) (diversification is part of the overall duty of prudence, unless directed pursuant to an ESOP to invest in employer stock).

While ERISA generally imposes duties of care, skill, prudence, diligence and diversification upon plan fiduciaries, it exempts fiduciaries from overseeing employer stock plans or investment options from any duty to diversity such investments:

> In the case of an eligible individual account plan (as defined in Section 1107(d)(3) of this title), the diversification requirement of paragraph (1)(C) and the prudence requirement (only to the extent that it requires diversification) of paragraph (1)(B) is not violated by acquisition or holding of qualifying employer securities (as defined in Section 1107(d)(4) and (5) of this title.

29 U.S.C. § 1104(a)(2); *see Steinman v. Hicks*, 352 F.3d 1101, 1103 (7th Cir. 2003) ("Congress believing employees' ownership of their employer's stock a worthy goal, has encouraged the creation of ESOPS both by giving tax breaks and by waiving the duty ordinarily imposed on trustees by modern trust law (including ERISA…) to diversity the assets of a pension plan.")

35.16 The Terms of the Plan

Fiduciaries are required under ERISA to act "in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with [ERISA]." ERISA 404(a)(1)(D), 29 U.S.C. § 1104(a)(1)(D). A fiduciary cannot be found liable for a breach of fiduciary duty if she follows the terms of the plan documents -- again, assuming those documents are consistent with ERISA. *See Tatum v. RJR Reynolds Tobacco Co.*, 392 F.3d 636 (4th Cir. 2004) (plaintiff and the Secretary of Labor (as amicus curie) argued that the plan fiduciaries, in divesting employer stock, had a duty to ignore the plan document if it was imprudent to sell).

When the terms of the plan require investment in employer stock, certain courts view this duty in conflict with ERISA's prudence and diversification requirements. In this regard, courts have acknowledged that there may be a time when a fiduciary must not follow the terms of the plan because investment in employer stock has become imprudent. *See Moench v. Robertson*, 62 F.3d 553 (3d Cir. 1995). On the other hand, courts have held that a fiduciary's decision to purchase or hold employer stock is exempt from the duty to diversify and related duty of prudence. *See Kirschbaum v. Reliant Energy, Inc.*, 526 F.3d 243, 248 (5th Cir. 2008); *Wright v. Oregon Metallurgical Corp.*, 360 F.3d 1090, 1097 (9th Cir. 2004).

35.17 Prohibited Transactions

ERISA defines certain transactions between a plan and a party in interest as "prohibited transactions." *See* ERISA § 3(14) and § 406(a), 29 U.S.C. § 1002(14) and § 1106(a). (A "party in interest" is defined as, to name a few, "a fiduciary … counsel, or employee of [an] employee benefit plan," "a person providing services to such plan," or an "employer … whose employees are covered by such plan. ERISA § 3(14)(A), (B), (C), 29 U.S.C. § 1002(14)(A), (B), (C)). Specifically, ERISA provides that a fiduciary must not allow a plan to enter into a transaction with a party in interest that will constitute a direct or indirect: (i) sale or exchange, or leasing of any property; (ii) lending of money or extension of credit; (iii) furnishing goods, services, or facilities; (iv) transfer or use of any assets of the plan; or (v) acquisition of employer security or employer real property. *See Dupree v. The Prudential Insurance Company of America*, 2007 WL 2263892, at *38 (S.D. Fla. Aug. 10, 2007) (discussing several prohibited transaction exemptions at great length).

For example, any arrangement for services between a plan and a service provider is a prohibited transaction under the rule that a fiduciary must prevent a plan from engaging in a transaction which he knows constitutes the furnishing of services or a transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan. ERISA 406(a)(1)(C), (D), 29 U.S.C. § 1106(a)(1)(C), (D). Given these definitions, it is difficult to understand how a plan can operate if a "prohibited transaction" is a transaction between the plan and its services providers. Fortunately, there are statutory and class exemptions that clarify the situation. *See, e.g.*, ERISA § 408(b)(2), 29 U.S.C. § 1108(b)(2) (exempting contracts with service providers if certain conditions are met, as discussed below). *See Dupree*, *supra*, 2007 WL 2263892, at *39_(discussing the applicability of ERISA Section 408(b)(2) with respect to payment of investment management fees for investments in single client accounts).

ERISA also defines certain transactions between the plan and fiduciaries as "prohibited transactions." *See* ERISA § 406(b), 29 U.S.C. § 1106(b) (prohibiting fiduciaries from engaging in conflicts of interest). Specifically, as set forth in ERISA Section 406, a fiduciary cannot deal with the assets of the plan for his own interest, may not participate on behalf of a party in a transaction whose interests are adverse to the interests of the plan or the plan's participants and beneficiaries, and cannot receive any kick-backs.

35.18 Statutory and Class Exemptions

A major exemption from the prohibition against certain arrangements between plans and service providers is provided by ERISA Section 408(b)(2), which requires the following: (i) that the contract or arrangement is reasonable, (ii) the services are necessary for the establishment or operation of the plan; and (iii) no more than reasonable compensation is paid for the services. *See* 29 U.S.C. § 1108(b)(2); 29 C.F.R. 2550.408b-2(b)(c) and 2550.408c-2. Accordingly, if these requirements are met, then the transaction may properly occur.

In 2008, the DOL proposed amended regulations to provide additional guidance on when a contract or arrangement is "reasonable" under ERISA Section 408(b)(2). *See* 72 Fed. Reg. 70988 (Dec. 13, 2007). These proposed amendments were not finalized and were placed on hold by the new administration in January 2009. However, they serve as the basis for new legislation that is being proposed. *See* H.R. 1984 (the "401(k) Fair Disclosure for Retirement Security Act of 2009," introduced by Representative George Miller (D-CA-7) on April 21, 2009).

In addition to the statutory exemptions, the DOL has issued class and individual exemptions, certain of which specifically relate to financial-type transactions. One of the more popular class exemptions is Prohibited Transaction Exemption ("PTE") 84-14. *See* 70 Fed. Reg. 49305 (Aug. 23, 2005). It permits transactions between an investment fund managed by a qualified professional asset manager ("QPAM") and a party in interest with respect to a plan participating in the fund. The asset manager must meet certain equity capital or net worth requirements to qualify as a QPAM under the exemption. The fiduciary must ensure or obtain a representation from the asset manager that it qualifies as a QPAM.

35.19 Individual Exemptions

In addition to the foregoing, should a particular transaction not meet a statutory or class exemption, an application for individual relief may be made to the Office of Exemptions of the ,EBSA, DOL. In order to grant an exemption, the DOL must find that the exemption is administratively feasible, in the interests of the plan and of its participants and beneficiaries, and protective of the rights of participants and beneficiaries of the plan.

Recent individual exemptions have involved "Auction Rate Securities," which are debt instruments or preferred stock with an interest rate or dividend that is reset at specified intervals through a Dutch auction process. *See* 74 Fed. Reg. 8992 (Feb. 27, 2009). With respect to transactions involving ERISA Title I plans, the DOL has granted exemptions to permit (i) the sale or exchange of an Auction Rate Security by a plan to the Sponsor of such plan, or (ii) a lending of money or other extension of credit to a plan in connection with the plan's holding of an Auction Rate Security from a securities firm or any of its current or future affiliates or subsidiaries or other introducing brokers or clearing brokers, where the loan is repaid in accordance with its terms and guaranteed by the Plan Sponsor. *Id.*

35.20 Personal Liability and Civil Actions

ERISA Section 409(a) exposes fiduciaries to personal liability for their breaches of fiduciary duty:

> Any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries ... shall be personally liable to make good to such plan any losses to the plan resulting from each such breach....

29 U.S.C. § 1109(a).

To prove a breach of fiduciary duty, a plaintiff must establish that the defendant: (i) was a fiduciary; (ii) was acting in the capacity of a fiduciary; and (iii) acted in breach of his duties. *See Silverman v. Mutual Benefit Life Insurance Co.,* 941 F. Supp. 1327 (E.D.N.Y. 1996). Moreover, ERISA Section 502 allows only participants, beneficiaries, and fiduciaries to bring an action for violations of ERISA. 29 U.S.C. § 1102.

35.21 Best Practices for Fiduciary Compliance

The best practices for fiduciary compliance include three important procedures. These procedures are using due diligence to review the plan documents, policies and procedures; carefully selecting and regularly monitoring service providers; and providing formal and continuous fiduciary training to all plan fiduciaries.

35.21.1 Review of Plan Documents, Policies, and Procedures

A starting point for complying with ERISA's fiduciary requirements is to review the plan's governing documents. Certainly upon appointment as a fiduciary, or as soon thereafter as possible, the plan document and summary plan description ("SPD") should be reviewed and a determination should be made as to whether the plan is being operated in compliance with those documents. A determination should also be made as to whether the plan document or SPD need to be amended.

With respect to plan investments, the fiduciaries must first ascertain whether the plan has an investment policy statement ("IPS") and guidelines and, if the plan has no such statement, the fiduciaries should adopt one. If an IPS is in place, it should be reviewed in light of current economic conditions. In 1994, the DOL issued Interpretive Bulletin 94-2 encouraging plan fiduciaries to adopt written statements of investment policy. Interpretive Bulletin 94-2 also states that compliance with ERISA's prudence requirement requires maintenance of proper documentation of the activities of the investment manager and of the named fiduciaries of the plan in monitoring the investment manager.

[WARNING] Fiduciaries remain personally liable if they select or retain an investment manager or consultant when it is not prudent to do so. *See California Ironworkers Field Pension Trust v. Loomis Sayles in Co.,* 259 F.3d 1036 (9th Cir. 2001); *Lowen v. Tower Asset Management, Inc.,* 829 F.2d 1209 (2d Cir. 1987).

35.21.2 Contracting with Service Providers and Monitoring

When selecting and monitoring service providers, ERISA requires that a fiduciary have sufficient information to make informed decisions about the services, costs, and qualifications of the service provider. *See, e.g.,* Field Assistance Bulletin 2002-3 (November 5, 2002) and Advisory Opinions 97-16A (May 22, 1997) and 97-15A (May 22, 1997); *see also Abbott v. Lockhead Martin Corp.,* 2009 WL 839099 (S.D. Ill. Mar. 31, 2009).

The DOL has further stated that a fiduciary must consider the proposed compensation or fees, the service provider's qualifications, and the quality of services being retained. In this regard, a fiduciary should not consider the compensation or fees to the exclusion of other factors. Thus, a fiduciary is not required to select the lowest-cost service provider, as long as the compensation or fees paid to the service provider are reasonable in light of the particular facts and circumstances.

In 2005, the Securities and Exchange Commission ("SEC") and the DOL issued a document entitled "Selecting and Monitoring Pension Consultants – Tips for Plan Fiduciaries," which includes a model questionnaire to be sent to proposed service providers. The questionnaire was designed to solicit more information about conflicts of interest and includes the following questions:

- If you are hired, will you acknowledge in writing that you have a fiduciary obligation as the plan's investment advisor while providing the consulting services being sought?

- Do you consider yourself a fiduciary under ERISA with respect to recommendations you provide the plan?

Of course, after a service provider is hired, at some point the fiduciaries may decide to change service providers. Fiduciaries have a duty to continue to monitor service providers and, if the fiduciaries subsequently discover that the services are below expectations or that the provider is overcharging the plan, the fiduciaries would not only be justified in changing the service provider at that time but arguably would be required to do so or be in breach of their own fiduciary duties.

With respect to "Ponzi" schemes, a fiduciary may be held liable for causing losses to a plan by failing to take precautionary steps to limit a service provider's ability to embezzle assets from the plan. *See Chao v. Merino,* 452 F.3d 174 (2d Cir. 2006) (fiduciary was aware that service provider had previously embezzled funds). The recent events relating to Bernard Madoff and investments with BLMIS has prompted the DOL to provide guidance on what to do if plan assets were invested with Madoff entities. The DOL has stated that fiduciaries shall take the following steps: (1) request disclosures from investment managers, fund managers, and other investment intermediaries regarding the plan's potential exposure to investments at risk; (2) seek advice regarding the likelihood of losses; (3) make appropriate disclosures to other plan fiduciaries and the participants and beneficiaries; and (4) consider whether the plan has a claim that will reasonably lead to recovery of Madoff-related losses. *See Statement of EBSA – "Duties of fiduciaries in Light of recent Events Regarding Bernard L. Madoff investment Securities LLC"* found at http://www.dol.gov/ebsa/pdf/madoffguidance.pdf.

Fiduciaries are also required to know all of the expenses that are being paid by the plan, directly or indirectly, and to determine if they are reasonable (i.e., whether the expense is competitive in the marketplace and whether the plan and its participants receive value commensurate to the cost). 29 U.S.C. §§ 404(a)(1)(A)(ii), 406(a) (1) (C), and 408(b) (2). Fiduciaries are not required to choose the least expensive services,". . . ensure that fees paid to service providers and other expenses of the plan are reasonable in light of the level and quality of services provided." *See* www.dol.gov ("A Look at 401(k) Plan Fees"). Fiduciaries should be provided with written disclosure of all compensation and other payments, direct or indirect, related to the investments being recommended.

In 1996, the Advisory Council to the DOL's Working Group on Service Providers drafted representative types of questions to which fiduciaries should seek answers to satisfy their obligations as fiduciaries under ERISA. We believe these questions provide reasonable guidance to help fiduciaries comply with their obligations under ERISA and we have, therefore, included them in the Appendix to this Chapter.

35.21.3 Fiduciary Training

Plan fiduciaries should have formal and continuous fiduciary training. In fact, during DOL investigations, when government officials interview plan fiduciaries, one question that is guaranteed to be asked is whether the fiduciary can describe what she thinks are her fiduciary duties under ERISA. Furthermore, in recent settlements the DOL has made periodic fiduciary training a mandatory term of settlement.

Additionally, fiduciary training is extremely useful given that ERISA, a complicated law to begin with, is constantly evolving and that litigation in this area is at an all time high. The ability to detect issues and know when to consult with trusted advisors is critical. Detecting fiduciary issues early can help prevent lawsuits and government investigations. In addition, with counsel, a breach may be detected and corrected thorough the DOL's Voluntary Fiduciary Correction Program or the Delinquent Filer's Voluntary Correction Program.

In addition to reviewing the specific fiduciary duties under ERISA, fiduciary training can include the following: the roles of the sponsor, administrator, management, and service providers; the basics of trust law; effective decision making; basic administrative operations and processes; disability issues; asset classes and their characteristics; historical risk and returns; investment tolerance; diversification and asset allocation; and performance measurement.

PART III -- ERISA LITIGATION AND RISK MANAGEMENT

35.22 Common Claims

The following in a non-exhaustive list of the type of ERISA cases being filed, many of which are being filed as class actions: (i) "stock drop" cases (alleging that participants lost value in their plan accounts as a result of a drop in stock prices, as discussed in detail below), (ii) fee cases (alleging that it was imprudent for the fiduciaries to select certain funds because the fees were too high), (iii) merger and acquisition cases (alleging that participants lost benefits as a result of a merger or acquisition), (iv) early retirement benefits cases (alleging that participants were misled into accepting early retirement and received fewer benefits as a result), (v) cash balance

cases (alleging that the participant's benefit decreased when his account was transferred from a traditional plan to a cash balance plan), (vi) discrimination/retaliation cases (alleging that the participant was retaliated against for claiming benefits), (vii) retiree health benefits cases (alleging that the participant did not received the promised health benefits), and (viii) cases alleging that fiduciaries engaged in prohibited transactions, had a conflict of interest, and/or breached their fiduciary duties.

35.23 Settlements

ERISA litigation is at an all time high and plaintiff's counsel have become more sophisticated in pleading violations of ERISA. In 2008, the top ten private plaintiff ERISA settlements totaled $17.7 billion, a significant increase from the year before, in which the top ten ERISA settlements totaled $1.818 billion. *See "Annual Workplace Class Action Litigation Report"* (Seyfarth Shaw 2009).

A decision to settle a case on behalf of a plan is a fiduciary act subject to all of the fiduciary duties and responsibilities under ERISA. PTE 2003-39 68 FR 75632, 75635. It is important for fiduciaries to engage in prudent processes, and document such processes, in reaching a decision as to whether or not to sue or whether to settle a claim on behalf of a plan. 29 U.S.C. § 1104.

Settlements authorized by fiduciaries must be reasonable, in light of the plan's likelihood of full recovery, the risks and costs of litigation, and the value of claims foregone. Such settlements must be no less favorable to the plan than comparable arm's-length terms and conditions that would have been agreed to by unrelated parties in similar circumstances. In addition, the transaction must not be part of an agreement, arrangement or understanding designed to benefit a party in interest. PTE 2003-39, Application No. D-11100, in 68 Fed. Reg. 75632, 75635 (Dec. 31, 2003). How these factors are weighed by fiduciaries will differ, depending on the type of case, but will always require a prudent decision-making process, given the facts and circumstances of the particular situation. PTE 2003-39; 68 FR 75632, 75636.

When plan fiduciaries enter into settlement agreements on behalf of plans which are suing such entities as the employer or an investment provider, those entities are normally "parties in interest" (*i.e.*, related to the plan under ERISA and DOL regulations). It is the DOL's view that a potential claim or "chose in action" is a type of property and that a plan's release of its claim against such party in interest may constitute a prohibited sale or exchange with the plan, as well as a prohibited transfer or use of plan assets for the benefit of a party in interest. *See* DOL Opinion Letter 95-26A. On the other hand, there are many situations in which a plan settles litigation which may not give rise to a prohibited transaction or may otherwise be covered by an existing statutory or administrative exemption. For example, settlement with a service provider of a dispute related to the provision of services or incidental goods to the plan that is otherwise exempt under ERISA 408(b)(2) would not be considered a prohibited transaction by the DOL. *See* DOL Opinion Letter, 95-26A.

One court examined the issue of whether an administrator of a self-insured health plan breached his fiduciary duty by failing to bring suit against the employer for failure to pay claims. *Herman v. Mercantile Bank NA*, 137 F.3d 584 (8th Cir. 1998), *as amended*, 1988 US App. LEXIS 7496 (8th Cir. 1988). The court held that in order to find that a fiduciary breached its duty for failure

to pursue a lawsuit, the court must find that the lawsuit would be successful and advantage the beneficiaries of the plan. The court also took into consideration the length of time it would take for the lawsuit to benefit the plan. *Id.* at 587.

With respect to the DOL's view that the exemption provided in Section 408(b)(2) may cover an exchange of property made solely to resolve claims arising out of the performance of an underlying service arrangement, the DOL notes that this exemption would *only* apply if:

> (1) the underlying service arrangement giving rise to the party in interest relationship is exempt under Section 408(b)(2) and the underlying arrangement continues to meet the requirements of Section 408(b)(2), after taking into account --
>
> (a) the settlement itself,
>
> (b) the alleged conduct of the service provider which gave rise to the claim, and
>
> (c) the following additional factors where the nature of the alleged conduct makes their consideration appropriate -
>
> (i) the service provider's ability to provide adequate assurances that the alleged conduct which gave raise to the claims and similar conduct will not occur in the future, *including, where relevant, the service provider's willingness to acknowledge intentional wrongdoing or negligence*, and
>
> (ii) the plan fiduciaries' ability to guard against the opportunities for any future abuse that may be inherent in the party in interest relationships between the settling parties and the plan;
>
> (2) the party in interest relationship arises solely from service arrangements that are exempt under Section 408(b)(2); and
>
> (3) the settlement is a reasonable arrangement from the point of view of the plan in that the plan fiduciaries have prudently determined that the plan will receive payment in the settlement that is at least equal to the value of the plan's claims considering the risks of litigation. DOL Advisory Opinion 95-25A.

35.24 Fidelity Bond

ERISA generally requires every person who "handles" plan assets to be bonded, i.e., those who, with respect to plan assets, have the authority to sign checks, endorse instruments, or disburse funds. The purpose of the bond is to protect against misappropriation by persons handling plan assets and, generally, the amount required must not be less than 10% of the funds handled. ERISA § 412, 29 U.S.C. § 1112. Under 29 CFR § 2580.412-11, the bond must insure those who handle funds, from the first dollar of loss up to the maximum amount that can be purchased with plan assets is $500,000 per plan. In the case of a plan with employer securities, the maximum amount that can be purchased with plan assets is $1,000,000. *See* Pension Protection Act of

2006, Pub. L. No. 109-280, 120 Stat. 780 (2006). Additional bonding above the $500,000 or $1,000,000 can be purchased using other assets not coming from the plan such as assets of the plan sponsor.

The fidelity bond may not have a deductible, as in a fiduciary liability policy. However, based on the DOL regulation and guidance, fidelity bonds can have a deductible but only after exhausting the required maximum amount (*i.e.*, the $500,000 or $1,000,000 amount, whichever is applicable) *See* 29 CFR § 2580.412-11 and *DOL Field Assistance Bulletin No. 2008-04 – Guidance Regarding ERISA Fidelity Bonding requirements.*

35.25 Fiduciary Liability Insurance

Obtaining fiduciary liability insurance -- and at the proper amounts (a "tower" of insurance) -- is a major risk management tool that ERISA fiduciaries must consider. These policies provide Directors and Officers type insurance coverage, in that they protect directors, officers, and executives from allegations of breach of fiduciary duty under ERISA. In addition, these policies provide protection in connection with administrative errors and omissions in the day-to-day operation of a plan.

ERISA § 410 (29 U.S.C. § 1110) provides, in part, that a plan can purchase insurance for its fiduciaries or for itself to cover liability or losses occurring by reason of the act or omission of a fiduciary, if such insurance permits recourse by the insurer against the fiduciary in the case of a breach of fiduciary obligation by such fiduciary.

Understanding how these policies are triggered is crucial to understanding whether the plan and its fiduciaries will be adequately protected. The typical fiduciary policy provides the following terms and conditions, which should be thoroughly analyzed at least no later than the moment an allegation of misconduct or breach of duty is made against a fiduciary.

• Insuring Clause

The insuring clause provides, in part, that the Insurer shall pay all sums it becomes legally obligated to pay as damages on account of any claims made during the Policy Period as a result of any actual or alleged breach of fiduciary duty committed by any Insured.

• Defense Costs Coverage

These policies usually permit the Insured to select counsel from a list of approved law firms and require that the Insurer pay for defense fees and costs after the retention/deductible has been satisfied.

[STRATEGIC POINT] Prior to deciding which insurance company to buy coverage from, it is important to find out which law firms are approved by the insurance companies being considered. If a particular firm is preferred by the plan and its fiduciaries and it is not on an insurance company's "approved" list, the fiduciaries may attempt to negotiate the addition of that law firm through a special endorsement to the Policy.

• Definition of "Claim": may include a written demand for monetary or non-monetary relief; civil, criminal or arbitration proceeding commenced by service of a complaint, return of an indictment or receipt or filing of a notice of charges; formal agency or regulatory proceeding; or an informal or fact finding investigation.

• Definition of "Insured": may include any "Natural Person Insured," which are past, present or future directors, officers, and/or employees of the sponsoring organization in their capacity as fiduciaries, administrators or trustees of a covered plan, any plan, or the sponsor organization.

• Definition of "Wrongful Act": may include a violation of any of the responsibilities, obligations or duties imposed upon fiduciaries by ERISA or similar law; any matter claimed against an Insured solely by reason of his, her or its status as a fiduciary; any act, error or omission solely in the performance of counseling employees, participants and beneficiaries, providing interpretations, handling records, and activities affecting enrollment, termination or cancellation of employees, participants and beneficiaries.

• Definition of "Loss": may include, damages, judgments, settlements and defense costs; certain civil penalties (ERISA § 502(l), (i), or (c) penalties); certain penalties under the IRS or DOL amnesty programs. Excluded from the definition of loss are: other penalties, taxes, uninsurable matters, benefits

• Exclusions: Some of the more common exclusions under these policies are: dishonesty or personal profit by insured; knowing or willful (or reckless) violation of any statute, rule, or law; criminal or deliberate acts; claims or notice of circumstance reported to prior insurers; pending or prior litigation or investigations; failure to collect contributions owed to a plan; failure to fund a plan in accordance with ERISA; failure to procure, maintain, or renew adequate insurance; failure to comply with workers' compensation, unemployment, social security and similar laws; bodily injury/property damage; discrimination (except in violation of ERISA); and Insured versus Insured.

35.26 Employer Securities and Stock Drop Cases

Increasingly, companies are being named as defendants by plaintiffs' counsel in what are known as employer or company "stock drop" class action lawsuits. These lawsuits -- which tend to allege violations of both the federal securities laws and ERISA -- continue to be filed in part because participants are still investing a large percentage of their retirement savings in employer stock, despite the well publicized losses in retirement savings accounts held in the Enron and Worldcom plans.

Indeed, as discussed above, ERISA specifically authorizes and promotes such employee ownership mechanisms. An employer may sponsor an ESOP consisting exclusively or primarily of employer stock, and the plan fiduciaries are relieved of the ordinary requirement of diversification. Similarly, there is no diversification requirement with respect to plan investments in qualified employer securities in a 401(k) plan offering a number of other investment options and allowing participants to direct and change their own investments in them. *See* 29 U.S.C. §§ 1104(a)(2) and 1107(a)(2).

Further, suits are also being filed against fiduciaries as a result of their investments in funds consisting of mortgage backed securities, which have lost tremendous value as a result of the subprime mortgage crisis. Indeed, companies have already sustained tremendous losses as a result of the crisis, with estimates of the eventual losses as high as $300 billion. Predictably, plaintiffs have filed litigation alleging not only that the securities laws have been violated but that ERISA has been violated as well, claiming that investment in mortgage backed securities was too risky an investment for a retirement account.

Over the past few years there has been an explosion of ERISA fiduciary litigation in response to adverse corporate news, and it is likely to increase given the current economic climate. The cases arise in a number of different circumstances -- from the alleged fraud and insider self-dealing of the Enron executives to cases where the company simply suffers a decline in stock value due to business and market conditions. A leading plaintiff's firm maintains a website, www.erisafraud.com, identifying companies it has sued or is suing, as well as others under investigation.

In virtually all of these cases, the plaintiff makes two sets of allegations. First, the plaintiffs allege that those responsible for overseeing the ESOP or the investment options in a 401(k) plan failed in their fiduciary obligation under ERISA to diligently evaluate whether company stock was a prudent investment for the plan. Second, in most of the cases, plaintiffs allege, much like in a securities case, that corporate insiders failed to disclose material adverse information about the company, thereby permitting the plan and its participants to acquire stock at "artificially inflated prices."

35.27 Typical Impediments to Recovery

Case law suggests that there are certain impediments to succeeding on a claim for breach of fiduciary duty based on alleged imprudence in offering employer stock in an Eligible Individual Account Plan ("EIAP") or ESOP, or in failing to disclose adverse information about the company. Certain Circuits have not ruled directly on the issue of whether a fiduciary has an affirmative duty to disclose nonpublic corporate developments that might affect the value of the employer stock to plan participants. However, the Second Circuit has held recently that this requirement is not one of the disclosure requirements explicitly provided under ERISA, and that it would be inappropriate to infer such a duty from the general fiduciary provisions of ERISA (duty of loyalty and prudence). *See In re Citigroup ERISA Litigation*, 2009 WL 2762708, *21 (S.D.N.Y. Aug. 31, 2009).

35.28 The Presumption of Prudence

In light of ERISA's express exemption of EIAPs and ESOPs from the requirements of diversification, it is unclear that a fiduciary may ever be held liable for losses in company stock investments in an EIAP or ESOP. *Wright v. Oregon Metallurgic Corp.*, 360 F.3d 1090, 1097-98 (9th Cir. 2004). Although a number of appellate courts have now held that liability can attach, they are nonetheless in agreement that company stock investments are to be deemed presumptively prudent. *Kuper v. Lovenko*, 66 F.3d 1447 6th Cir. 1995); *Moench v. Robertson*, 62 F.3d 553 (3d Cir. 1995). Under these cases, to rebut the presumption of prudence requires that "the plaintiff must show that the ERISA fiduciary could not have believed reasonably that

continued adherence to the [plan's terms] was in keeping with the settl[o]r's expectations of how a prudent trustee would operate." *Moench*, 662 F.3d at 571.

These cases also suggest that the presumption of prudence may be overcome only by showing that fiduciaries knew of events calling into serious question the viability of the company and the prospects that there would be any long-term value in the employer stock. *See, e.g., Moench*, 62 F.3d at 572 (presumption may be overcome where fiduciaries know that company's financial situation "is seriously deteriorating and there is a genuine risk of insider self-dealing."). A number of courts have resisted any hard-and-fast pronouncements about the particular circumstances in which the presumption may be overcome, but they have done so principally because the cases have been before them on motions to dismiss, without any developed factual record. *See, e.g., Lalonde v. Textron, Inc.*, 369 F.3d 1 (1st Cir. 2004).

35.29 The Requirement of Causation

The language of ERISA Section 409(a), permitting recovery from a fiduciary of losses, specifically requires that such losses *result from* a breach of his or her fiduciary responsibilities, requiring as a condition for imposing monetary liability that the breach alleged be the proximate cause of a loss to the plan. Several courts have applied the loss causation standard in securities fraud cases set forth by the Supreme Court in *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005), to ERISA cases. *See In re Boston Scientific Corporation ERISA Litigation*, 254 F.R.D. 24 (D. Mass. 2008); *Bendaoud v. Hodgson*, 578 F. Supp. 2d 257 (D. Mass. 2008); *but see In re Cardinal Health Inc. ERISA Litigation*, 424 F. Supp. 2d 1002 (S.D. Ohio 2006) (holding that *Dura's* loss causation requirements applicable in cases of securities fraud does not apply in the context of ERISA claim for breach of fiduciary duty based on material misrepresentation and/or failure to disclose material information). In *Dura*, the Supreme Court held that to recover for securities fraud based on an allegation that the plaintiff purchased stock whose price was "artificially inflated" by misrepresentation, the plaintiff must be able to link the misrepresentation to a drop in the stock price after purchase.

The causation requirement is important in ERISA stock drop cases. Loss must be measured starting from the time of the alleged breach. Further, the measure of recovery will depend on what the court determines a prudent and loyal fiduciary should have done, and that the defendants did not do, at a particular point in time. If the prudent action was to have closed a stock fund to new investments at a particular time, subsequent losses on holdings in the fund as of that date would not be recoverable because that loss is not attributable to the breach. As noted above, losses based on fraud type theories of fiduciary breach are similarly limited.

The only case where losses on the existing holdings in company stock would be found to have "resulted from" a breach of fiduciary duty is where the breach was in the failure to liquidate existing holdings of company stock. However, this would be difficult to prove as the presumption of prudence would apply Furthermore, usually employer stock funds are established in accordance with the plan documents (such as ESOPs), which may additionally provide that the participants, rather than the fiduciaries, are entitled to direct their own investments. Thus, liability pre-supposes that the fiduciary should have overridden the plan's clear terms. Fiduciaries who override plan terms in that fashion may well be violating ERISA,

and could be subject to liability for such action. *See Tatum v. RJR Reynolds Tobacco Co.*, 392 F.3d 636 (4th Cir. 2004).

35.30 Best Practices: Risk Management Against Employer Stock Drop Cases

Defending and ultimately resolving an employer stock drop class action lawsuit can be quite costly. Furthermore, these cases are disruptive to the company's business as, more often than not, the company's D&Os are named in the lawsuit. In this regard, fiduciaries and plan sponsors should make an assessment as to whether the employer stock fund is a viable and appropriate investment. This would entail an analysis of the employer stock itself as well as how it mixes in with the entire investment portfolio.

After reviewing the employer stock fund, fiduciaries should implement separate and specifically tailored procedures for managing the fund. Fiduciaries should also be aware that directed trustees have a duty to investigate if they notice a "red flag" of misconduct. *See Pugh v. Tribune*, 521 F.3d 686, 699 (7th Cir. 2008). In addition, should a fiduciary find that he or she is in a conflict, he or she may then make a determination as to whether an independent fiduciary should be retained to temporarily manage the fund.

Fiduciaries who retain an independent fiduciary must consider the same factors used when retaining any other service provider. It should be clear that the independent fiduciary is to opine on the viability of the employer stock and execute its autonomous determination as to whether to retain or sell the employer stock. *See Bunch v. W.R. Grace & Co.*, 555 F.3d 1 (1st Cir. 2009).

After this process, the fiduciaries need to decide what, if any, communications should be made to the plan participants. Under ERISA, fiduciaries must disclose material facts regarding the risks attendant to an employer stock fund. *See Anweiler v. American Electric Power Service Corp.*, 3 F.3d 986, 991-992 (7th Cir. 1993).

Lastly, fiduciary liability insurance should be obtained (or, if already obtained, reviewed) to ensure that the plan and its fiduciaries are adequately protected against loss.

35.31 Plan Fees and Expenses

Since 2006, there has been an increased focus by plaintiff's lawyers, the DOL, and Congress on fee arrangements for 401(k) plans, leading to a flurry of litigation and proposed regulatory and legislative activity. Numerous class action lawsuits involving Fortune 100 companies have been filed which include allegations of excessive fees and expenses and failure to provide sufficient investment information to inform participants.

Further, to improve fee disclosure by plans, the DOL has revised the Form 5500 Annual Report/Report of Employee Benefit Plan (discussed below), including Schedule C.

[STRATEGIC POINT] Fiduciaries need to review the plan's current contracts and arrangements with its service providers to ensure that they are reasonable as required by ERISA Section 408(b)(2). When reviewing these plan documents, fiduciaries should use as a guide the proposed DOL regulations on fees as well as any recent case law. Note that ERISA Section 408(b)(2) is a statutory exemption from the prohibited transaction provisions under ERISA. In

this regard, failure to meet the requirements under ERISA Section 408(b)(2) would mean that the fiduciaries engaged in a prohibited transaction with the service provider and would be exposed to liability and excise taxes.

Recently, the Seventh Circuit upheld the district court's finding that there was no violation of ERISA by Deere and Fidelity for failure to disclose revenue sharing arrangements that existed between Fidelity Trust and Fidelity Research, since the arrangement violated no statute or regulation. *Hecker v. Deere & Company*, 556 F.3d 575 (7th Cir. 2009). The court stated that the participants were informed about the total fees imposed by the various mutual funds and were free to direct their investments to lower cost funds if they chose to do so, *Id.* at 585, and concluded that no breach of fiduciary duty occurred in the selection of the investment options. In fact, the Seventh Circuit even questioned "whether Deere's decision to restrict the direct investment choices in its Plans to Fidelity Research funds is even a decision within Deere's fiduciaries duties." *Id.* at 586.

While the *Deere* case is noteworthy, the SEC has stated that revenue sharing arrangements "not only pose potential conflicts of interest, but may also have the indirect effect of reducing investors' returns by increasing the distribution-related costs incurred by a fund." 69 Fed. Reg. 6438, 6441 n. 21 (Feb. 10, 2004). Thus, at present, an ERISA fiduciary is arguably required to disclose such fee arrangements to plan participants because such arrangements present a potential conflict of interest and would likely have a direct effect on a participant's account. Further, there is a pending bill in Congress that may require the disclosure of such fee arrangements.

Aside from fees charged by investment vehicles, there are other fees that must be reviewed. For example, labor expenses may be paid from plan assets. *See* DOL Advisory Opinion 89-09A (June 13, 1989) (advising corporation that provided administrative and other services to the employee benefit plans it sponsored that employees should maintain time sheets of all hours worked separated by plan for which work was done). In *Dole v. Formica*, 1991 U.S. Dist. LEXIS 19743, *6-*8 (N.D. Ohio Sept. 30, 1991), the trustees of a Union pension fund arranged for business agents of the Union to provide administrative services to the fund in exchange for compensation from the fund based on a percentage of fund contributions. The court found that this was a transaction between the plans and a party-in-interest under Section 406(a)(1)(C), but that the "arrangement is not a per se violation of ERISA." *Id.* at *22-*23. Relying on Section 408(b)(2)'s exemption for reasonable compensation, the court determined that the fee arrangement was reasonable when first implemented because it was based on the time the Union agents actually spent on servicing the funds, as determined by a study conducted by the fund trustees. *Id.* at *23. However, the trustees did not review the arrangement for over ten years and it had become unreasonable. *Id.* Ultimately, the court recognized that "the Union was an acceptable, or even a preferable service provider" but held that the trustees acted "unreasonably in paying a straight percentage of the contributions as compensation for services when the services rendered are undocumented." *Id.* at *26.

In addition, the court found that the trustees could not properly review the arrangement because of the "lack of record-keeping" by the Union agents. *Id.*; *see also id.* at *8 ("The business agents kept no records or documentation identifying or describing the services they provided to the Fund or the amount of time spent on such services."). The court further found that the trustees

could have demonstrated that the funds paid reasonable compensation by "showing the cost to the Funds if these services were provided by others." *Id.* at *25. *See also Donovan v. Dillingham*, 1984 U.S. Dist. LEXIS 20546, at *7 (N.D. Ga. Jan. 10, 1984) (finding prohibited transaction with party-in-interest where plan trustees employed wholly owned corporation as administrator of trust and instead of specifying amount of compensation, paid the corporation the "excess amount of contributions remaining after the insurance premiums had been purchased").

PART IV – REPORTING AND DISCLOSURE

35.32 Form 5500 and Audited Financials

The DOL recently revised the annual reporting requirements plans must make on Schedule C of Form 5500. *See* 72 Fed. Reg. 64710 (Nov. 16, 2007). Effective for 2009 plan year filings, the new Schedule C requires plans to report service providers who receive $5,000 or more in compensation during the plan year, and to report direct compensation paid to service providers in a line item separate from indirect compensation received by service providers from sources other than plan or plan sponsor. 72 Fed. Reg. at 64712 (Nov. 16, 2007).

Service providers whose compensation is limited to "eligible indirect compensation" (i.e, certain specified types of common investment related fees) must provide the plan administrator with written disclosures of (i) the existence of indirect compensation, (ii) the services provided or the purpose of the indirect compensation, (iii) the amount or a description of the formula used to calculate the compensation, and (iv) the identity of the parties paying and receiving the compensation. *Id.*

If a service provider fails or refuses to provide such necessary compensation disclosures, the plan administrator must specifically identify the service provider on the revised Schedule C.

The DOL believes that these revisions will assist plan administrators in monitoring compensation arrangements, better understand the impact of fees, and better evaluate the value of the services retained, and that plan administrators will now have the ability to negotiate fair prices for necessary plan services. 72 Fed Reg. 64719 (Nov. 16, 2007).

ERISA has comprehensive and extensive reporting and disclosure requirements, depending on the type of plan. The following reflects some of the major requirements.

35.33 Summary Plan Description/ Summary of Material Modifications

The Summary Plan Description (the "SPD") is the main document for informing participants and beneficiaries about the plan and how it works. The DOL requires that the SPD be written in a manner that can be understood by the average participant and have sufficient details so participants can assess their benefits, rights and obligations under the plan. The DOL has prescribed certain requirements for style, format and content of the SPD. *See* 29 C.F.R. § 2520.102-2 and 2520.102-3.

The SPD must be distributed to participants automatically within 90 days of being covered under the plan and to beneficiaries within 90 days of receiving benefits. Should there be any changes to the plan, an updated SPD must be distributed every 5 years.

Usually when a plan is amended, a Summary of Material Modifications (the "SMM") must be issued to participants and beneficiaries describing the material modifications to the plan and changes to the SPD. The SMM must be distributed to participants and beneficiaries no later than after the end of the plan year in which the change was made.

35.34 Summary Annual Report

The Summary Annual Report (the "SAR") is a short report giving a basic summary of the Form 5500. Again, the DOL requires that the SAR be in a certain format. *See* 29 C.F.R. § 2520.104b-10(d). The SAR must be distributed to participants and beneficiaries within 9 months after the end of the plan year, or 2 months after the due date for filing the Form 5500.
Note that the SAR is not required for defined benefit plans beginning after December 31, 2007, because such information is now provided in the annual funding notice.

35.35 Pension Benefit Statement

The Pension Benefits Statement (the "PBS") provides the total benefits and total nonforfeitable pension benefits, if any, which have accrued, or the earliest date in which they become nonforfeitable.

The PBS for a 401(k) type plan must provide the value of each investment to which assets in the individual account have been allocated. The PBS for individual account plans, providing for participant direction, must include the following explanations: any limitations or restrictions on directing investments; the importance of a well-balanced and diversified portfolio (which includes a statement of the risk of holding more than 20% of a portfolio in employer securities); and a notice directing participants to the DOL's website for further information on investing and diversification.

The PBS must be issued quarterly for participant directed account plans and annually for non-participant directed plans. For defined benefit plans, the PBS must be issued once every 3 years or at least once a year if the administrator provides notice of the availability of the PBS and ways to obtain it.

35.36 Conclusion

As should be apparent from the foregoing discussion, complying with ERISA and its regulations is no easy task given the complexity of the statute and the fact that the law continues to develop at a rapid pace as a result of a number of factors. A fiduciary's task is made that much more difficult given that the issue of whether a person has breached fiduciary duties is extremely fact-intensive and may vary depending on the particular circuit within which the case is brought. It is thus often difficult to predict whether a particular course of action will shield the fiduciary from liability or make the fiduciary an easy target for the government or plaintiff's bar.

Notwithstanding these challenges, this Chapter has attempted to provide an overview of the basic requirements of ERISA and concrete steps that companies and their fiduciaries should take in order to remain compliant and to avoid liability. Whether the task involves establishing a

benefits committee, selecting a service provider, monitoring other fiduciaries, or selecting or monitoring investments, the key to ERISA compliance is to, at all times, act in accordance with the fiduciary duties outlined above, i.e., (i) act for the "exclusive purpose" of the plan, (ii) act with "prudence," (iii) use "diversification" with respect to plan investments (unless exempted, as discussed), and (iv) act in accordance with the "terms of the plan."

PART V: PRACTICE RESOURCES

§ 35.37 Research References

- Report of the Working Group on Guidance in Selecting and Monitoring Service Providers, dated November 13, 1996, found at http://www.dol.gov/ebsa/publications/srvpro.htm.

- ERISA Reporting and Disclosure Provisions: Labor and Employment Law, Chapter 149

- Discrimination Claims Under ERISA: Employee Rights Litigation: Pleading and Practice, chapter 9