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From the Editors

Employer Stock Action

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For some time and in several issues of *ELR*, we've been bemoaning the fact that we have so little occasion to address the type of litigation that has really dominated ERISA World over the last few years: cases seeking recovery of declines in value of employer stock held in a 401(k) or other ERISA plan.

Part of our problem has been that so few of these cases are at, or will ever get to, an appellate stage, which is one of our normal selection criteria. We've dealt with that problem in two ways. First, we've been eager to write up any appellate decision of any significance. Second, we've bent our own rule sometimes and have talked about the cases more broadly than just by looking at appellate decisions.

Luckily, we have new reason to pursue both of those directions. Not in this issue — but soon — we'll have a chance to address the recent decision of the 3rd Circuit in the *Schering-Plough* case, 2005 WL 1993990 (August 19, 2005). What excited defendants about the now-reversed district court decision was its conclusion that a suit seeking to obtain recovery of losses for fewer than all participants in a defined contribution plan was not one that could be brought under Section 502(a)(2) of ERISA because it was for individual, not plan-wide, relief. Without stealing our own story, the 3rd Circuit decision says no, thus permitting these suits to proceed as originally pled.

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One appellate opinion, even a closely-watched one, rarely resolves all questions, and there are always more nuances to be fought over. The trend that the *Schering-Plough* district court seemed to have begun, however, has certainly slowed, if not halted completely. Along the same lines, we'll be awaiting eagerly the decision from the 5th Circuit on rehearing in *Milofsky v American Airlines*, 404 F.3d 338 (2005) [rehearing *en banc* granted, 2005 WL 1691535 (July 19, 2005)], a case that presents analogous issues, albeit in factually distinct circumstances. The fact that the 5th Circuit vacated its original pro-defendant decision is already news worth noting, but we'll have to wait for a new decision to know exactly what the court thinks is good law.

While this looks like one or more articles about appellate decisions in the near future,

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this issue also contains an article by Jim Carey and Alan Miller of the Jones Day firm discussing a question that has primarily played itself out in the employer stock cases at the district court level. That question is, in our view, maybe the key question in these cases: what duty, if any, does an appointing fiduciary have to make disclosures to an appointed fiduciary?

The reason this issue is key is simple. To the extent these cases are about the prudence of a particular stock investment, defendants have a lot of attractive arguments. Since the cases are dealing with publicly traded stock, it's pretty easy to argue that there is no fiduciary duty to outguess the market. While we're oversimplifying somewhat, we think it's a hard claim to establish that a fiduciary of a plan designed to invest in employer stock should have reached a conclusion that the stock was simply too unsuitable to be a plan investment when, out in the public market, there are as many buyers as sellers, and many of those buyers and holders are themselves sophisticated investors.

One of the main ways plaintiffs try to counter that defense is to contend that someone in the fiduciary chain had knowledge that the market was not working, i.e., had inside knowledge that the stock price was inflated due to some undisclosed material adverse financial issue within the company. Sometimes that claim of adverse inside information is made against a defendant with an obviously relevant fiduciary role, e.g. responsibility for determining whether the plan should hold employer stock. More frequently, however, the claim involves a defendant with a more attenuated fiduciary role.

One such claim that is frequently made is that someone with insider knowledge had a fiduciary role in appointing day-to-day fiduciaries and thus in monitoring their conduct to make sure the appointment remained appropriate. Having thus successfully applied the fiduciary tag to the appointing fiduciary, the next step in the claim is to argue that that person had an ERISA fiduciary duty to affirmatively disclose to the appointed fiduciary

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ducing a legitimate nondiscriminatory reason for its decision to lay off Schweitzer. What was the reason?

"All of this evidence, even viewed in the light most favorable to Schweitzer, leads this court to conclude that the union's ability to discharge the cost of Schweitzer's benefits was merely incidental to a much larger effort to cut costs out of economic necessity."

Is this really what the court meant to say? Again, let's hypothesize that Schweitzer's medical costs were extremely high. If Schweitzer had been terminated because this would save his very high benefit costs, would the 6th Circuit have allowed Local 100's financial exigencies to avoid a §510 violation? We are most uncertain.

Perhaps the law will evolve differently, but we harbor little optimism that exigent financial circumstances will allow an employer to single out the employees with highest benefit costs for adverse treatment. For example, while running at a loss certainly meets almost everyone's definition of a financial exigency, most corporations consider it a financial exigency when profits are inadequate. Firing someone to reduce benefit costs and increase profits is almost exactly the fact pattern that §510 was designed to monitor.

Where Does This Leave Us?

On balance, we stand by our earlier formulation of a preferred basis for the court's decision – §510 is not violated when the benefit costs of a fired employee are no more than those of remaining employees. We suppose there may be exceptions to this black and white approach, but we have kicked it around for a while and find it hard to imagine a case where we particularly mind the application of this rule.

We suppose the extreme case would occur if Mr. Schweitzer had no costs other than benefits. [For the moment, ignore our suspicion that this can't occur under federal or state minimum wage laws.] If the only costs of a fired employee were benefit costs, and the employee was fired only for financial reasons, how comfortable would we be with the proposition that there's no §510 violation? We think we could get there but acknowledge that there is something a little curious on the surface in concluding that §510 does not apply when the only benefit of firing someone is avoiding benefit costs.

Perhaps considerations like that led the 6th Circuit to cloak its decision in the more standard nomenclature of failure to prove a *prima facie* case. Nevertheless, we suspect that we are not alone in concluding that *Schweitzer* may have reached the right result but used an unsatisfying process to get there. ■

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anything relevant to the prudence of the company stock held by the plan, including the adverse inside information.

Jim's and Alan's article argues that it's not that simple. We won't give away the plot line, but they do a nice job of looking at other strands of law, including appellate decisions in other ERISA disclosure contexts, to make their argument. Since we count ourselves among those who agree that the disclosure claim is often overblown, we see a lot we like in the article, which is not the same thing as saying that we might not make some arguments

differently. That, however, is what litigation is all about, trying to come up with the best arguments that can be mustered.

Saying that, we recognize that there are always counterarguments, and, if any of our plaintiff friends want to use these pages to make them, we're always interested in good arguments. Sooner or later, this question will play itself out in the courts, but, the way things are going, it looks like later before we have any decision that would even vaguely be thought of as definitive. ■

The Employer Stock Cases: Does an Appointing Fiduciary Have a Duty to Disclose?

James F. Carey and Alan S. Miller; Jones Day; Dallas, Texas

Introduction

Plaintiffs in the *Enron* litigation¹ alleged, among other things, that the defendants who appointed the members of the Enron Administrative Committee, the fiduciary in charge of investments (including investment in Enron stock) for Enron's Savings Plan and Employee Stock Ownership Plan, breached their fiduciary duty of loyalty to plan participants by failing to disclose to the Committee material information about Enron's true financial condition. In its amicus brief opposing defendants' motion to dismiss, the Department of Labor argued that the duty of an appointing fiduciary to monitor the performance of the appointed fiduciary includes an affirmative duty to disclose information relevant to the appointed fiduciary's discharge of its duties. The *Enron* court refused to dismiss the complaint against the appointing ERISA fiduciaries (which included Enron Corporation, CEO Ken Lay and members of the Compensation Committee of Enron's board of directors) and left open the claim against these defendants for failure to disclose.

In the many employer stock cases that have followed in the wake of *Enron*, plaintiffs' claim of a failure to disclose by an appointing fiduciary has become a powerful allegation that has made it extremely difficult for defendants to dismiss the claim on the pleadings. The argument typically runs like this: the act of appointing a fiduciary is itself a fiduciary function; the appointing fiduciary has a duty to monitor its appointee; trustees at common law have an affirmative duty of disclosure to beneficiaries, a duty that has been applied to ERISA fiduciaries; therefore, an appointing fiduciary's duty to monitor includes the duty to disclose material information to the appointed fiduciary. As noted below, this argument has succeeded with courts in addition to the *Enron* court, at least at the motion to dismiss stage of the proceedings.

The notion that an appointing fiduciary has a continuing affirmative duty to disclose information to the appointed fiduciary creates a dilemma for fiduciaries who are directors, officers or other employees of an employer that sponsors a 401(k) or other individual account plan with an employer stock fund. While it is recognized that an ERISA fiduciary may wear "two hats" – one as settlor and one as a fiduciary – and may have financial interests that are adverse to the interests of the beneficiaries but in the best interest of the company, a fiduciary may nevertheless wear only his fiduciary hat when making fiduciary decisions.² The inevitable conflicts of interest that face in-house fiduciaries of an employer stock fund often make it impossible, as a practical matter, for these fiduciaries to separate their role as ERISA fiduciary from that of company employee or director. The obvious solution to this predicament is to remove the conflict by appointing an independent fiduciary.

Consider, for example, a public company's board of directors whose only fiduciary function under ERISA is the appointment of an institutional fiduciary to act as independent fiduciary (as named fiduciary, trustee or investment manager) for the employer stock fund in a 401(k) plan. The independent fiduciary will have the exclusive authority under the plan document to determine at what point the employer stock fund is no longer a prudent investment option, to freeze the fund to new investments in employer stock and to sell the stock if necessary. In addition, the plan document will relieve the in-house fiduciaries of any authority over the employer stock fund. It is the expectation and understanding of the board and the independent fiduciary that the independent fiduciary will not be in possession of any inside information but will discharge its duties to the plan on the basis of information available to the public markets, with the goal of putting the plan in the same position with

respect to the employer stock fund as a public stockholder of the plan sponsor.

Can the board of directors, having prudently selected an independent fiduciary for this purpose, hang up its fiduciary hat and turn its attention to operating the company under the business judgment rule for the benefit of its stockholders? Or will an ongoing duty to disclose information about the company to the independent fiduciary foil its attempt to avoid conflicts of interest? To answer this question, we begin by looking to the general duty of an appointing fiduciary under ERISA to monitor the appointed fiduciary and to the trustee's duty of disclosure under common law and then consider why it may not be appropriate to apply that common law duty of disclosure indiscriminately to all ERISA fiduciaries.³

The Duty to Monitor under ERISA

We start with two well-accepted general principles of ERISA fiduciary law. First, the appointment of plan fiduciaries is a fiduciary function. This is because a person who has responsibility for the selection and retention of plan fiduciaries has discretionary authority or control over the management of the plan within the meaning of Section 3(21) of ERISA. ERISA Interpretive Bulletin 75-8, 29 C.F.R. § 2509.75-8. The courts have accepted the Department of Labor's view as set forth in Interpretive Bulletin 75-8. *Miniat v. Globe Life Ins. Group, Inc.*, 805 F.2d 732 (7th Cir. 1987); *Leigh v. Engle*, 727 F.2d 113 (7th Cir. 1984); *Hickman v. Tosco Corp.*, 840 F.2d 564 (8th Cir. 1988).

Second, an appointing fiduciary has an ongoing duty to monitor the appointed fiduciary. ERISA Interpretive Bulletin 75-8, *supra*; *Leigh v. Engle*, 727 F.2d at 135; *Newton v. Van Otterloo*, 756 F. Supp. 1121, 1132 (N.D. Ind. 1991). In Interpretive Bulletin 75-8, the Department of Labor described the duty to monitor as follows:

At reasonable intervals the performance of trustees and other fiduciaries should be reviewed by the appointing fiduciary in such 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. No single procedure will be appropriate in all cases; the proce-

cedure adopted may vary in accordance with the nature of the plan and other facts and circumstances relevant to the choice of the procedure.

Interpretive Bulletin 75-8, *supra*, at FR-17.

However, apart from affirming the existence of a general duty to monitor appointed fiduciaries, neither Interpretive Bulletin 75-8 nor case law provides any guidance about the precise nature of this duty. Many of the published decisions involve motions to dismiss and do not reach any conclusion as to whether an appointing fiduciary took sufficient action to fulfill its duty to monitor. *See, e.g., Leigh v. Engle*, 727 F.2d at 135 (appointing fiduciary has "a duty to monitor appropriately the administrator's actions"); *Newton v. Otterloo*, 756 F.Supp. at 1132 (no breach of duty to monitor where board members not on notice of "possible misadventure by their appointees"); *Mehling v. New York Life Ins. Co.*, 163 F.Supp.2d 502, 509-10 (E.D. Pa. 2001) (implicit in a fiduciary's power to select named fiduciaries is "the duty to monitor the fiduciaries' actions, including their investment of plan assets"). The lack of guidance in these decisions is hardly surprising: as the Department of Labor has stated in its *Enron* brief, the duty to monitor is a question of fact, dependent on the circumstances.⁴

Several courts have shown a reluctance to impose a broad disclosure duty on appointing fiduciaries, citing Interpretive Bulletin 75-8 for the general principle that the duty to monitor is a "limited" one.

[When board members appoint fiduciaries], their responsibility, and, consequently, their liability, is limited to the selection and retention of fiduciaries (apart from co-fiduciary liability arising under circumstances described in section 405(a) of [ERISA]).

Interpretive Bulletin 75-8, *supra*, at D-4. These decisions, which include recent employer stock cases, have refused to extend the duty to monitor beyond a periodic assessment of the appointed fiduciary's competence to perform its duties. *See, e.g., In re Calpine Corp.*, No. C-03-1685 SBA, 2005 WL 1431506 (N.D. Cal. 2005) (duty of an ERISA fiduciary to review the performance of its appointees is a limited one; duty to monitor/disclose claims

dismissed); *In re Dynege, Inc. ERISA Litig.*, 309 F. Supp. 2d 861 (S.D. Tex. 2004) (duty to monitor/disclose claims dismissed where no allegation that directors exercised *de facto* control over the appointed fiduciaries or had notice of incompetence or wrongdoing by the appointed fiduciaries); *In re Williams Cos. ERISA Litig.*, 271 F. Supp. 2d 1328 (N.D. Okla. 2003) (duty to monitor/disclose claims against board of directors dismissed because authority limited to appointment of committee, and board had no authority to control investment decisions or to communicate plan information; rejected DOL amicus argument that directors had a duty to provide information); *Crowley v. Corning*, 234 F. Supp. 2d 222 (W.D. N.Y. 2002) (same).

On the other hand, several courts have refused to dismiss allegations in employer stock cases based on a broad concept of the duty to monitor, including a duty to disclose complete and accurate information about the company's financial condition to the appointed fiduciary. Although these courts have not examined the contours of the duty to disclose, or the facts and circumstances that must be present for it to arise, the opinions indicate that at least under some circumstances the duty to monitor includes an affirmative duty to disclose information to the appointed fiduciary. See, e.g., *In re Polaroid ERISA Litig.*, 362 F. Supp. 2d 461, 477 (S.D. N.Y. 2005) (citing *In re WorldCom, Inc.*, 263 F. Supp. 2d 745, 765 (S.D. N.Y. 2003) ("When a corporate insider puts on his ERISA hat, he is not assumed to have forgotten adverse information he may have acquired while acting in his corporate capacity.")); *In re CMS Energy ERISA Litig.*, 312 F. Supp. 2d 898 (E.D. Mich. 2004) (court refused to dismiss claim that directors violated duty to monitor by, among other things, failing to provide critical information to the appointed committee); *Howell v. Motorola*, 337 F. Supp. 2d 1079 (N.D. Ill. 2004) (plaintiffs' allegations concerning defendants' duty to monitor were sufficient to withstand a motion to dismiss); *In re ADC Telecomm., Inc. ERISA Litig.*, No. 03-2989 ADM/FLN, 2004 WL 1683144 (D. Minn. 2004) (plaintiffs' "broad allegations under the rubric of the ill-defined and limited duty to monitor" were sufficient to withstand a motion to dismiss).

With this background, we turn next to the common law of trusts and consider whether the

common law provides a basis for extending the duty to monitor to include a duty to disclose.

Trustee's Common Law Duty of Disclosure and Application to ERISA

The common law of trusts recognized the affirmative duty of a trustee to disclose material information to a *beneficiary*, even in the absence of an inquiry:

Even if the trustee is not dealing with the beneficiary on the trustee's own account, he is under a duty to communicate to the beneficiary material facts affecting the interest of the beneficiary which he knows the beneficiary does not know and which the beneficiary needs to know for his protection in dealing with a third person with respect to his interest.

RESTATEMENT (SECOND) OF TRUSTS § 173, cmt d (1959).

This common law rule regarding a trustee's duty to disclose to beneficiaries has been applied to non-trustee fiduciaries in many ERISA cases, either as an affirmative duty to inform plan participants or to respond truthfully to inquiries from plan participants. *Varity Corp. v. Howe*, 516 U.S. 489, 506 (1996) (employer/administrator must not deliberately lie to plan participants); *Eddy v. Colonial Life Ins. Co. of Am.*, 919 F.2d 747 (D.C. Cir. 1990) (plan administrator had an affirmative duty to advise participant of circumstances that threaten interests relevant to the relationship, even if the participant did not ask the right question); *Bixler v. Cent. Pa. Teamsters Health & Welfare Fund*, 12 F.3d 1292 (3rd Cir. 1993) (employer/administrator had not only a negative duty not to misinform, but also an affirmative duty to inform when the administrator knows that silence might be harmful); *Fischer v. Phila. Elec. Co.* 994 F.2d 130 (3rd Cir. 1993) (employer/administrator had both a negative duty to refrain from misrepresenting early retirement benefits under "serious consideration" and an affirmative duty to disclose upon an employee's request); *Martinez v. Schlumberger, Ltd.*, 338 F.3d 407 (5th Cir. 2003) (employer/administrator had negative duty not to mislead, but no affirmative duty to disclose, even upon inquiry).

Importantly, the cases which have applied this common law trustee obligation to an ERISA

fiduciary involve plan administrators or other fiduciaries who are directly responsible for the fiduciary function at the heart of the nondisclosure claim. See, e.g., *Martinez v. Schlumberger*, *supra* (reviewing the history of nondisclosure cases both before and after *Varity*); *Eddy v. Colonial Life Ins. Co. of Am.*, *supra* (third party plan administrator); *Bixler v. Cent. Pa. Teamsters Health & Welfare Fund*, *supra* (employer/plan administrator); *Mullins v. Pfizer*, 23 F.3d 663 (D. Conn. 1995) (employer/plan administrator); *Glaziers & Glassworkers Union Local No. 252 Annuity Fund v. Newbridge Sec.*, 93 F.3d 1171 (3rd Cir. 1996) (investment advisor). It is a reasonable application of common law principles to impose the trustee's disclosure duties on ERISA fiduciaries in an analogous ERISA setting. Among a trustee's core functions at common law was the overall administration of the trust and the investment of trust assets. In *Varity Corp. v. Howe*, the Supreme Court concluded that the role of an ERISA plan administrator is essentially equivalent to that of a trustee at common law.⁵ To the extent an ERISA fiduciary is standing in the shoes of a common law trustee as to administration of the plan or the investment of plan assets, applying a trustee's common law disclosure obligations to the fiduciary is consistent with the structure of ERISA's fiduciary duty provisions. It is another matter entirely, however, to apply the obligations of a trustee or plan administrator to an ERISA fiduciary whose duties are limited to the appointment and removal of other plan fiduciaries.

Appointing Fiduciaries Are Not Analogous to Common Law Trustees

A case consistently cited by the Department of Labor for the proposition that an appointing fiduciary's duty to monitor includes the duty to disclose is *Glaziers & Glassworkers Union Local No. 252 Annuity Fund v. Newbridge Sec.*, *supra*. *Glaziers* did not involve an appointing fiduciary but a brokerage firm which, if it were a fiduciary (an issue the court of appeals did not decide), was a fiduciary by virtue of providing investment advice to the plan in question. The alleged breach of duty related to the brokerage firm's failure to warn the plan of questions regarding the honesty of a former brokerage firm employee who, after

leaving the brokerage firm, continued to provide investment advice to the plan. The alleged failure to disclose in *Glaziers* therefore had a direct nexus to the actions that made the brokerage firm a fiduciary in the first place – investment advice, a core trustee function at common law – and to the former employee of the brokerage firm who was directly involved in the investment advice.

An appointing fiduciary, unlike a trustee, has no direct authority or control over the administration of a plan or the investment of plan assets. In fact, an appointing fiduciary more nearly stands in the place of the settlor at common law than in that of the trustee. Under the common law of trusts, a settlor has a duty to appoint a competent trustee to administer the trust⁶ but otherwise has no fiduciary obligation to the trust's beneficiaries unless the settlor is exercising a power of control over trust administration or trust property, and then only with respect to the exercise of that power.⁷ By relying on *Glaziers* to extend to an appointing fiduciary a broad, continuing and affirmative duty of disclosure to the appointed fiduciary, the Department of Labor is advocating a radical departure from the common law and from the ERISA cases that have applied the common law duty of disclosure to ERISA fiduciaries having responsibilities over a plan similar to a trustee's administrative and investment responsibilities over a trust. At common law, the settlor appointing a trustee has no such responsibility in the absence of a retained power over the trust.

At least one court of appeals has recognized the novelty of this approach. In *Beddall v. State Street Bank and Trust Co.*, 137 F.3d 12 (1st Cir. 1998), the court cautioned that applying a broad, general duty of disclosure to a fiduciary with limited authority is unprecedented in ERISA. *Beddall* involved the question of whether a plan trustee that had no authority or responsibility for the plan's real estate investments nevertheless had a duty to disclose to participants its concerns over the valuation of the real estate, which was the responsibility of an investment manager appointed by the plan administration committee. Plan participants sued the trustee when it turned out that the real estate had been overvalued by the investment manager, causing previously retired participants to receive a

windfall and the plaintiffs to sustain a loss. Although the court found it unnecessary to decide the issue because of a defect in the plaintiffs' pleadings, the court summarized the disclosure issue as follows:

Refined to bare essence, the question is whether an ERISA fiduciary for one purpose has an obligation to disclose his suspicions even when there is no nexus between his particular fiduciary responsibilities and the perceived jeopardy. This is an issue of first impression, certainly in this circuit, and perhaps more broadly.

Beddall, 137 F.3d at 22. The court noted that the common law of trusts, on which ERISA fiduciary duties are based, generally treats the communication of material facts to the beneficiary as "the core of a fiduciary's responsibility," citing *Eddy v. Colonial Life Ins. Co. of Am.*, *supra*, and went on to distinguish the cases cited by plaintiffs to support such a duty, including *Glaziers*:

We note, however, that the *Eddy* court described ERISA's fiduciary duty to disclose as the duty "not only to inform a beneficiary of new and relevant information as it arises, but also to advise him of circumstances that threaten interests *relevant to the relationship.*" *Eddy*, 919 F.2d at 750 (emphasis supplied). Indeed, every case that the plaintiffs have cited in support of an affirmative duty to disclose arises in a context in which the plaintiff charges the defendant with withholding information related (i.e., relevant) to the fiduciary's association with the plan. See, e.g., *Ream v. Frey*, 107 F.3d 147, 149-50 (3d Cir. 1997); *Glaziers and Glassworkers Union Local No. 252 Annuity Fund. Newbridge Securities, Inc.*, 93 F.3d 1171, 1175-77 (3d Cir. 1996).

Id. at n. 4 (emphasis in original). At a minimum, the discussion in *Beddall* suggests that courts should "tap the brakes" before rushing headlong to apply disclosure obligations in areas where such obligations may conflict with other important features of ERISA's statutory structure.

ERISA Structural Considerations

In addition to being a highly questionable application of the common law of trusts, the

disclosure duty championed by the Department of Labor and the plaintiffs in the employer stock cases is an unwarranted blurring of the ERISA limits on fiduciary responsibility.

Whether a person is a fiduciary under ERISA is not determined by label, but is a "functional test" – does the person in fact exercise one or more of the functions described in Section 3(21) relating to plan administration or the investment of plan assets. A corollary rule is that under ERISA, a person is a fiduciary only *to the extent* he performs or has the authority to perform one or more of the defined fiduciary functions. *Pegram v. Herdrich*, 530 U.S. 211, 225 (2000) (the threshold question in an ERISA case is whether a person was acting as a fiduciary when taking the action subject to complaint).

Consistent with ERISA's "to the extent" rule, fiduciary status is "not an all or nothing proposition." *Beddall*, 137 F.3d at 18. The phrase "to the extent" indicates that a person is a fiduciary only with respect to those aspects of the plan over which he exercises authority or control. *Sommers DrugStores Co. Employee Profit Sharing Trust v. Corrigan*, 793 F.2d 1456, 1459 (5th Cir. 1986). Fiduciary liability under ERISA arises not in broad, general terms, but in "specific increments correlated to the vesting or performance of particular fiduciary functions." *Beddall*, 137 F.3d at 18, citing *Maniace v. Commerce Bank*, 40 F.3d 264, 267 (8th Cir. 1994).

In addition, Section 402(c)(3) and Section 405(c) of ERISA both permit named fiduciaries to allocate and delegate their responsibilities among investment managers and other fiduciaries. A named fiduciary that appoints an investment manager is relieved of liability for the acts and omissions of the investment manager, subject only to a duty to monitor and to co-fiduciary liability. Interpretive Bulletin 75-8, *supra*, at FR-15 and FR-17. If a named fiduciary responsibility is allocated to another named fiduciary pursuant to Section 405(c) or is carried out by a person appointed by the named fiduciary, the named fiduciary will have very limited liability for the acts of the other fiduciary. Specifically, Section 405(c)(2) provides that the named fiduciary will not be liable for any act or omission of the other named fiduciary or of the appointed fiduciary except for (i) any breach of

fiduciary duty in connection with the allocation or appointment, or in continuing the allocation or appointment or (ii) any co-fiduciary liability under Section 405(a). The provisions of Section 402(c)(3) and Section 405(c) mean, at a minimum, that an appointing fiduciary's continuing responsibility is less than that of the appointed fiduciary. These provisions also strongly suggest that an appointing fiduciary's duty to monitor under Section 404(a)(1) of ERISA is tied solely to the appointment itself (*i.e.*, to the competence and loyalty of the appointed fiduciary), not to the appointed fiduciary's discharge of its duties.

One of the most common uses of the delegation authority permitted by ERISA is the appointment of independent fiduciaries to handle important or sensitive decisions. From the hallowed *Donovan v. Bierwirth* decision by Judge Friendly, through countless individual prohibited transaction exemptions, to the recent Prohibited Transaction Class Exemption 2003-39 for settlement of securities and ERISA lawsuits, plan sponsors have been encouraged to appoint independent fiduciaries to engage in transactions involving the plan sponsor and its affiliates.⁸ The reason for appointing an independent fiduciary in these situations is to remove any question as to whether an in-house fiduciary can vigorously represent the interests of plan participants, untainted by loyalties to the plan sponsor, and to ensure that the terms of the transaction reflect the results of arm's-length negotiations. For example, if a plan sponsor proposes to sell shares of its stock to its employee stock ownership plan (ESOP) in exchange for the ESOP's promissory note, the transaction must satisfy certain requirements in order to qualify as an exempt transaction under ERISA and the Internal Revenue Code. Among these requirements are that the ESOP may not pay more than adequate consideration (fair market value) for the stock⁹ and that the terms of the loan must be at least as favorable to the ESOP as a comparable loan resulting from arm's length negotiations between independent parties.¹⁰ To assure that these requirements are satisfied, a well-advised plan sponsor will appoint an independent trustee of the ESOP to negotiate the terms of the sale and the loan with the plan sponsor. Note that with privately held plan sponsors, under generally accepted valuation methodology, there is a range of

value, as opposed to an exact dollar amount, that will satisfy adequate consideration, and there is nothing in the ERISA or the Internal Revenue Code that prohibits the ESOP from entering into a transaction with the plan sponsor that is more favorable to it than would result from arm's length negotiations. It has never been suggested, however, by the Department of Labor or the courts that the plan sponsor in such a transaction must disclose to the trustee the minimum terms that it will accept from the ESOP in order to satisfy its duty to monitor and avoid a breach of its duty of loyalty to plan participants. Similarly, there is no indication in PTE 2003-39, *supra*, that a plan sponsor settling a securities class action lawsuit must disclose to the independent fiduciary it has appointed to represent its plan in the settlement that it would be willing to increase the settlement by a few million dollars to achieve a global settlement of all claims. Indeed, the whole premise of the ESOP requirements and scores of prohibited transaction exemptions published over the years is that the appointment of a competent independent fiduciary to represent a plan allows the plan sponsor to deal with the plan solely in its capacity as employer and plan sponsor and without regard to any fiduciary duty it would otherwise owe to plan participants. The disclosure duty of appointing fiduciaries that the Department of Labor and the plaintiffs' bar are urging courts to adopt is fundamentally opposed to the rationale underlying these administrative and regulatory exemptions.

Settlor and Fiduciary Functions and the Nature of Employer Stock

There is another structural component of ERISA, borrowed from the common law of trusts, that bears on the question of an appointing fiduciary's disclosure obligations. The Supreme Court has repeatedly recognized that, even if a plan sponsor also serves as a fiduciary, business decisions or other "settlor functions" are outside the scope of ERISA and are not subject to ERISA's fiduciary obligations. *See, e.g., Curtiss-Wright Corp. v. Schoonejongen*, 514 U.S. 73 (1995); *Lockheed Corp. v. Spink*, 517 U.S. 882 (1996). Moreover, information which a plan sponsor holds in its settlor capacity is not subject to any disclosure obligations that may apply to plan

fiduciaries. *Pegram v. Herdrich*, *supra*; *Payonk v. HMW Indus., Inc.*, 883 F.2d 221 (3rd Cir. 1989). Although it may be difficult in some circumstances, such as in *Varity* or some of the "serious consideration" cases, to determine whether a plan sponsor is speaking as a settlor or in its fiduciary capacity as plan administrator, there is no disagreement that if a plan sponsor is clearly speaking in its settlor capacity, its statements are not subject to ERISA's fiduciary standards.

An employer stock fund is a peculiar investment fund for a 401(k) or other individual account plan. As a single stock fund, an employer stock fund is by definition the riskiest investment fund offered by the plan, and because of this risk, no investment fiduciary given complete discretion to design an investment fund for the plan would choose an employer stock fund. In this sense, the decision to offer an employer stock fund always begins as a settlor and not a fiduciary decision: the employer stock fund exists only because the plan sponsor, acting as settlor, has designed the plan to provide employer stock as an investment option.

Recognizing the special nature of employer stock, Congress devised different fiduciary standards for managing employer stock than for managing other investments. Most importantly, the diversification requirements of Section 404(a) of ERISA, and the prudence requirements to the extent prudence would require diversification, do not apply to employer stock; the 10% limitation of Section 407(a) of ERISA on plan investments in employer stock does not apply to individual account plans; and transactions in employer stock between a plan sponsor and other parties in interest are generally exempt from the prohibited transaction provisions. Similarly, the court of appeals decisions that have considered the issue recognize that the prudence of holding employer stock in an individual account plan cannot be determined without reference to the plan sponsor's (*i.e.*, settlor's) intent. Thus, for example, the *Moench* court held that a fiduciary was entitled to at least a presumption that continuing to hold employer stock was prudent, where the terms of the plan required the plan assets to be invested "primarily" in employer stock.¹¹

In the context of employer stock, the practical effect of imposing an affirmative duty of disclosure on an appointing fiduciary would be to obliterate any meaningful distinction between the duties of the appointing fiduciary and those of the appointed fiduciary, as well as the distinction between settlor and fiduciary functions. Apart from the purely mechanical aspects of administering an employer stock fund, an independent fiduciary's sole duty is to determine whether to maintain the employer stock fund in accordance with the terms of the plan or whether prudence requires it to override the terms of the plan and curtail or eliminate the fund. This is because each employer's stock is unique. The purpose of the employer stock fund is to invest in the stock of that employer, not in the stock of the employer's peer companies or companies in the same industry. The investment considerations normally facing other plan fiduciaries do not apply: no decision has to be made between employer stock and other available equity funds or between employer stock and fixed income investments. The independent fiduciary has no other choices – there is no alternative investment fund that is comparable to the employer stock fund. The fiduciary's decision is basically an on/off switch. The *only* information relevant to the investment decision is information about the plan sponsor, and *all* material information about the plan sponsor could be relevant to the independent fiduciary. Because the plan sponsor will in almost all cases know material information about itself before the appointed fiduciary, a duty of disclosure would effectively transform a duty to monitor into a duty to take primary responsibility regarding the appointed fiduciary's only function. Moreover, to the extent an appointing fiduciary had an affirmative obligation to disclose to the appointed fiduciary information with respect to the plan sponsor, its fiduciary responsibilities would not be "limited" as provided in Interpretive Bulletin 75-8. Any material knowledge of the plan sponsor, positive or negative, known to the appointing fiduciary and acquired solely in its settlor capacity would give rise to an immediate fiduciary obligation to disclose to the independent fiduciary, thereby merging the appointing fiduciary's settlor and fiduciary functions. If this were the result required by ERISA, officers

and directors of a plan sponsor whose only plan duty is the appointment of fiduciaries could never operate the plan sponsor solely in their settlor capacity.

Conclusion

The imposition on the appointing fiduciary of an affirmative and continuing duty to disclose material information concerning the plan sponsor, even upon inquiry,¹² is not only at odds with the common law of trusts, from which the duty is allegedly derived, but is not supported by the many ERISA cases that have extended the trustee's disclosure duty at common law to non-trustee fiduciaries. The imposition of such a duty also collides with some fundamental ERISA fiduciary concepts: the distinction between settlor and fiduciary functions and the application of this distinction to employer stock funds; the "to the extent" limitation on a fiduciary's responsibility under Section 3(21); and the allocation and delegation of fiduciary functions under Section 402(c)(3) and Section 405(c). For these reasons, courts should be reluctant to accept uncritically the arguments of the Department of Labor and the plaintiffs' bar in favor of such a duty.

We have staked out our position in the setting of an independent institutional fiduciary appointed by a plan sponsor or its board of directors because we believe that this situation illustrates the role of a limited fiduciary in the least complicated way and permits the sharpest distinction between settlor and fiduciary functions. We are not sure that the principles we favor should not also apply to the appointment of in-house fiduciaries to perform the same function as the independent fiduciary. Practically, however, that situation will always raise more difficult questions of fact involving what the in-house fiduciaries knew and whether they acquired such knowledge from, or were operating under the control of, the appointing fiduciary and whether the appointing fiduciary enabled the appointed fiduciary to breach its duties. And as we all know, hard cases make bad law.

We should also point out that the position we are advocating would not relieve the appointed fiduciary from any duty it might otherwise have to disclose to participants relevant information in its possession. We question

only whether the appointing fiduciary has an obligation to furnish such information and in effect be forced to take on the responsibilities of the appointed fiduciary. Nor do we think that, if a court were persuaded to accept our views, ERISA's ability to protect participants would be diminished. Limiting the duty to monitor in the way we suggest does not mean that appointing fiduciaries are immune from liability for the type of corporate villainy on display in *Enron* and *WorldCom*. If an appointing fiduciary actually participates in any wrongdoing by the appointed fiduciary, exercises *de facto* control over the conduct of the appointed fiduciary or engages in deliberate deception, ERISA's duty of loyalty and co-fiduciary liability provide more than sufficient remedies. We do reject, however, as a basis for co-fiduciary liability the circular reasoning that an appointing fiduciary knows that the appointed fiduciary is breaching its duties solely because the appointed fiduciary does not have material information in the possession of the appointing fiduciary and acquired in its settlor capacity.

To us, the most compelling reason for courts to go slow on the monitoring and disclosure issue is the special place employer stock has under ERISA. It is the only plan investment that has statutory and regulatory exemptions from fiduciary provisions that would otherwise apply. In this sense, employer stock should be the least risky plan investment in terms of potential fiduciary liability. If, however, the duty to monitor entails the duty to disclose, then not only is the distinction between the appointing fiduciary and the appointed fiduciary meaningless, the appointing fiduciary, who by definition will always know (especially in hindsight) material information concerning the plan sponsor before anyone else, will never be able to disclose information in sufficient time to avoid liability. As a result, appointing fiduciaries will become guarantors of the performance of employer stock, thereby transforming the one plan investment with the greatest ERISA protections into the plan investment with the greatest risk of fiduciary liability. Such a result, it must surely be admitted, would frustrate Congress' intent and stand ERISA on its head. ■

(continued on back cover)

The Employer Stock Cases. . . (continued from page 23)

- 1 In Sec., Derivative & "ERISA" Litig., 284 F. Supp. 2d 511 (S.D. Tex. 2003).
- 2 *Enron*, 284 F. Supp. 2d at 550 (citing *Pegram v. Herdrich*, 530 U.S. 211, 225 (2000) ("ERISA does require, however, that a fiduciary with two hats wear only one at a time, and wear the fiduciary hat when making fiduciary decisions.")).
- 3 We are focused here only on the extent of an appointing fiduciary's duty under ERISA to disclose information, rather than on the clash between federal securities laws, which generally prohibit selective disclosure of information and prohibit trading on inside information, and ERISA, which certainly in some circumstances imposes a disclosure duty on fiduciaries.
- 4 Citing *Liss v. Smith*, 991 F. Supp. 278, 311 (S.D.N.Y. 1998)
- 5 *Varity Corp. v. Howe*, 516 U.S. at 502 (finding that Congress intended the duties of an "administrator" under ERISA to mirror those of a trustee at common law: "to perform the duties imposed, or exercise the powers conferred, by the trust documents" (citing Restatement (Second) of Trusts § 164 (1957))).
- 6 SCOTT & FRATCHER, THE LAW OF TRUSTS § 108.3 (4th Ed. 1987).
- 7 *Id.*, § 185.
- 8 *Donovan v. Bierwirth*, 680 F.2d 263 (2nd Cir. 1982); Prohibited Transaction Class Exemption 2003-39, 68 FR 75632 (Dec. 31, 2003); see, e.g., Proposed Exemption re: BNP Paribas S.A. and affiliates, 70 FR 25601 (May 13, 2005) (independent fiduciary required for employer stock transactions with plan sponsor and affiliates); Proposed Exemption re: Trammell Crow Company, 51 FR 36613 (Oct. 14, 1986) (independent fiduciary required for real estate transactions with plan sponsor and affiliates), granted at 51 FR 45966 (Dec. 23, 1986).
- 9 29 C.F.R. § 2550.408e.
- 10 Treas. Reg. § 54.4975-7(b)(3)(iii).
- 11 *Moench v. Robertson*, 62 F.3d 553, 566-67 (3rd Cir. 1995). In *Wright v. Oregon Metallurgical Corp.*, 360 F.3d 1090 (9th Cir. 2004), the court went further and criticized the *Moench* court's presumption of prudence as too strict and difficult to reconcile with ERISA's statutory protections for employer stock. The court stated that interpreting ERISA's prudence requirement to subject fiduciaries to even a tempered duty to dispose of employer stock arguably "threatens to eviscerate" Congressional intent and the guiding rationale for ERISA's statutory protections.
- 12 Because we do not think the law supports any affirmative duty of disclosure by an appointing fiduciary, the appointing fiduciary should have no duty to respond to inquiries from either the appointed fiduciary or a plan participant. To the extent a court chose to analyze an appointing fiduciary's disclosure duty by looking to "serious consideration" cases dealing with contemplated benefit enhancements, it could reach this result by following the Fifth Circuit's lead in *Martinez v. Schlumberger Ltd.*, *supra*, which held that "no comment" can be a proper fiduciary response: "[T]he proper course for an employer to follow is not to affect the employee's decision . . . in any way - not by lying to them . . . nor by being forced to tip off the employees to its business strategies to aid them in taking best advantage . . ." *Martinez*, 338 F.3d at 430.

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