ROUGH SEAS AHEAD?
CHARTING A SAFE COURSE FOR
COMPANY STOCK PLAN
FIDUCIARIES

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In the 80’s and 90’s issues involving company stock investments in retirement plans received little attention. Yes, there was a significant flurry of leveraged ESOP/KSOP activity in the late 80’s, and an occasional case that caught the attention of ERISA specialists. But as the stock market continued its successful run in the 90’s, many employees were quite pleased with the performance of company stock investments in their retirement plans and plan committees were busy tracking pension fund investment performance or reviewing the variety of investments offered in the 401(k) plan. Enron changed that. Enron captured our attention and even brought company stock losses in retirement plans to the nightly news. ERISA fiduciary suits were brought not only against Enron,¹ but also against, most notably, Rite Aid,² WorldCom,³ Global Crossing,⁴ Lucent Technologies,⁵ Nortel Networks,⁶ Tyco International,⁷ and the Williams
Companies, and one class action firm created a website "erisafraud.com."

These recent suits typically follow a significant loss of value in the company stock investment of an ESOP and/or 401(k) plan. The ERISA suits often follow the filing of class action litigation charging a company with securities laws violations. The ERISA claims generally focus on breach of fiduciary duty and are often coupled with accusations of impropriety on behalf of corporate officers. Some of the cases allege a conflict of interest, which precluded the plan sponsor or internal fiduciaries from investigating the merits of a continued investment in company stock. Most charge that the plan sponsor or its officers, who might also be members of a plan fiduciary committee, should have disclosed material non-public information to plan participants who continued to invest in the employer’s stock. The complaints typically allege a fiduciary breach for failure to discontinue new purchases of company stock and failure to sell or liquidate the stock before
a further price decline. Some accuse the plan sponsor of failing to register the plan’s company stock investment under an S-8 filing and claim the fiduciaries breached their duty by not exercising the plan’s rescission rights. Typical defendants may include individual plan committee members, the plan sponsor, officers or directors responsible for appointing plan fiduciaries and the trustee.

The Department of Labor has weighed in on the Enron issues, initially in an amicus brief opposing the Enron defendants’ motion to dismiss the ERISA class action complaint and then a subsequent filing of their own ERISA fiduciary breach suit against various Enron defendants. Most of the positions taken by the DOL are not new: The people who appoint fiduciaries have a responsibility to monitor the appointees; if the company stock investment is no longer appropriate under ERISA, the fiduciary may be required to cease new investments; and a directed trustee may have some responsibility to determine if the directions it receives are proper. The amicus brief shed further light on
the DOL’s position regarding inside information and
disclosure of certain information to fiduciaries and
participants. The brief says that appointing fiduciaries (the
board or other individuals who appoint fiduciaries for the
plan or plans) have the obligation to insure the appointed
fiduciaries have accurate and critical information necessary
to carry out their duties. This includes an affirmative duty to
protect plan participants from misleading information and to
correct inaccurate or misleading information so that
participants will not be injured; this may require that
additional information be provided to participants if the
fiduciaries (or appointing fiduciaries) are aware of particular
threats to plan assets. The brief describes steps the Enron
fiduciaries could have taken to protect the participants that
would have satisfied both the requirements of ERISA and
federal securities laws. These steps include informing all
Enron shareholders of Enron’s poor financial condition,
removing the fund as a plan investment option, or notifying
the SEC and DOL that potential misinformation was provided to plan participants.

The DOL’s amicus brief also argues that Northern Trust, as the trustee of the Enron ESOP and Savings Plans, was acting in a fiduciary capacity with respect to the lockdown, or blackout period, and breached its fiduciary duty to participants even if it was only a directed trustee. Northern Trust was not, however, named as a defendant in the DOL fiduciary breach suit, although it remains a defendant in the ongoing Enron ERISA class action suit that has been consolidated with the DOL suit.

The DOL reinforced its longstanding position in both the amicus brief and the fiduciary breach suit that plan fiduciaries have an obligation to participants to monitor and review the plan’s investment in company stock, and this obligation is not eliminated simply because the plan requires investment in company stock. This should serve as a reminder that plan fiduciaries should pay attention to investments in employer securities.
The Enron case presents a particularly egregious set of facts that few readers of this publication are likely to encounter. The suits alleges that Enron’s CEO and other management individuals improperly promoted continued investment in Enron stock during employee meetings even as they were aware of the financial deterioration and continued downward spiral of the company. It is not surprising that the DOL cast a broad net to identify who a fiduciary is and what the duties of the board and management are with respect to employer securities in ERISA plans. It will take time to see how the courts resolve these questions -- in any given case, who are the responsible fiduciaries and exactly what are they responsible for? Even if Enron seems fare afield from the experiences of ordinary ESOPs, the issues raised here provide one of the most thorough encapsulations of how to run—and not run—an ESOP. There are steps fiduciaries can take right now to improve their oversight of company stock investments. What is evident from cases past and present is that fiduciary
process still remains important. While each situation must be considered on a case by case basis, the following is intended to serve as a general guide for fiduciaries to consider when navigating in the post-Enron environment.

Know the ERISA Basics

Section 404(a)(1) of ERISA provides that a fiduciary must “discharge his duties solely in the interest of participants and beneficiaries...for the exclusive purpose of providing benefits to participants and beneficiaries and defraying reasonable expenses of administering the plan...with the care, skill, prudence and diligence under the circumstances then prevailing as a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims...by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so...in accordance with the documents and instruments governing the plan insofar as
such documents and instruments are consistent with the provisions of Title I of ERISA.” These are easily remembered as:

1. **Duty of Loyalty**: Act solely in the interest of participants.

2. **Exclusive Benefit**: Act only to provide retirement benefits and pay plan expenses.

3. **Prudent Expert**: Use due diligence and appropriate expertise.

4. **Diversification**: There is an exemption for ESOPs and company stock funds in other defined contribution plans, to the extent they hold “qualifying employer securities,” and an exemption from the prudence requirement to the extent that it also requires diversification. However, ESOP fiduciaries still must act
prudently concerning whether to buy or sell company stock when they know or should know that the stock is not an appropriate investment.

5. Pursuant to Plan Documents: Follow plan documents to the extent they are consistent with ERISA.

Read the Documents

To understand who the fiduciaries are and what their respective duties are, it is important to read the plan documents and trust agreement. On more than one occasion plan committee members thought the company had full responsibility for company stock investments, yet the documents indicated it was the committee’s responsibility; or trustees thought they were directed (told what decisions to make by another body or individual and thus partly exempt from fiduciary obligations), but the trust agreement provided them with investment discretion as well as valuation
responsibilities; or plan sponsors thought the trustee was the primary fiduciary for company stock, when in fact the trust document looked more like a mere custody agreement. In some documents, the company, acting through its Board of Directors, is responsible for the company stock investment or appointing the members of a fiduciary committee for a plan.

Often the committee may have the primary responsibility for company stock oversight and/or for directing the trustee with respect to investments in employer securities. Many institutional trust agreements attempt to limit the trustee’s responsibilities to custody type functions while others provide the trustee with significant discretion over investments including company stock. Look in the documents for clear delegation of responsibilities and any limitations on specific duties as well as indemnification provisions. Identify which fiduciary is responsible for determining if the company stock continues to be an appropriate plan investment. The documents are not always clear. Determine if the plan requires an “exclusive”
investment in company stock or provides the fiduciary with
greater discretion by requiring only that the plan be
“primarily” invested in company stock. Some plans have
investment policies or guidelines specific to the company
stock investment. Review the voting and tender provisions
to see who has primary and residual fiduciary responsibility
in exercising these rights.

The Summary Plan Description and other
employee communications should also be reviewed. If
voting and/or tender rights are passed through to participants,
a clear description of the rights and an explanation of how to
exercise those rights should be provided to participants
during the voting/tender process.

Appoint and Monitor Competent Plan
Fiduciaries

Often the company sponsoring the plan, acting through its
Board of Directors, is responsible for appointing plan
fiduciaries such as a plan committee and a trustee. The
Department of Labor’s long-held position is that the
appointment itself is a fiduciary act and carries with it a duty to monitor the performance of the appointed fiduciary.\textsuperscript{11} While there is no requirement for a fiduciary to have a pre-existing expertise in ERISA or financial matters through course study or seminars, the appointed fiduciaries should be capable of understanding the duties and responsibilities imposed upon them by ERISA. Individual fiduciaries should also have the ability and adequate resources to hire experts necessary to assist them in acting prudently in the execution of their fiduciary responsibilities. When appointing individuals, review their experience to determine if they have demonstrated sufficient accomplishments and/or competent decision-making responsibility during their career. In certain situations, it may be better to exclude individuals who are likely to acquire inside information that might someday present significant conflicts with the fulfillment of plan fiduciary responsibilities. Once appointed, individuals should attend meetings, implement sufficient processes, review investment performance, address appropriate issues
and report back to the board or individuals responsible for monitoring the fiduciaries.

If appointing an institutional fiduciary or trustee, prepare a list of questions or a written request for proposal and interview several candidates. Determine if the institution has experience specific to company stock investments and what background or expertise the individuals involved in providing the fiduciary services has. Each candidate should describe the general process or practices it has developed to address company stock issues. If the trustee is directed with respect to company stock investments, how does the trustee determine if the directions it receives are “proper”? What type of reporting or presentations will the institution provide on a periodic basis so that the appointing body may properly monitor the trustee’s performance?
Understand the Company Stock Investment

It is important for the fiduciary to have a general understanding of the operation and composition of the plan's company stock investment. The fiduciary should be aware if the investments in company stock are elective, mandated or both (for example, many 401(k) plans provide that deferrals can be invested in company stock at the election of the participant, but matching contributions are required to be invested in company stock). Often there are minimum holding requirements or other limitations on the investment such as restrictions from transferring to other investment options. Many company stock investments operate in a fund accounting environment with a cash or short-term investment component. Others are invested strictly in shares of the stock. It is helpful to understand how the liquidity needs of the plan are managed and if the stock is publicly traded common stock or convertible preferred stock, if the stock is registered, or if the investment is in the common stock of a private company. These are all facts which may impact how
a fiduciary monitors the stock investment and determines if it is appropriate to continue to buy, hold or sell stock.

Company stock investments in ESOPs and other eligible individual account plans, such as 401(k) plans, are exempt from the diversification requirements of ERISA and these plans may invest up to 100% of their assets in employer stock.\textsuperscript{13} However, a fiduciary is required to follow a plan document only to the extent the document is consistent with ERISA.\textsuperscript{14} The critical question remains -- under what circumstances is it inconsistent with ERISA to follow a plan provision that calls for investment in company stock?

Courts have found that if the plan provides for an investment in company stock there is a presumption that it is appropriate to invest in company stock.\textsuperscript{15} It is often asserted that this presumption may be overcome and that at some point it may be imprudent to continue to invest in company stock. The line, however, is anything but clear.\textsuperscript{16} What is clear in this post Enron environment, is that it is
risky business for a fiduciary not to monitor the performance of a plan’s company stock investment.

If a plan meets all the requirements of Section 404(c) of ERISA and the corresponding regulations, a safe harbor is provided to shield fiduciaries from liability resulting from a participant’s investment decisions. This protection is available if the participants are provided with sufficient information to make a reasoned decision. (Many of the recent cases include claims of misleading disclosures and material misrepresentations that were alleged to have been made to participants.) However, even if the company stock fund investment meets the regulatory requirements, the general fiduciary provisions of ERISA may still apply to the initial designation of the investment alternatives and the ongoing determination that such alternatives remain suitable and prudent options for the plan.\textsuperscript{17}
Be Familiar with the Prohibited Transaction Rules

Transactions between a plan and a party-in-interest are generally prohibited under ERISA unless there is an applicable exemption.\textsuperscript{18} There are certain exemptions for acquisitions and sales of “qualifying employer securities” where the acquisition or sale is for “adequate consideration” and no commission is charged. There is also an exemption for certain ESOP loans under Section 408(b)(3) of ERISA. If a class exemption does not exist, there is a process for applying for an individual exemption. There are rules prohibiting self-dealing under Section 406(b) of ERISA. The prohibited transaction rules are extensive and relatively complicated. A fiduciary should seek the advice of a qualified legal expert when a company stock transaction involves a party in interest.
Establish a Process

In evaluating whether a fiduciary acted in a prudent manner and solely in the interests of the participants and beneficiaries, courts and regulators often place as much or more importance on the manner in which a fiduciary arrived at a particular determination as the actual merits of the decision. To show that a fiduciary exercised procedural prudence in connection with a company stock investment, it is helpful for the fiduciary to have implemented a process to periodically review the company stock investment and perform sufficient due diligence to identify, discuss, and address issues as they arise.

A periodic performance review for company stock could be implemented in a manner consistent with the review process for all other retirement plan investments or offerings. If the stock is publicly traded, the fiduciary should be aware of dramatic price fluctuations or significant news. If it is stock of a private company, the fiduciary might review, with its valuation advisor, the company’s financial
reports and any material contingent liabilities. The fiduciary might implement a more active monitoring process or further meet to discuss the company stock investment in certain situations that could include:

- significant price decline vs. the market or industry peers
- debt/credit quality deterioration
- material negative news
  - financial restatements
  - unexpected earnings results
  - integrity of executives questioned
  - contingent liabilities and/or court decisions
- declining volume/float
- analysts dropping coverage
- distressed industry
- potential bankruptcy concerns

The decision to override a plan document or another fiduciary’s direction or a participant’s direction to invest in company stock is a very serious responsibility and generally
takes place in only extraordinary situations. However, an adequate review process indicating that the fiduciary is monitoring the investment and addressing issues when extreme situations occur may be a well-advised step for any company stock fiduciary.

**Make Reasoned Decisions**

A fiduciary must also demonstrate substantive prudence by making sound decisions. A thorough evaluation of the merits of the potential actions to be taken by the fiduciary should be completed before the fiduciary makes a final determination. If the investment becomes a problem situation, the prudence of a continued investment is highly suspect, the viability of the company is questionable or the stock is experiencing a potentially irreversible decline in value, the fiduciary might consider the following actions:

- reduce or eliminate transfer restrictions
- modify plan provisions with respect to in-kind matching obligations
• increase the cash position of the company stock fund
• suspend or discontinue new investments in the stock
• sunset the company stock as an investment option
• evaluate an exit or sales strategy
• select a default investment
• commence a selling program or an orderly liquidation

Engaging in discussion about these matters with the plan sponsor may be desirable or essential.

In these problem situations it is sometimes critical for the fiduciary to have independent expert advice. Independent legal counsel may be desirable, and a financial or investment expert may also be advisable. The retention of an independent fiduciary may be appropriate to avoid potential conflicts of interest. Donovan v. Bierwirth19 involved internal plan fiduciaries who were corporate officers actively opposing a takeover attempt. These fiduciaries refused to tender the plan’s stock and even had the plan buy more than a million additional shares. The court stated that the fiduciaries were required to make all their plan
fiduciary decisions with “an eye single” to the interests of the plan and its participants. The court concluded that the fiduciaries should have realized that their plan fiduciary judgment was biased and that by failing to ensure the plan’s interests were properly considered and protected, the trustees breached their duty to act “solely in the interest” of the plan.

Review SEC Issues

If the plan sponsor’s stock is publicly traded, certain SEC filings may be involved. If the plan permits participant directed elective deferrals to be invested in company stock, the issuer of the stock must file a Form S-8 registration statement for the plan. If the Form S-8 is not filed, does not cover a sufficient number of shares or is not current (the company’s financial statements are not current), the plan may have a right to rescind all stock purchased within the previous year. For example, one of the claims in the Rite Aid case alleged a breach of fiduciary duty for failure to exercise the plan’s rescission rights. Are the plan’s purchases and
sales of company stock directed by the company or by a committee? The plan may be considered an affiliate of the company for SEC Rule 10b-18 or other purposes and so may be subject to blackout and aggregated volume restrictions. Does the plan own 10% or more of the company? If so, plan sales of company stock may be subject to the filing and disclosure requirements of SEC Rule 144 and further restricted by the amount of stock the plan may sell over a certain period. If the plan owns 5% or more of the company, a Form 13(d) or (g) filing may be necessary. It is helpful for the plan fiduciary to consult with experienced legal counsel when addressing plan and fiduciary issues related to securities laws and regulations.

**Document Decisions**

Meetings to discuss the fiduciary's responsibilities, due diligence or analysis, potential actions, considerations and determinations should be held and documented in the form of minutes. The minutes may include the date of the meeting,
the individuals who attended the meeting as well as any advisors present or participating in the meeting. Sufficient time should be allotted to fully discuss and consider appropriate actions and question advisors. It is often helpful to summarize the issues discussed as well as critical questions raised by the committee to the advisors. Written materials or analysis provided at the meeting should generally be retained. Plan documents should be reviewed and/or amended to appropriately implement the fiduciary’s desired actions. In a recent case where fiduciaries were sued for selling ESOP stock, the court specifically referenced amended plan language that provided the fiduciaries with appropriate discretion to sell ESOP stock to diversify the plan's assets.  

**Litigation/Settlement Decisions**

If a plan or its participants has potential claims or if litigation has been initiated, a fiduciary may have to evaluate the potential claims; this sometimes might be hard for an internal
fiduciary, because of potential conflict issues. Such claims might include breach of fiduciary duty, prohibited transaction issues, securities law claims, and claims against professionals. The fiduciary should determine if it is appropriate to pursue the claims, monitor existing litigation, or participate in a class action. In these situations issues to address may include: the sources and appropriateness of the recovery or the value of the consideration for potential settlement; the extent of any releases; the basis of the plan’s participation in a class action (the trust’s trading activity may differ from the participants’ trades); and the compensation of legal counsel. The Department of Labor has proposed a prohibited transaction class exemption covering situations where a plan, or fiduciary on behalf of the plan, is considering resolving claims against parties in interest in exchange for consideration. The proposed exemption provides guidelines and rules for the fiduciary to follow in the context of such situations.
Conclusion

It is important to remember that fiduciaries do not have to guarantee the results of their decisions and are not expected to accurately predict investment results or market performance.\textsuperscript{22} The mere fact that company stock price declines after an ESOP or 401(k) plan acquires it is not, in itself, evidence that fiduciaries acted improperly. What fiduciaries are expected to do is act in a diligent, prudent manner with the interests of participants always at the forefront of their determinations. With careful charting, perhaps the seas are not as rough as they may appear.

\begin{itemize}
\item \textsuperscript{1} Tittle v. Enron Corp. et al., Civ. Act. No. H-01-3913 (S.D.Tex.)
\item \textsuperscript{2} Kolar v. Rite Aid Corp., 01-CV-1229 (E.D.Pa.)
\item \textsuperscript{3} In re Worldcom, Inc. ERISA Litig., 02-Civ.-4816 (DLC)
\item \textsuperscript{4} McAllister v. Winick, 02-CV-7461 (S.D.N.Y.)
\item \textsuperscript{5} Reinhart v. Lucent Technologies, 01-CIV-3491 (D.N.J.)
\item \textsuperscript{6} In re Nortel Networks Corp. “ERISA” Litig., 3:03-CIV.-1537 (M.D. Tenn.)
\end{itemize}
In re Tyco International Ltd. Securities Derivative and “ERISA” Litig., 02-MOL-1335-B (D.N.H.)

In re Williams Companies ERISA Litig., 02-CV-153-H (N.D. Ok)

Chao v. Enron Corp., et al., H-03-2257 (S.D. Tex.)

For example, a District Court recently dismissed a typical suit against the company and its directors, but refused to dismiss the claims against a plan committee. In re Williams Companies ERISA Litig., No. 02-CV-153-H (M) (N.D. Okla., 7/14/03)

29 C.F.R. Section 2509.75-8

Under ERISA Section 403(a)(1) a trustee must follow “proper directions” of a named fiduciary which are “not contrary” to Title I of ERISA. Although ERISA is almost thirty years old, there is very little law on what the phrase “proper directions” actually means.

ERISA Sections 404(a)(2) and 407(b)(2)

ERISA Section 404(a)(1)(D).


ERISA Section 406


68 FR 6953 (Feb. 11, 2003)