

THE MICHEL-SHAKED GROUP

RESEARCH FROM OUR EXPERTS

Fiduciary Responsibility in the Case of Defined Contribution Plans

by Allen Michel & Israel Shaked

It has long been recognized that ERISA (Employee Retirement Income Security Act of 1974) requires fiduciaries such as plan trustees, plan administrators, chief investment officers, money managers and others to bear responsibility for overseeing retirement plans. However, with the well-publicized severe losses borne by employees in defined contribution pension plans such as those associated with Enron, the responsibility of plan fiduciaries is now receiving increased attention from both employees and the courts. Cases in which plan participants were not properly informed about changes in the risk/return profile of the company or where participants were provided information misrepresenting relevant facts about the company are now being litigated. Companies such as Enron that have encountered severe financial distress are but the tip of the iceberg. Others, through lack of communication and misrepresentation, may have caused plan participants to also suffer serious losses in their pension portfolios.

Firms have been increasingly switching their retirement plans offered to employees from defined benefit plans to defined contribution plans. A defined benefit plan

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The opinions expressed in this article are those of the authors and do not necessarily reflect those of the Michel-Shaked Group.

promises to pay an employee a specific amount per period in retirement. The amount is generally paid throughout the participant's lifetime with the risk of payment borne by the plan sponsor. A defined contribution plan is one in which employers and/or employees contribute a specified percentage of income or dollar amount to fund either a lump-sum payment from the company or an annuity upon retirement. In such plans the retiree bears the financial risk that she/he will outlive the funds available for retirement. The 401(k) has become the most popular of the different types of defined contribution plans. Of these plans, those that permit a participant or beneficiary to exercise control over the assets in the retirement account are frequently referred to as 404(c) plans.

Fiduciary Duty in 404(c) Plans

Under ERISA, fiduciaries are liable for losses suffered by the plan participants or beneficiaries that are caused by a breach of ERISA-imposed fiduciary duties and responsibilities. In 404(c) plans, if the plan and its fiduciaries comply with a broad range of requirements, liability is shifted to plan participants. These requirements assure that the fiduciaries provide sufficient information for the plan participants to make informed investment decisions. They also require that fiduciaries not misrepresent information or materially mislead the employees and beneficiaries. Similarly, requirements such as diversification, adherence to plan, etc. are also imposed. Should these conditions not be met, the burden of liability is not shifted to the plan participants. As a result, the fiduciaries have a choice. They can make full disclosure of relevant information to the plan participants and be absolved of liability resulting from poor investment performance, or not make complete disclosure and bear the risk of incurring

A Letter From Our Managing Directors

Dear Friend:

The past several years have seen a dramatic increase in ERISA class action litigation. Recently much of this litigation has focused on the fiduciary responsibility owed to plan participants.

We have been fortunate to have worked on a number of ERISA cases, both for the Department of Labor and in private litigation. While our firm's role has been to analyze possible breaches of fiduciary duty, as well as to determine possible damages associated with those breaches, in this article we focus on the obligations of plan fiduciaries. Namely, we present some of our insights about the fiduciary duty arising in those defined contribution plans where a participant or beneficiary exercises control over the plan's assets. These are frequently referred to as 404(c) plans.

The topic is one where there has been much debate and great acrimony. We hope this article is both clarifying and useful.

Best regards,



Allen Michel



Israel Shaked

any resulting liability from poor investment performance. To avoid liability, ERISA guides the fiduciaries to make full, complete disclosures about company performance to plan participants.

More generally, fiduciaries are responsible for exercising the duties of prudence, care and loyalty to plan participants. A fiduciary is said to act prudently if he/she acts with the care, skill, prudence and diligence that a "prudent man" would exercise under similar circumstances. Fiduciaries for participant-directed accounts must consider the prudence of investment options made available to plan participants and maintain oversight over these options. The duty of care necessitates that fiduciaries should provide sufficient information to plan participants to enable them to make knowledgeable choices. They should also provide investment monitoring and assist employees in evaluating and interpreting the

measurement of performance. In addition, participants should be allowed to give investment instructions with appropriate frequency to facilitate the re-balancing of the participant portfolios over time. The duty of loyalty requires that the fiduciaries resolve conflicts between the sponsoring organization and the plan in ways that are not disadvantageous to the plan or the plan participants.

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Moreover, it becomes the responsibility of the fiduciaries to be as faithful as possible to the pension plan participants and beneficiaries, not materially mislead them or make material misrepresentations to them.

Investment in Company Stock

One area of company pension plans where fiduciary responsibility received significant attention recently is where an option is provided to employees to invest in company stock. While company stock may well be a legitimate investment choice, in several matters it has been argued that fiduciaries have lost sight of their responsibilities of prudence, care and loyalty to the plan participants. Whether the fiduciaries are pressured to encourage investment in company stock or simply do not communicate risk/return changes adequately to plan participants, the plan participants may still not be provided the relevant information to make informed investment decisions.

Fiduciary responsibility relating to the issue of company-matched contributions to an employee's 401(k) plan is an area of continuing concern. In a number of matters investigated by the Department of Labor, the plan fiduciaries continued to maintain

a match in company stock as the company deteriorated financially and in some cases became financially distressed. In numerous instances, the participant is unable to transfer funds from the company stock fund to another option as the firm's finances worsen. Even in those situations where the company is making complete disclosures as to material events, but not enabling the individual to transfer funds in the case of deteriorating finances, the fiduciary is not exercising his/her duties of prudence, care and loyalty to the participants.

In cases of employer match plans where complete disclosures are being made to plan participants about the company's deteriorating financial condition, fiduciaries may argue that the purchase price was reasonable. They may argue that in an efficient market, pricing was fair and they should incur no liability. However, the overriding question is whether the firm's stock is now an appropriate investment in the employee's retirement plan. For many firms, the speculative nature of the investment following the financial deterioration makes the company stock an inappropriate investment for a retirement plan. As a result, while the fiduciary might have a number of reasons for wanting to keep the investment in company stock, the prudence, care and loyalty obligations trump all other motivations on the part of the fiduciaries.

Fiduciaries and Non-public Information

In the typical 404(c)-defined contribution plan where an employee has the opportunity to invest in company stock, the fiduciaries must exercise care to learn and transmit all relevant public information about the company. Moreover, if there is non-public information available to the fiduciary, that fiduciary also has a responsibility to act. Possible actions that are available to the fiduciary include removing the company stock from the set of possible investment choices, blocking further investment in the company's stock, advising employees against further investment in the stock or forcing the disclosure of the information publicly. While fiduciaries may well be reluctant to take some of these actions, the

consequences for the fiduciary of not doing so are severe.

Access to Sufficient Information

A plan fiduciary must not materially misrepresent a participant's benefits to the participants or plan beneficiaries. In fact, in *Bixler v. Central Pennsylvania Teamsters Health and Welfare Fund*, it was determined that fiduciaries have an affirmative duty to "inform when the fiduciary knows that silence can be harmful."¹ Moreover, plan participants and beneficiaries in 404(c) plans "must have access to sufficient information to enable them to make informed investment decisions."² Any misrepresentation that materially misleads investors in such a way that they are unable to make informed investment decisions has the effect of retaining the liability for poor investment choices with the plan fiduciaries.

While the motivations on the part of plan fiduciaries may vary significantly, there are certainly motivations to keep the stock price from plummeting as the firm faces financial difficulties and possibly financial distress. This is particularly true when plan fiduciaries wear multiple hats—namely, when they also act as corporate officers or play another role in senior management. In these situations it is necessary for the plan fiduciaries to remember their duties of prudence, care and loyalty to the plan participants and beneficiaries.

In sum, the duties and responsibilities of plan fiduciaries are paramount. Whether the company is performing well or in financial distress, the welfare of the plan participants and beneficiaries takes center stage. Much of the fiduciary-related litigation results from an investment in company stock by plan participants and beneficiaries. The litigation often arises as a result of an alleged breach of prudence, care and/or loyalty associated with periods of a significant downturn in the company's stock price. To avoid liability, the fiduciaries must meet the carefully crafted ERISA requirements at all times — including times of severe financial distress.

¹*Bixler v. Central Pennsylvania Teamsters Health and Welfare Fund* CA-3 (1993), 12F.3d 1292

²McInerney, Kerry, Pope, Elizabeth, Sulzer, Glenn and Thompson, Carol E, *2004 U.S. Master Pension Guide*, Chicago: CCH Inc. (2004).

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