



INDEPENDENT FIDUCIARY SERVICES®

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

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Presentation to CLE International
Subprime Lending Litigation Conference
Los Angeles, California
May, 2008

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THE FIDUCIARY CHALLENGES POSED BY EMPLOYER STOCK

ERISA imposes on plan fiduciaries a demanding standard of fiduciary responsibility which one widely accepted federal court opinion characterizes as “the highest known to law.” And the statute also generally bars plans from holding more than 10% of their plan assets in employer securities. But Congress also recognized that employers may legitimately desire to design particular plans to give their employees the opportunity to invest in employer stock. Accordingly, ERISA permits employers to create ESOPs and “individual account” plans such as 401k plans to invest up to 100% of their assets in employer stock, and relieves the fiduciaries of those plans of the duty to diversify plan assets which is a component of the basic standard of fiduciary responsibility applicable to other plans. In addition, Congress permitted 401k plans to give participants a range of investment options which, if properly selected and administered, relieves the plan’s fiduciaries of liability for losses that participants may suffer as a result of their individual asset allocation choices within those options, including 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.

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.

The precise role of the independent fiduciary can take any of several forms, and the courts have not "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.

The Independent Fiduciary as Fiduciary Adviser

One option which employers have pursued 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. Under this approach, the independent fiduciary takes some or all of the following steps:

- Analyzes the plan provisions related to the company stock. Often, the independent fiduciary recommends, in consultation with the plan's regular counsel, amendments as appropriate to "hard wire" into the plan text the company's decision that the plan make a company stock fund available to participants, and that the fund invest exclusively in company stock except as needed to maintain liquidity for benefit payment and investment transfer purposes. Properly drafted plan language can severely limit, if not entirely eliminate, the circumstances under which fiduciary



responsibility requires a fiduciary “override” of plan provisions requiring the offering of company stock as an investment option.

- Analyzes the plan’s rules governing participants’ rights to transfer into and out of the company stock fund, and recommend modifications as appropriate.
- Reviews the composition of the plan fiduciary committee to determine if changes are appropriate to create a decision-making body that is competent to carry out fiduciary responsibility but less likely to include members with inside knowledge that can create a duty of disclosure or action under some of the emerging case law.
- Reviews the process by which the fiduciary committee monitors the company stock for suitability as a plan investment, and recommends enhancements to the process to meet industry “best practices.”
- Reviews the text of the SPD and other communications to plan participants and recommends enhancements to assure they make appropriate disclosure of the terms of the plan, and of the risks associated with investing plan accounts in the company stock fund.
- Provides to the insider fiduciaries periodic outside, independent analysis of the company stock from an investment perspective in light of public information about the company and its industry.

This approach has the advantage of avoiding the potential adverse human resources consequences of a transfer of fiduciary responsibility to an outside firm. Employees need not wonder if their company is in some kind of “trouble” that requires that company executives step aside and given an outsider control over whether the plan will offer 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.

The Independent Fiduciary as Fiduciary Decisionmaker

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.



- Deciding the independent fiduciary’s status: named fiduciary versus “investment manager.” In the latter model, decision-making authority is delegated to the independent fiduciary, and the in-house fiduciaries retain a duty to monitor the independent fiduciary. If named fiduciary status is selected, then the authority has been allocated, and the monitoring duty can be severely restricted, if not entirely eliminated.
- Amending plan documents to provide for the independent fiduciary and “bake in” the company stock fund as an investment option.
- Defining the independent fiduciary’s authority with respect not only to the scope of discretion over the company stock, but also the authority to modify plan rules regarding participant investments in company stock and communication to plan participants.
- Disclosing the appointment of the independent fiduciary 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. Gaining that protection from liability, however, requires surrendering control over the plan, and placing the future of company stock as a plan investment in the hands of outsiders.

AN APPROACH TO FIDUCIARY DECISION-MAKING ON EMPLOYER STOCK

When an independent fiduciary or an in-house committee has decision-making authority regarding company stock, the starting point for exercising that authority is compliance with the terms of the plan documents in the context of the facts of the transaction or assets within its control, the interests of the plan’s participants and the applicable law. It is becoming increasingly common for plan documents to provide explicitly that the plan shall include a company stock fund, to be invested exclusively in company stock and a minimal “cash buffer” to the extent required to accommodate participant transfers and withdrawals from the fund. The purpose of such a structure is to render the fundamental decision to offer employer stock as an investment option a matter of plan design, a so-called “settlor” function, not subject to challenge under ERISA’s fiduciary standard. And some, but not all, courts have held that when a plan has such a provision, maintaining the company stock fund’s investments in the stock is presumptively prudent.

Accordingly, the ongoing fiduciary task is to decide (i) if and when circumstances and applicable law require that the plan’s explicit provisions and participants’ otherwise valid elections to invest some or all of their account balances in company stock be overridden, and (ii) what steps to take with respect to the company stock then held by the plan, and the future



contributions participants may elect. While the court decisions on this issue do not present a unified catalog of factors to be weighed or how to weigh them, it is our view that a fiduciary should consider tracking some or all of the following aspects of the company and its stock:

- The percentage of overall plan assets invested in company stock.
- The company's public filings and statements regarding its business and stock, including presentations in analyst conference calls.
- Recommendations and opinions of research analysts from major broker dealers that follow the stock and the company's business as well as other sources, e.g., rating agencies, Morningstar reports by respected analysts regarding the company and its industry.
- Decisions by major money managers that historically have owned the stock to hold the stock, acquire more or sell.
- Purchases and sales by insiders.
- Short selling activity
- Technical benchmarks concerning the stock such as P/E, P/B and other ratios, in isolation and in comparison to peers.
- Fundamental indicators of the company's financial stability, such as cash flow, debt-to-equity ratio, compliance with financial covenants, etc.
- Company-specific developments such as earnings restatements, replacements of auditors, significant litigation, regulatory challenges.
- Industry developments.

The objective of this analysis is not to identify circumstances in which a manager of a diversified stock portfolio might decide to reduce or eliminate the portfolio's holdings in the company's stock. Rather, the point would be to anticipate and identify the kinds of extraordinary events that would give rise to a fiduciary duty to override the plan's provisions regarding the company stock. IFS anticipates that such events would rarely arise short of indications that the company was in imminent danger of collapse rendering its stock worthless, although some courts have held that circumstances short of "imminent collapse" may also render continued ownership of the stock imprudent.

In addition, a fiduciary can use the facts it learns to determine whether to provide additional communications to plan participants, or changes in the plan's standard procedures governing participant elections to invest in company stock. Such changes could include:



- Requiring plan participants to periodically reaffirm their election to invest their current account balances and/or future contributions in company stock.
- Imposing limitations on the percentage of participants' account balances which may be invested in company stock.
- Providing reminders of the special risks associated with investing in a single stock as opposed to a diversified portfolio of stocks, or other asset classes.

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.



Significant Cases

Bunch v. W.R. Grace & Co., 532 F.Supp.2d 283 (D. Mass. 2008).

DiFelice v. US Airways, Inc., 497 F. 3d 410 (4th Cir. 2007).

Edgar v. Avaya, Inc., 503 F. 3d 340 (3d Cir. Sept. 26, 2007).

In re General Motors ERISA Litigation, 37 EB Cases 1951, 2006 WL 897444 (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).

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).

In re Syncor ERISA Litigation, 516 F.3d 1095 (9th Cir. 2008).



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Mr. Irving joined IFS in August 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' fiduciary decision-making practice, which focuses on providing independent, conflict-free, discretionary decisions regarding particular transactions or 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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