

AVOIDING FIDUCIARY DUTY FOR DIRECTORS AND OFFICERS

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I. INTRODUCTION

Recent highly publicized corporate reversals have spawned numerous class action lawsuits raising breach of fiduciary duty claims on behalf of participants in retirement savings plans holding investments in employer stock. Faced with significant individual losses, and abetted by an aggressive Department of Labor amicus program, courts have expanded ERISA's reach by adopting novel theories of fiduciary responsibility and, at the threshold, deeming directors and officers de facto fiduciaries. An understanding of these emerging rules is critical to assisting directors and officers avoid entanglement in the ERISA fiduciary litigation web.

II. WHO IS A FIDUCIARY?

A. ERISA imposes fiduciary liability only on fiduciaries, but the statute, unfortunately, deems not only those expressly designated to serve in that capacity to be fiduciaries, but also those who, perhaps unwittingly, assume fiduciary responsibilities. A fiduciary may be held personally liable for a breach of any of the duties described below. If a fiduciary allows a prohibited transaction to occur, the fiduciary (including individual members of a committee or other entity) may be personally liable for any losses the plan may incur in connection with the prohibited transaction. In addition, penalties may be imposed upon an individual fiduciary for permitting (or engaging in) a prohibited transaction or for failing to meet certain of ERISA's disclosure requirements.

ERISA precludes any plan or trust provision purporting to relieve a fiduciary of its fiduciary liability. An employer will typically indemnify its fiduciaries with respect to any plan-related liability, unless the fiduciary acts in bad faith or is grossly negligent. Fiduciary liability, however, may be imposed upon each individual fiduciary and the fiduciary's personal assets could be subject to liability claims. Accordingly, indemnification is important for any director, officer or employee of a plan sponsor who serves in a fiduciary capacity. Liability insurance for fiduciaries is also advisable, but is subject to limitations. Under section 410 of ERISA, a *plan* may purchase fiduciary liability insurance, *but only* if the policy permits recourse by the insurer against the fiduciary. In contrast, a policy acquired by the *employer* (and not by the plan) need not include such recourse.

B. Under ERISA, a person is a fiduciary with respect to a plan to the extent:

1. He exercises any discretionary authority or discretionary control respecting management or disposition of its assets;
2. He renders investment advice for a fee or other compensation, direct or indirect, with respect to any money or other property of such plan, or has any authority or responsibility to do so;

3. He has any discretionary authority or discretionary responsibility in the administration of such plan.

29 U.S.C. § 1002(21).

C. Consistent with the foregoing, in determining fiduciary status, courts look not only to the terms of the plan, but also to an individual or entity's actual conduct, i.e., "in terms of functional terms of control and authority over the plan." See *Mertens v. Hewitt Associates*, 508 U.S. 248, 262 (1993).

D. A person can be a plan fiduciary for some purposes but not others.

1. Under ERISA, an individual is a fiduciary only "to the extent" he or she performs one of the functions set forth under ERISA. More specifically, the inclusion of the phrase "to the extent" in ERISA's definition of fiduciary "means that a party is a fiduciary only as to the activities which bring the person within the definition." *Coleman v. National Life Ins. Co.*, 969 F.2d 54, 61 (4th Cir. 1992). "Because one's fiduciary responsibility under ERISA is directly and solely attributable to his possession or exercise of discretionary authority, fiduciary liability arises in specific increments correlated to the vesting or performance of particular fiduciary functions in service of the plan, not in broad, general terms." *Beddall v. State Street Bank and Trust Co.*, 137 F.3d 12, 18 (1st Cir. 1998).
2. A fiduciary may wear two hats – one fiduciary and one nonfiduciary. For example, an employer acts as a plan settlor (and not a fiduciary) in establishing, designing, amending or terminating an ERISA plan. ERISA permits an employer to wear "two hats" (i.e., function as both the sponsor (settlor) and a fiduciary) with respect to a plan. A sponsoring employer assumes the status of a fiduciary with respect to a plan only when, and to the extent, it functions as a fiduciary in the capacity of plan administrator and not when (or to the extent) it conducts business – the latter is not subject to ERISA fiduciary standards. Settlor functions include the design and adoption of a plan, plan amendments and plan terminations; whereas fiduciary functions include interpretation of the plan, plus administration and (depending on context) selection of plan investments. Thus, an employer's decisions to adopt a plan, to prescribe the benefits to be paid by the plan and to terminate an existing plan are not subject to fiduciary constraint. However, decisions as to whether the plan as adopted covers a particular group of employees, determinations as to how the asset classes of a plan are to be invested and the selection of insurance companies or other funding vehicles or service providers to a plan are subject to ERISA fiduciary standards and duties.

E. In some circumstances, corporate board members may be considered fiduciaries.

1. As the caselaw from the “stock drop” arena reveals, corporate board members’ risk is a function of their level of responsibility under the plan.
2. If board members’ powers are limited to appointing, retaining and removing fiduciaries, a court may limit breach of fiduciary claims against them to those specific acts in the context of a failure-to-monitor claim. *E.g., In re Reliant Energy*, 336 F. Supp. 2d 646, 656 (S.D. Tex. 2004) (“[A] person is a fiduciary only with respect to those aspects of the plan over which he exercises authority or control. For example, if an employer and its board of directors have no power with respect to a plan other than to appoint the plan administrator and the trustees, then their fiduciary duty extends *only to those functions*”) (internal quotes omitted); *Crowley v. Corning*, 234 F. Supp. 2d 222 (W.D.N.Y. 2002) (holding that since board of directors only had power under the plan documents to appoint, retain, or remove members of the investment committee, the board’s fiduciary obligations only extended to acts associated with its powers).
3. However, if board members have the responsibility to approve recommendations by the plan administrators with respect to investment options, then they may be considered fiduciaries with respect to investment decisions. *Yeseta v. Baima*, 837 F.3d 380 (9th Cir. 1988).
4. If the plan does not name the board as a fiduciary and does not provide the board with discretionary authority in administering the plan, the board may be dismissed as a defendant.

III. WHAT ARE THE FIDUCIARY’S DUTIES?

A. Generally.

Borrowing liberally from the common law of trusts, the ERISA statute states that: a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and -

- (A) for the exclusive purpose of:
 - (i) providing benefits to participants and their beneficiaries; and
 - (ii) defraying reasonable expenses of administering the plan;
- (B) with the care, skill, prudence, and diligence under the circumstances then prevailing that 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;

- (C) 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; and
- (D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this subchapter and subchapter III of this chapter.

29 U.S.C. § 1104(a)(1).

As a general proposition, fiduciary obligations are among the “highest known to the law.” *Bussian v. RJR Nabisco*, 223 F.3d 286 (5th Cir. 2000).

B. Duty of Loyalty.

Fiduciaries are to act with “complete and undivided loyalty to the beneficiaries of the trust” and with an “eye single to the interests of the participants and beneficiaries.” *Leigh v. Engle*, 727 F.2d 113 (7th Cir. 1984). In other words, a fiduciary must discharge its duties for the exclusive purpose of providing benefits to the participants and their beneficiaries and defraying reasonable administrative expenses. Generally, a fiduciary cannot consider the interest of any other person such as the employer sponsor, even if a member of the fiduciary body is also serving as an employee or officer of the sponsor. The duty of loyalty is owed to participants and beneficiaries as a group. Accordingly, all participants and beneficiaries must be treated equitably and fairly. While ERISA specifically allows a fiduciary to be a participant or beneficiary, or an officer, employee or agent of the employer, the law is equally clear that when a person is serving in a fiduciary capacity, such person may only consider plan matters.

C. Duty of Prudence.

A fiduciary must use the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person, acting in a like capacity and familiar with such matters, would use in the conduct of an enterprise of like character and with like aims. The duties require a fiduciary to be active in conduct. It must inquire, question and consider, and not merely rely upon the advice of others. Even in situations where a fiduciary has appropriately hired experts or service providers to assist it with its duties, the fiduciary must still be active in monitoring those activities. The duty of prudence as interpreted by the courts has evolved into something approaching that of the obligation imposed upon a prudent expert. If a fiduciary does not have the requisite expertise to evaluate a decision properly, then that fiduciary has an obligation to obtain the assistance of experts to assist the fiduciary in making the decision. A fiduciary’s lack of familiarity with a particular subject is not an excuse for an imprudent decision.

D. Duty of Diversification.

With respect to qualified plans, a fiduciary must diversify plan investments to minimize the risk of large losses, unless it would be clearly prudent not to do so. The duty to diversify is a separate duty from prudence. Therefore, it is not sufficient that a fiduciary select quality investment managers and/or investments. It is necessary that these investments be diversified as

to type, size and market in order to comply with this separate fiduciary duty. Even where a fiduciary does not directly make investment decisions (e.g., where participants direct their own investments under individual account plans), the fiduciary must still ensure that the investment funds selected for the savings plan provide a broad range of investment choices for participants (protection of plan fiduciaries under the rules governing participant-directed investments also requires a broad range of investment types among participant directed options) and that the investment managers appointed for pension plans similarly fulfill their duties of diversification.

E. Duty to Follow Plan Documents.

A fiduciary must act in accordance with the documents that govern the plan, so long as such action is consistent with ERISA and other applicable law. A fiduciary must be familiar with the plan document (and what it specifically permits and prohibits) so as to avoid a violation of law.

F. Prohibited Transactions under Section 406.

Unless a statutory or administrative exemption applies, a fiduciary may not cause a plan to engage in a transaction if it knows or should know that the transaction constitutes a direct or indirect sale, exchange or lease of any property between the plan and a party in interest; the lending of money or other extension of credit between a plan and a party in interest; the furnishing of goods, services or facilities between a plan and a party in interest; or a transfer to, or use by or for the benefit of, a party in interest of any assets of the plan. A “party in interest” is a defined term under ERISA and includes, but is not limited to, the employer and its affiliates, their officers, directors and employees, parties who provide services to the plan, including fiduciaries, and certain relatives of any of the foregoing. A fiduciary is also precluded from engaging in acts of self-dealing. Accordingly, a fiduciary may not use the assets of a plan for its own benefit, act in any transaction where the fiduciary has a conflict of interest, or receive consideration from any party that is dealing with the plan.

G. Duty Not to Mislead/Misinform Plan Participants.

The oft-cited standard for this duty is *Bixler v. Central Pennsylvania Teamsters Health & Welfare Fund*, 12 F.3d 1292 (3d Cir. 1993) (affirmative duty to disclose requires fiduciary to inform participants “when the trustee knows that silence might be harmful”).

IV. THE CURRENT LITIGATION MILIEU

A. The DOL Brief In *Enron* On The Duty To Monitor.

1. The DOL argued that “[t]he ‘ongoing responsibilities of a fiduciary who has appointed trustees’ require that ‘[a]t reasonable intervals the performance of trustees and other fiduciaries should be reviewed by the appointing fiduciary in such a manner as may be reasonably expected to ensure that their performance has been in compliance with the terms of the plan and statutory standards, and satisfies the needs of the plan’ Thus,

an appointing fiduciary has a duty of oversight to promote compliance with ERISA's fiduciary obligations and to prevent misconduct or injury."

2. "Corporate officers who appoint fiduciaries must 'ensure that the appointed fiduciary clearly understands his obligations, that he *has at his disposal the appropriate tools to perform his duties with integrity and competence, and that he is appropriately using those tools.*'"
3. The duty to monitor includes the obligation to monitor the appointed committee's conduct and take appropriate action if the appointed committee is not protecting the interests of Plan beneficiaries and participants. Appropriate action could include removing the appointees or freezing the investments.
4. The duty to monitor may also include ensuring that appointees have accurate information about the company's financial condition.
5. The DOL alleged that defendants breached their fiduciary duty by failing to monitor the administrative Committee that controlled the plan, disseminating misleading and inaccurate information, and withholding critical financial information from the Administrative Committee.

B. The *Enron* Ruling.

1. The subsequent *Enron* decision relied heavily on the DOL's amicus brief in widening the scope of who qualifies as a fiduciary for ERISA liability. *See In re Enron ERISA Litig.*, 284 F. Supp. 2d 511 (S.D.Tex. 2003).
2. The court held that fiduciary status under ERISA is to be determined by looking at actual authority or power over the ERISA plan, as well as formal title and duties of parties at issue. *Id.* at ____.
3. The duty to monitor also carries with it the duty to take action upon discovery that the appointed fiduciaries are not performing properly. *Id.* at ____.
4. Failure to monitor and remove fiduciaries for misconduct may result in exposure to liability under ERISA section 405. *Id.* at ____.
5. "[B]ecause Enron (i.e. a corporation acting through employees who perform functions on behalf of the corporation) has authority and control over appointments of fiduciaries to administer the plan and control its investments, it also has a fiduciary duty to monitor its employees." *Id.* at 659.

V. AVOIDING/LIMITING FIDUCIARY LIABILITY GENERALLY

A. The goal is to avoid the imposition of fiduciary liability consistent with the observation that “[a]n individual cannot be liable as an ERISA fiduciary solely by virtue of her position as a corporate officer, shareholder or manager.” *In re World Com, Inc.*, 263 F. Supp. 2d 745 (S.D.N.Y. 2003).

1. Document with precision the identities of the fiduciaries and record their responsibilities.
2. Limit who has authority to communicate with participants on benefits issues - plan documents should inform participants that only certain designated individuals have that authority.
3. Do not rely on statutory default rules that make the plan sponsor the named fiduciary or so designate the plan sponsor in the plan. Doing so dramatically increases the likelihood that any corporate official will be deemed an agent of the fiduciary under authority, as in *Taylor v. People’s Natural Gas*, 49 F.3d 982 (3d Cir. 1995).

B. Exercising Duty to Appoint.

1. Carefully evaluate candidates and document the selection process. *The ability to demonstrate care in the process may be more important than the result.* For the DOL, “procedural prudence” is paramount, and not necessarily the outcome.
2. Be certain that qualifications and experience are consistent with responsibilities.
3. Discharge carefully the duty to monitor – meet regularly with appointees and document their performance.

C. Participant Communications.

1. Use plain language in participant communications.
2. Reserve the right to rely on plan documents in the SPD.
3. Maintain careful records of written communications.
4. Centralize responsibility for oral communications.
5. Prepare scripts on routine issues.
6. Maintain a logbook of benefits related questions and requests for plan documents.

VI. ADVICE/ACTIONS TO MINIMIZE LIABILITY IF ELIGIBLE INDIVIDUAL

ACCOUNT PLAN INVESTS IN EMPLOYER STOCK

A. Plan Design Decisions/Advice.

1. Decide whether to permit the plan to invest in employer stock to any significant extent.
2. Consider the objectives of the plan and whether investment in employer stock conforms to those objectives. Do employees have opportunities to acquire employer stock outside of the qualified plans?
3. Exposure may be mitigated to the extent the documents governing the plan clearly require investment in company stock whereas a fiduciary with greater discretion might be exposed to greater liability.
4. Ensure that the plan documents are consistent.
5. Decide whether to fund employer stock investments, i.e., require matching funds to be in employer stock.
6. Taking into account the Court of Appeals' ruling in *In Re Schering-Plough*, No. 04-3073 (3d Cir. Aug. 19, 2005), consider whether employer stock should be held in an ESOP within the savings plan.

B. Fiduciary Governance Structure.

1. Consider the structure carefully and make the structure clear.
2. Consider who should serve as a fiduciary (try to minimize the involvement of senior officials more likely to have non public financial knowledge).
3. If a member of the committee will have non public financial knowledge, clearly limit the scope of the committee's involvement with the plan and inform the committee that its primary function is to ensure that the named fiduciary committee members are qualified to perform their duties.

C. Decisions Concerning Employer Stock.

Conduct a periodic fiduciary review of the stock's appropriateness as an investment. Consider using an independent fiduciary and/or investment advisor.

D. Communications with Participants.

1. Be careful of how enthusiastic you are when encouraging such an investment in company stock.
2. Advise participants clearly about the risks in such an investment.

3. Adopt participant education programs.
- E. Other Potential Solutions.
1. Remove all restrictions on the sale or diversification of company stock.
 2. Offer employer stock through either a match or an employee-directed investment, but not both.
 3. Place a cap on the amount of company stock that participants can hold in their accounts.
 4. Educate employees on the risk of holding nondiversified instruments such as company stock.
 5. Consider a targeted communication/education program for participants who hold large amounts of company stock.
 6. Convert the 401(k) into a KSOP.
 7. Offer a wider variety of other investment options.
 8. Perform an audit to ensure compliance with ERISA section 404(c).

VII. ATTORNEY-CLIENT PRIVILEGE

Be careful out there! ERISA fiduciaries may not assert the attorney-client privilege against a plan beneficiaries on matters related to their function as fiduciaries. This principle is the “fiduciary exception” to the attorney-client privilege. Thus, if one attorney advises both the fiduciary and the plan sponsor, it is important to respect the distinctions between settlor and fiduciary functions so as to minimize the risk that the plan sponsor will also lose the protection of the attorney-client privilege. Moreover, in-house counsel should not serve on a committee that will serve as a plan fiduciary because doing so will compromise counsel’s ability to serve in the role of counsel to the committee.