



INDEPENDENT FIDUCIARY SERVICES®

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EMPLOYER SECURITIES AS 401K PLAN ASSETS: MITIGATING RISK WITH AN INDEPENDENT FIDUCIARY

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THE FIDUCIARY CHALLENGES POSED BY EMPLOYER STOCK

One of the results of the Enron, WorldCom and other corporate debacles was that those companies' employees suffered devastating losses on their investments in company securities within their 401k plans. The litigation that inevitably followed has resulted in a series of court opinions which impose hard to manage standards of fiduciary conduct – and potential personal liability – on corporate executives who serve as fiduciaries of 401k plans that offer company stock as an investment option. Some of the cases hold that under certain circumstances fiduciaries have a duty to disobey plan provisions and bar plan participants from investing their plan accounts in company stock. Others indicate that fiduciaries may even have to liquidate plan holdings of company stock, even though the plan document requires that company stock be held as a plan asset and plan participants have declined to exercise their right to transfer their accounts from the company stock fund to other investment options. Court decisions also suggest that corporate insiders must disclose to plan fiduciaries, and perhaps plan participants, non-public information about the company germane to the “prudence” of company stock as a plan investment, leaving executives confused, at best, about how to reconcile their ERISA fiduciary duties with their obligations under the federal securities laws.

REDUCING RISK WITH THE INDEPENDENT FIDUCIARY STRATEGY

While the law continues to evolve, one of the consistent themes that has emerged is that fiduciary liability for losses suffered by 401k plan participants' company stock investments is linked to the inherent potential conflict of interest between corporate responsibility and fiduciary responsibility when corporate insiders serve as 401k plan fiduciaries. The knowledge they routinely acquire in their corporate “day jobs” can expose them to liability if the value of the company's stock declines dramatically and 401k plan accounts invested in company stock suffer losses that can be linked to facts they did not publicly disclose or use for the plan's benefit. That risk is enhanced when the fiduciaries do not have a regular process in place for considering the continuing advisability of offering company stock as an investment option under the plan.

An emerging strategy for mitigating this risk is the engagement of an independent fiduciary to take some, most or all responsibility for fiduciary functions related to the employer stock in a 401k plan. Transferring fiduciary discretion, responsibility and liability from corporate executives to a firm with no connections to the company but qualified to make prudent judgments about company stock *in the context of the law governing 401k plans and the specific plan provisions governing company stock* can permit the company's leaders to devote their attention to managing the business without worrying about a separate, special duty to one constituency, plan participants. Since the hardest decisions under ERISA about company stock as an investment option inevitably arise only in times of stress on the business, it is advisable to create a structure appropriate for those decisions in advance, before the storm arrives.

TWO OPTIONS: ADVISOR OR DECISION-MAKER

The precise role of the independent fiduciary can take any of several forms, and the courts have not yet "blessed" any structure as certain to assure that neither the employer nor any of its officials retains any remnant of liability for deciding on the precise structure or overseeing the independent fiduciary who is appointed. And the decision about the role of the independent fiduciary must be made in conjunction with decisions about how the text of the plan should treat company stock. Additionally, the human resources policy implications of introducing an outside firm into this aspect of plan administration should be considered.

One option is to engage an independent fiduciary for the limited role of giving advice to the plan's regular fiduciaries while those fiduciaries retain decision-making responsibility for the company stock. On a substantive level, the independent fiduciary's advice can produce a combination of plan provisions and fiduciary processes that can provide a strong defense against a claim of breach of fiduciary responsibility if later events result in plan losses on its employer stock holdings.

These advantages must be weighed against the fact that corporate executives will continue serving as plan fiduciaries, with the decision-making authority that can give rise to fiduciary liability. And some cases suggest that the corporate officials responsible for selecting the fiduciary committee themselves have fiduciary responsibilities arising out of their decision to appoint, and corresponding duty to monitor, the fiduciary committee.

An alternative to the advisory role for the independent fiduciary is transferring all decision-making regarding the company stock to the independent firm. Several important issues must be addressed in formulating the independent fiduciary's role as decision-maker and communicating that role to the plan's participants and beneficiaries. This approach is intended to relieve the company and its executives of fiduciary responsibility, and potential liability, to the maximum intent possible as the law develops. The more explicitly the plan documents provide for an independent fiduciary to exercise discretion, perhaps even by amending the documents to name the specific firm as a named fiduciary, the better the company is positioned to argue that its decisions regarding the company stock are matters of plan design characterized as "settlor" functions not subject to fiduciary standards.



THE IMPORTANCE OF INDEPENDENCE

The benefits of interposing an independent fiduciary, as adviser or decision-maker, can be diluted if the fiduciary's independence is subject to question. If the fiduciary firm – by itself or through affiliates -- engages in businesses such as underwriting securities offerings, actively managing securities portfolios or issuing research on public companies, its actions as independent fiduciary can be measured against its conduct or public statements in those other contexts. It is important to select a firm that is independent and free from potential conflicts of interest.

CONCLUSION

Offering company stock as an investment option in defined contribution plans remains popular with employers and employees. Plan sponsors are addressing the risks associated with company stock by engaging qualified, independent firms to provide fiduciary advice or decision-making regarding that asset, and they are doing so BEFORE problems on the corporate front develop which can result in liability. Careful consideration of the role the independent fiduciary is to play, combined with diligent consideration of the qualifications and independence of candidates for that position enhance the prospects that the risks will be effectively mitigated on a cost-efficient basis.



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Andrew Irving joined IFS in 2003 after more than 25 years of private law practice representing public, Taft-Hartley and corporate pension and welfare plans, labor unions, corporate plan sponsors and financial institutions serving the benefit plan community.

Mr. Irving leads IFS's fiduciary decisionmaking practice; which focuses on providing independent, conflict-free discretionary decisions regarding particular transactions involving benefit plan assets. Mr. Irving also works on governance and legal aspects of Operational Review projects and, as our General Counsel, oversees IFS' internal legal affairs. He brings to this work his extensive experience counseling and litigating on behalf of benefit plans and their fiduciaries on a broad range of issues including fiduciary responsibility, plan design and varied aspects of compliance with ERISA and Internal Revenue Code requirements. He has also worked with plan fiduciaries and the investment community designing sophisticated investment products and strategies to comply with statutory requirements, such as synthetic guaranteed investment contracts, direct real estate investments and hedge "fund of fund" vehicles. Having worked with leading investment and actuarial firms, Mr. Irving has in-depth knowledge of the interrelated roles various service providers play in assisting trustees with their duties.

In 2005, Mayor Michael R. Bloomberg appointed Mr. Irving to the New York City Conflicts of Interest Board, which administers the New York City Charter's Code of Ethics for the City's elected officials and public employees.

Mr. Irving is a *cum laude* graduate of Yale University and received his law degree from Columbia Law School, where he was a member of the Law Review. Mr. Irving served as law clerk to United States District Judge Eugene H. Nickerson. He works from IFS' Newark, New Jersey office.

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