Focus On…Compensation
Offering Company Stock As an Investment Option in Retirement Plans

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In today's economy, company officers and boards of directors are focusing on cost-saving measures for their company retirement plans that will result in increased company revenues and stock prices. Those same managers, however, often forget to implement cost-saving procedures to limit their own personal liability with respect to the company's retirement plans. As plan fiduciaries, these same budget-minded businessmen may end up defending a lawsuit alleging that they have breached their fiduciary responsibilities, leading to retirement plan losses. Given the current wave of lawsuits over plummeting stock prices and retirement plan mismanagement relating to company stock, it is more important than ever to be aware of the risks of fiduciary liability associated with offering company stock in a retirement plan.

Who Is a Fiduciary?

Section 3(21)(A) of the Employee Retirement Income Security Act of 1974 (ERISA) describes a fiduciary as someone who does any of the following: (1) exercises any discretionary authority or control over management of the plan or exercises any authority or control over management or disposition of the plan's assets; (2) renders or has authority or responsibility to render investment advice concerning the plan's assets for a fee or other compensation; or (3) has discretionary authority or responsibility over administration of the plan.

Because many managers have the power to determine the investment offerings of the company's retirement plans, control the company's stock, and/or have discretionary authority or responsibility over the day-to-day administration of the plan, they are likely to qualify as "fiduciaries" under ERISA. For this reason, a thorough understanding of the role of a fiduciary and how to implement procedures to limit fiduciary liability is important for managers.

What Are Fiduciary Responsibilities and Obligations?

Statutory Fiduciary Requirements

Both ERISA and the Internal Revenue Code (the IRC) impose specific duties on fiduciaries of employee benefit plans with respect to their handling of plan assets. Those duties are similar to the duties imposed on trustees by state law. Generally, the fiduciary duty rules are intended to protect a participant's benefits. The Eleventh Circuit has defined "fiduciary liability" under ERISA as an obligation to the plan, plan participants, and beneficiaries to act prudently and unselfishly in regard to the administration of plan assets.

The primary fiduciary standards of care are addressed in ERISA § 404, which sets forth four specific duties of fiduciaries, each discussed below.

- *Exclusive Benefit Rule:* A plan fiduciary must exercise discretion solely for the purpose of providing plan benefits and defraying reasonable expenses of administering the plan.
- *"Prudent Man" Rule:* A plan fiduciary must perform functions for the plan 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 like character and like aims. In short, a plan fiduciary must investigate and evaluate investments, and must invest prudently.

- *Prudent Diversification Rule:* A plan fiduciary must prudently diversify investment of the plan in order to minimize the risk of large losses and sufficiently fund future benefit obligations.
- *Adherence to Plan Document Rule:* A plan fiduciary must discharge its duties in accordance with the plan's documents and instruments, but only to the extent they are consistent with ERISA's terms.

Exclusive Benefit Rule

A plan fiduciary must exercise discretion solely for the purpose of providing plan benefits and defraying reasonable expenses of administering the plan. Generally, a plan fiduciary must:

- Act with undivided loyalty to the participants;
- Not make decisions regarding the plan investments that will benefit the employer at the expense of the participants; and
- Defray reasonable expenses of administering the plan. This means that while plan assets may be used to pay for plan administration, the costs must always be reasonable.

A plan fiduciary must discharge all plan duties solely in the interests of plan participants for the exclusive purpose of providing benefits under the plan and defraying reasonable expenses of administering the plan. This requirement is commonly referred to as the "exclusive benefit rule" or sometimes the "duty of loyalty."

Thus, plan fiduciaries must consider their duties of loyalty when dealing with company stock within a retirement plan. These duties could arise, for example, when fiduciaries find themselves responsible for voting on behalf of company stock held by a retirement plan.

Under the exclusive benefit rule, courts have also placed restrictions on the content and timing of communications with participants. Two prominent themes that affect company stock have been raised by the courts:

No Misleading Statements

As the Third Circuit has noted in *In re* Unisys Savings Plan Litigation, an ERISA fiduciary may not materially mislead those to whom it has a fiduciary duty, even where the information is arguably being provided outside of the retirement plan. In other words, "when a plan administrator speaks, it must speak truthfully." Plan fiduciaries have an affirmative duty to not mislead participants.

The Supreme Court applied a similar analysis in Varity v. Howe, finding a breach of fiduciary duty for knowing misrepresentations by an employer. In *Varity*, the company encouraged employees to transfer to a new subsidiary, all the while assuring employees that the subsidiary was financially sound and that benefits would remain at the same level as before. In fact, the company hoped to avoid certain benefit obligations through the transfers. Within a couple of years, employees who accepted the transfers lost significant benefits due to the insolvency of the subsidiary. The Court held that the company had breached its fiduciary duty, stating: "To participate knowingly and significantly in deceiving a plan's beneficiaries in order to save the employer money at the beneficiaries' expense is not to act 'solely in the interests of the plan participants and beneficiaries'" as required by ERISA.

Several courts have held plan sponsors liable for misinformation provided by individuals working for the plan sponsor even when the individuals were not ERISA fiduciaries in their own right. Employees of

the plan sponsor and other agents of the plan sponsor who have authority regarding benefits issues (such as representatives of a third-party administrator) can create fiduciary liability for the plan sponsor by misinforming or failing to inform participants and beneficiaries. Moreover, the individual making a misrepresentation need not even know it is false. In all events, the end result will depend upon the overall circumstances and the express terms of the plan document.

Plan fiduciaries who provide information about the company stock, whether in their roles as plan fiduciaries (e.g., in responding to a specific participant question), or in their corporate roles, should be mindful of possible liabilities which may arise from such information.

No Harmful Silence

Both *Unisys* and *Varity* highlight the issue of potential fiduciary liability for deliberate, negligent, or innocent misrepresentations to plan participants concerning their retirement plans, such that great care should be taken to avoid making misleading statements. It is important to note, however, that the duties recognized by the courts not only preclude active misleading of participants and beneficiaries, but it also imposes an obligation to inform when silence or the withholding of material information might be harmful.

In a case involving a trustee that resigned to avoid liability with respect to a retirement plan, the court held that the trustee had a duty to inform participants because it knew a material fact that was not known to participants but was necessary for the participants to protect themselves against another party. The case involved a 401(k) plan and a series of flagrant breaches by the company's owner, including a long-term failure to remit employee and employer contributions to the bank-trustee, failure to provide necessary information to the trustee, and failure to respond to the trustee's continued requests for the appointment of a successor trustee. The bank-trustee resigned and, in accordance with the trust agreement's terms, delivered the plan assets to the owner who promptly converted them to his own use. A plan participant sued the bank for breach of fiduciary duty, and the court imposed liability because the bank, knowing the owner's past conduct regarding the plan, nevertheless turned over plan assets to the owner; it also did not inform the plan participants about the company's problems so that they could take steps to protect their plan assets. The court said that ERISA does not require a fiduciary to provide participants notice of every piece of potentially adverse information, but it does require the fiduciary to share the information when the information is necessary for the participants to protect themselves against another party. The court stated that the trustee could not avoid liability by simply resigning if doing so would jeopardize the plan or its assets.

Another potential for "harmful silence" arises in the context of a publicly-traded company, where plan fiduciaries may have inside knowledge about corporate problems—information that could affect investor confidence and the company's market value. Some plan fiduciaries have argued that federal securities laws preclude them from disclosing this type of information to plan participants. In making this argument, defendants typically point to the fact that federal securities laws should be the proper framework for determining when inside information can and should be disclosed to investors. It would be improper (so the argument goes) for fiduciaries to release sensitive information to plan participants but not to the investing public in general. Moreover, requiring full public disclosure in order to avoid potential breaches of fiduciary duty under ERISA would effectively mean that ERISA supplants federal securities laws in determining when corporate officials need to disclose information. In dealing with these arguments, most courts have ruled that plan fiduciaries can not hide behind federal securities laws to excuse their inaction. At least one court, however, has concluded that a prohibition on disclosing information under federal securities laws is sufficient to prevent a plan fiduciary from passing on information to participants, and therefore the fiduciary's silence does not constitute a breach of fiduciary duty under ERISA.

Plan fiduciaries who come into possession of negative information about company stock or company

value in general should carefully consider any obligation they may have to disclose the information to retirement plan participants.

Prudent Man Rule

Plan fiduciaries must perform functions for the retirement plan with the care, 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 like character and like aims. In short, plan fiduciaries must investigate and evaluate investments, and must properly evaluate decisions made with respect to investments (e.g., voting of company stock).

ERISA creates a presumption of expertise for fiduciaries that forces fiduciaries to be judged as "prudent experts." The "prudent expert" rule requires the fiduciary to act in a prudent fashion for the level of competency, experience, and training of other individuals "familiar with such matters." In other words, this rule requires a standard where training and experience is expected for specific matters.

Each fiduciary must make an independent investigation and decision with respect to any investment, including company stock, because acting with prudence also encompasses procedural prudence.

Plan fiduciaries should remember that, even if they do not regularly have direct access to all material information about company stock, or even if they are not part of the finance or other key management roles within the company, they may still be held to a standard that treats them as having this kind of knowledge.

Prudent Diversification Rule

Available investment choices must enable a participant to diversify his or her account in order to minimize the risk of large losses, especially due to value of the company stock. The investment choices offered by the plan and the size of the participant's account balance are factors to be considered in determining whether a plan provides reasonable diversification. Company stock, whether offered as one of large or a small number of investment choices within the retirement plan, may not always qualify as prudent diversification. In some situations, a participant's account will be so small that the only prudent means of ensuring appropriate diversification is with a "look-through investment vehicle," such as an investment company (including mutual funds) or a common or collective trust fund or pooled investment fund maintained by a bank, a bank deposit, or a guaranteed-investment contract of a bank. Where a look-through investment vehicle is used, the underlying investments must be considered in determining whether a plan's investment alternatives offer sufficient diversification to meet the requirements for being one of the minimum three investment choices.

Beginning in 2006, rules on diversifying out of company stock held in a retirement plan were mandated by the Pension Protection Act of 2006 (PPA). A plan allowing participant investments in company stock now has to include provisions that permit the participant to sell the company stock holdings and move the assets to another investment option. The PPA requires that plan sponsors allow participants to diversify out of company stock after three years of service for employer non-elective or matching contributions that were made in company stock. For employee contributions, diversification out of company stock must be permitted immediately. The plan must also provide a written notice to participants at least 30 days before they are eligible to exercise these rights. A minimum of three other materially different investment options with diversified risk and return characteristics must be offered under the plan. It should also be noted that the PPA increases the maximum fidelity bond amount to $1 million for plans that hold company stock or other securities.

Some of the most difficult rules to administer under the PPA regarding diversification involve what restrictions may be applied to trading company stock in a retirement plan. Generally, participants must be provided reasonable opportunities to divest out of or reinvest in company stock no less frequently than

quarterly, and no restrictions or conditions may be imposed on such divestment or reinvestment that are not imposed on the investment of other assets of the plan, including a restriction on divestment of company stock that is not imposed on another investment option and a benefit that is conditioned on investment in company stock. However, one exception to this rule is that a plan may impose a restriction on company stock disinvestment or reinvestment due to securities laws or actions that are reasonably designed to ensure compliance with such laws.

Plan fiduciaries should make sure that their retirement plans have procedures and processes in place to comply with these PPA diversification requirements, as well as to provide proper proof of compliance.

Adherence to Plan Document

Plan fiduciaries must discharge their duties in accordance with the plan documents and instruments, but only to the extent they are consistent with the IRC and ERISA's terms. Plan fiduciaries should note that retirement plans that offer company stock will typically contain provisions required by the IRC and ERISA relating to pass-through of voting, dividends, and other typical stockholder-related actions and information. Fiduciaries should make themselves familiar with these rules and ensure that procedures and processes are being followed by staff and others administering the retirement plan.

Why Should Fiduciaries Worry About Company Stock Rules?

A fiduciary breaching his or her responsibility is personally liable for any losses to the plan resulting from the breach. In addition, the fiduciary is responsible for restoring to the plan any profits that the fiduciary made through use of any plan asset. When multiple fiduciaries are responsible for a breach, their liability is joint and several, meaning any one of them can be held liable for the full amount of the breach.

Although fiduciary exposure cannot be completely eliminated, especially where company stock is offered, there are some ways to limit exposure. Chief among them is for the fiduciary to understand his or her obligations and to document steps taken to comply. With the uncertain economy and its impact on most companies' stock prices, fiduciaries should be focusing on making sure that they are adequately protected from personal liability for losses in company stock value.

When Offering Company Stock As an Investment Option in a Retirement Plan, Fiduciaries Should:

- Educate participants about diversification and asset allocation.
- Educate participants about the risks related to investments in company stock.
- Review any restrictions on the transfer or sale of the company stock to ensure the interests of participants are considered.
- Monitor company stock in the same manner as any other plan investment option.
- Provide appropriate disclosures with proper written documentation.
- Comply with ERISA Section 404(c) regarding participant-directed investments.
- Set limits on the amount of company stock that a participant may hold in his or her account. (For example, limit company stock to 20 percent of participant's account balance.)
- Suspend investments in company stock when the financial health of the company is at risk.

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