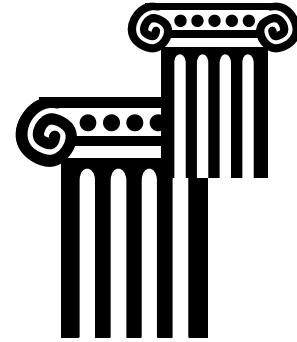


Independent Fiduciary Services®



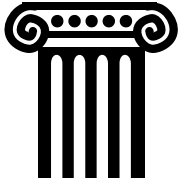
**2008 Subprime Lending Litigation Conference
CLE International
ERISA Breakout Session**

***Managing Fiduciary Risk in Company Stock
and Other Plan Investments***

May 2008

Andrew Irving, Esq.
Managing Director & General Counsel
Email: AIrving@IndependentFiduciary.com

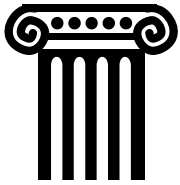
Independent Fiduciary Services®



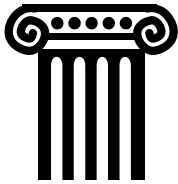
Contents:

I. Company Stock

- ❖ Emerging Trends for Company Stock
 - ❖ Managing Company Stock
 - ❖ Implications for Other Investment Options
-
- **Identifying and Managing Risk in ERISA Portfolios**
 - ❖ The Duty to Identify, Understand and Manage Risk
 - ❖ Elements Affecting the Level of Risk
 - ❖ Steps to Identify and Manage Risk



Company Stock

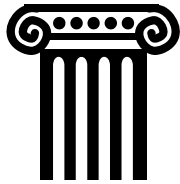


Emerging Trends for Company Stock

Eliminating Company Stock as an Investment Option

- ❖ Some anecdotal evidence but no widespread trend.
 - More pro-defendant court rulings in stock-drop cases
 - Company officials resist elimination strategy
- ❖ 2006 review by Congressional Research Service shows that 261 of 500 largest companies still offer Company Stock as an investment option.
- ❖ EBRI survey data show that participants are “voting with their feet”:
 - 44.5% of participants in plans offering Company Stock have none in their accounts at 12/31/06, up from 37% in 2004.
 - Company stock represents 11% of total 401(k) plan assets at 12/31/06, down from 19% in 1999.

Emerging Trends for Company Stock (cont'd)



Limiting Company Stock as an Investment Option

- ❖ Bills were introduced post-Enron but none enacted.
- ❖ 2006 Survey data showed 17% of “large company” plans imposed limits, and 13% more were planning on introducing them.
- ❖ DOL model notice to participants cites 20% of investment in a single company.



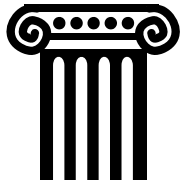
Emerging Trends for Company Stock (cont'd)

Hiring Independent Fiduciaries

- ❖ As Advisor
- ❖ As Decision-maker

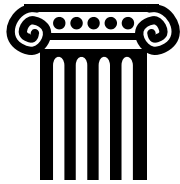
Changing Composition of Plan Committee

Emerging Trends for Company Stock (cont'd)



“Baking In” Company Stock in the Plan Document/KSOP

- ❖ Intended to exclude the Company Stock Fund from the scope of fiduciary discretion.
- ❖ Sharply limits the fiduciary committee’s ability to respond to events impacting the Company Stock.
- ❖ DOL footnote in the 404(c) regulations may undermine the effectiveness of this strategy if no KSOP (but see *Langbecker v. EDS*)
- ❖ Will the “settlor” doctrine really stand up when the facts get ugly?



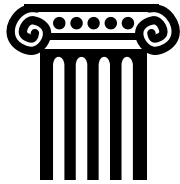
Managing Company Stock

Importance of Process

- ❖ Document who has authority for what

THE WHO	THE WHAT
The Board of Directors and its Committees	Eliminate the Stock Fund
The Fiduciary Committee(s)	Set/Change “Liquidity Level”
Company Executives	Suspend/Limit/Freeze
Contributions	
The Trustee	Communicate with Participants

- ❖ Regular Reports to the Right People
- ❖ Document Deliberations and Decisions

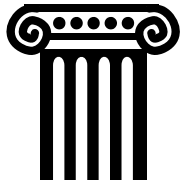


Managing Company Stock (cont'd)

What to Watch

(Can you really wait until the Company's "imminent collapse?")

- ❖ If *Moench* applies, the key is recognizing when "investing in employer securities would defeat or substantially impair the accomplishment of the purposes of the trust."
- ❖ The "brink of bankruptcy" is not required to trigger a duty to divest. *Edgar v. Avaya, Inc.*
- ❖ Watching the stock price is not enough, and by itself is just not relevant.
 - Claim dismissed in *Smith v. Delta Air Lines* despite 92% decline in stock price.
 - Claim dismissed in *In re McKesson HBOC, Inc. ERISA Litigation* despite 75% decline in stock price.
- ❖ Judge Posner in *Summers v. State Street Bank*: The Debt-Equity Ratio

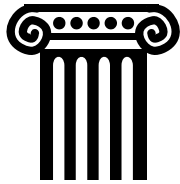


Managing Company Stock (cont'd)

What to Watch

(Can you really wait until the Company's "imminent collapse?") (cont'd)

- ❖ And if *Moench* doesn't apply, a "myriad of circumstances . . . could violate the [prudent person] standard." (*In re Syncor*)
- ❖ Other fundamentals about the Company (*Landgraff v. Columbia/HCA*)
 - Government investigations
 - Earnings restatements
 - Wall Street analysts
 - Bond ratings
 - Revenues
 - Net Income
 - Cash Flow
 - Significant litigation/regulatory challenges at the heart of the business
 - Pension funding? (*In re General Motors ERISA Litigation*)

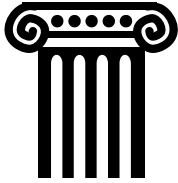


Managing Company Stock (cont'd)

What to Watch

(Can you really wait until the Company's "imminent collapse?") (cont'd)

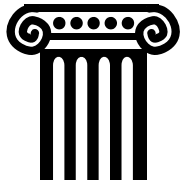
- ❖ The Stock (in isolation and compared to peers)
 - P/E, P/B, EPS
 - Insider trades/short sales
 - Performance versus broad indices and peers
- ❖ The Plan
 - Plan demographics
 - Trends in concentration of Company Stock
 - The breadth of other investment options (but the Fourth Circuit opinion in *DiFelice v. US Airways* saw things a lot differently than did the District Court)



Managing Company Stock (cont'd)

What to Do with All this Information

- ❖ Consider communicating with participants
- ❖ Consider hiring an independent fiduciary
- ❖ Consider diversifying the Company Stock Fund itself
- ❖ Amend the Plan to impose limits or even eliminate the Company Stock Fund



Implications for Other Investment Options

Selecting the options is still a fiduciary decision

- ❖ DOL footnote in the 404(c) regulations
- ❖ But *Langbecker v. EDS* decision may mitigate liability for imprudent selections

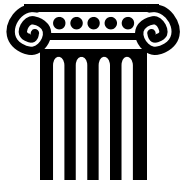
What about diversification? 4th Circuit decision in *DiFelice* says (in dictum) every option must be prudent

- ❖ Does this mean you have to assume for each option that it would be prudent if a participant put all of her assets in it?
- ❖ How diverse must each option be?
 - What about the “Dogs of the Dow” Strategy?
 - See, e.g., the Van Kempen Nasdaq Select 10 Portfolio (10 stocks)



Identifying and Managing Risk in ERISA Portfolios

Duty to Identify, Understand and Manage Risk



ERISA's Duty of Prudence

- ❖ Process is key
- ❖ But substantive outcomes matter too

The President's Working Group on Financial Markets

- ❖ “Investors in private pools of capital should obtain accurate and timely historical and ongoing material information necessary to perform due diligence regarding the pool’s strategies, terms, conditions, and risk management, thereby enabling such investors to make informed investment decisions.” Agreement Among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital, February, 2007.



Elements Affecting the Level of Risk

Stated Investment Objectives and Guidelines

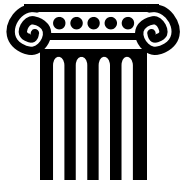
Management and Commingled Vehicle Structure

- ❖ Experience and Background
- ❖ Succession Planning
- ❖ Is it an ERISA “Plan Asset” Vehicle? If not, who is the fiduciary?

Independence of Service Providers (e.g., auditors and appraisers)

Conflicts of Interest

Valuation Methodology and Frequency

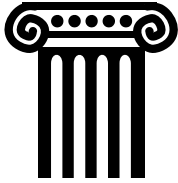


Steps to Identify and Manage Risk

Clear Investment Policy Statement

“The maintenance by an employee benefit plan of a statement of investment policy designed to further the purposes of the plan and its funding policy is consistent with the fiduciary obligations set forth in ERISA § 404(a)(1)(A) and (B).” U.S. Department of Labor ERISA Interpretive Bulletin 94-2, 29 CFR § 2509.94-2.

- ❖ Identify goals for the Fund as a whole, and the Fund’s risk tolerance
- ❖ Enumerate permissible asset classes
 - ❖ Range of % of plan assets for each
 - ❖ Diversification at the asset class and manager level
 - ❖ Clear benchmarks
 - ❖ Rebalancing policy

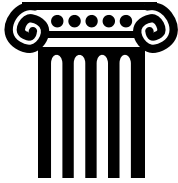


Steps to Identify and Manage Risk (cont'd)

Rigorous Manager Search Process

- ❖ Use an RFP
 - ❖ Investment Philosophy and Process
 - ❖ Key Personnel
 - ❖ Historical Performance: RISK ADJUSTED

- ❖ Ask all the Key Questions: What do they do and how do they do it?
What does a worst case scenario look like?

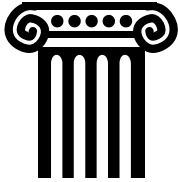


Steps to Identify and Manage Risk (cont'd)

Rigorous Manager Search Process (cont'd)

- ❖ Examine the Key Documents for Commingled Funds
 - ❖ Trust Agreement
 - ❖ Guidelines
 - ❖ “Basket” clauses
 - ❖ Liquidity and withdrawal rights

- ❖ Negotiate Tight Contracts and Side Letters (if you can)
 - ❖ Notice Requirements
 - ❖ Standard of Care

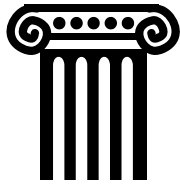


Steps to Identify and Manage Risk (cont'd)

Regular and Careful Monitoring

- ❖ Guideline Compliance
 - ❖ Diversification
 - ❖ Risk
 - ❖ “Style Drift”

- ❖ Performance: Don't be Afraid to Look a Gift Horse in the Mouth



Steps to Identify and Manage Risk (cont'd)

Regular and Careful Monitoring

- ❖ Risk Assessment

“Overseers [of institutional investors, e.g. DOL] should ensure that these investors (and their asset managers) develop an independent view of the risk characteristics of the instruments in their portfolios, rather than rely solely on credit ratings.” President’s Working Group on Financial Markets, Policy Statement on Financial Market Developments, March, 2008

- ❖ Personnel and Management Changes

- ❖ Gains and Losses of Clients



Case Citations

- ❖ *DiFelice v. US Airways, Inc.* 497 F. 3d 410 (4th Cir. 2007).
- ❖ *Edgar v. Avaya, Inc.*, 503 F. 3d 340 (3d Cir. 2007).
- ❖ *In re General Motors ERISA Litigation*, 37 EB Cases 1951 (E.D. Mich. 2006).
- ❖ *Landgraff v. Columbia/HCA Healthcare Corp.*, 2000 WL 33726564 (M.D. Tenn. 2000), *aff'd*, 30 Fed. App. 366 (6th Cir. 2002) (Table).
- ❖ *Langbecker v. EDS*, 476 F. 3d 299 (5th Cir. 2007).
- ❖ *In re McKesson HBOC Inc. ERISA Litig.*, 29 EB Cases 1229 (N.D. Cal. 2002), 391 F. Supp. 2d 812 (N.D. Cal. 2005), *cert. denied*, 516 U.S. 1115 (1996).
- ❖ *Moench v. Robertson*, 62 F.3d 553 (3d Cir. 1995).
- ❖ *Smith v. Delta Air Lines, Inc.*, 422 F. Supp. 2d 1310 (N.D. Ga. 2006).
- ❖ *Summers v. State Street Bank & Trust Co.*, 453 F. 3d 404 (7th Cir. 2006), *cert. denied*, 127 S.Ct. 1249 (2007), *cert. denied*, 127 S.Ct. 1257 (2007).
- ❖ *In re Syncor ERISA Litigation*, 516 F. 3d 1095 (9th Cir. 2008)