ERISA AND THE 401(K) PLAN FIDUCIARY

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ERISA AND THE 401(K) PLAN FIDUCIARY[1]

In the relatively short period of time since their reintroduction in 1980, cash or deferred arrangements, commonly referred to as "401(k) plans," have become the retirement plan of choice for large and small employers alike. During much of this period of time, the fiduciaries of 401(k) plans have operated in relative safety. The great bull market of 1982 to 1999 masked occasional missteps, proving the old saw that "a rising tide floats all ships."

The bear market that began in 2000 (and may or may not have ended), corporate scandals best illustrated by the demise of Enron, and the more recent revelations concerning abuses in the mutual fund industry have brought a new focus to the conduct of 401(k) plan fiduciaries. In light of this increasing attention, the fiduciaries of 401(k) plans are well-advised to pay more attention to their duties under the law.

Like the more traditional forms of retirement programs, 401(k) plans are characterized as "employee pension benefit plans" for purposes of the Employee Retirement Income Security Act of 1974 ("ERISA").[2] Accordingly, the individuals who are responsible for the administration and management of a 401(k) plan are characterized as "fiduciaries"[3] under ERISA and are subject to the same fiduciary standards that apply to the fiduciaries of any other form of retirement plan. These generally applicable fiduciary requirements are described in Section I, below.

A number of issues that 401(k) plan fiduciaries confront on a regular or recurring basis are addressed in Section II.

I. GENERAL EXPLANATION OF THE FIDUCIARY RESPONSIBILITY RULES

ERISA imposes certain obligations on the individuals or entities who are responsible for the administration and management of employee benefit plans such as 401(k) plans. The fiduciaries of a 401(k) plan are required to observe ERISA's "Exclusive Benefit Rule" and its "Prudent Person Rule," both of which are described below. A 401(k) plan fiduciary also must

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[1] This paper was included in the course materials for the 2005 "ALI-ABA Video Law Review, ERISA Fiduciary Responsibility Issues Update." This version of the paper has been updated to reflect the more significant developments occurring between January 1, 2005 and April 30, 2006.

Anne Meyer, Megan Thiel and Sara Van Houten assisted with the preparation of this updated paper. Ms. Thiel and Natalie Mathews assisted with the research and analysis regarding the fiduciary responsibilities associated with the appointment of an investment manager. Eric Kintner analyzed the responsibilities of a directed trustee. Ms. Mathews, Ms. Meyer, Mr. Kintner, Ms. Thiel and Ms. Van Houten are attorneys with Snell & Wilmer L.L.P.

[2] ERISA is codified at 29 U.S.C.A. § 1001 et seq. All references in this paper are to the ERISA section numbers.

[3] ERISA section 3(21)(A) provides that a person is a fiduciary with respect to a plan to the extent that he or she: (1) exercises any discretionary authority or control with respect to the management of the plan or exercises any authority with respect to the management or disposition of plan assets; (2) renders investment advice for a fee or other compensation with respect to any plan asset or has any authority or responsibility to do so; or (3) has any discretionary responsibility in the administration of the plan.

administer the plan in accordance with its terms and is subject to ERISA's co-fiduciary liability and prohibited transaction rules.[4]

A. The Exclusive Benefit Rule

ERISA section 404(a)(1)(A) requires that a fiduciary discharge his or her duties with respect to a plan for the exclusive benefit of plan participants and their beneficiaries and for the purpose of defraying the expenses of administering the plan.[5] Similarly, section 403(c) of ERISA provides that "the assets of a plan shall never inure to the benefit of any employer and shall be held for the exclusive purposes of providing benefits to participants in the plan and their beneficiaries and defraying reasonable expenses of administering the plan."

Although the "Exclusive Benefit Rule" of sections 403(c) and 404(a)(1)(B) is phrased in terms of "never," "solely" and "exclusively," the courts have recognized that a literal reading of the statute is nonsensical and have readily acknowledged that incidental benefits may flow to the fiduciary or the plan sponsor as long as the fiduciary's primary motivation is to benefit the plan.[6]

B. The Prudent Person Rule

Under the "Prudent Person Rule" of ERISA section 404(a)(1)(B), a 401(k) plan fiduciary must discharge his or her duties with the care, skill and diligence that would be exercised by a reasonably prudent person who is familiar with such matters. Although some commentators have suggested that section 404(a)(1)(B) imposes a "prudent expert" standard, the better view is that the Prudent Person Rule is a restatement of the prudent person standard developed as part of the common law of trusts.[7]

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[4] For a more detailed discussion of ERISA's fiduciary responsibility requirements, see Employee Benefits Committee, Section of Labor and Employment Law, American Bar Association, Employee Benefits Law, ch. 5 (BNA 1991) [hereinafter referred to as "Employee Benefits Law"].

[5] The Exclusive Benefit Rule applies to all areas of plan administration and not merely the investment of plan assets. 29 C.F.R. § 2550.404a-1 (1979).

[6] See Hughes Aircraft v. Jacobson, 525 U.S. 432, 445-46 (1999). Also see Hlinka v. Bethlehem Steel Corp., 863 F.2d 279, 286 (3rd Cir. 1988, superseded on other grounds); Oster v. Barco of California Employees Retirement Plan, 869 F.2d 1215, 1217 (9th Cir. 1988, superseded on other grounds); Trenton v. Scott Paper Co., 832 F.2d 806, 809 (3rd Cir. 1987), cert. denied, 485 U.S. 1022, 108 S.Ct. 1576 (1988); United Steelworkers of America, Local 2116 v. Cyclops Corporation, 860 F.2d 189, 202 (6th Cir. 1988); Morse v. Stanley, 732 F.2d 1139, 1146 (2nd Cir. 1984); and Donovan v. Bierwirth, 680 F.2d 263, 271 (2nd Cir. 1982). cert. denied, 459 U.S. 1069, 103 S.Ct. 488 (1982).

[7] Employee Benefits Law, ch. 5, at 275. Thus, a fiduciary will be held to the standard of any prudent fiduciary who is skilled in carrying out and familiar with the duties with which he or she is charged. In Donovan v. Cunningham, 716 F.2d 1455, 1467 (5th Cir. 1983), the Fifth Circuit noted that "[s]ome commentators have suggested that the reference in Section 404 to a prudent person "familiar with such matters" creates a "prudent expert" standard under ERISA. However, a review of the relevant history of Section 404 does not support this view; rather, it confirms that the emphasis of Section 404 is on flexibility."

C. The Diversification Requirement

As a general rule, the investment diversification requirement of ERISA section 404(a)(1)(C) places an affirmative duty on a plan fiduciary to diversify plan investments unless, under the circumstances, it is clearly prudent not to diversify.[8]

Under ERISA section 404(a)(2), an "eligible individual account plan" may acquire and hold qualifying employer securities or qualifying employer real property without regard to the diversification requirements or the diversification element of the Prudent Person Rule. Profit sharing, stock bonus, thrift, or savings plans may qualify as "eligible individual account plans" as may certain money purchase pension plans.[9]

D. Compliance with Plan Documents

ERISA section 404(a)(1)(D) requires and allows a fiduciary to follow the provisions of the plan, but only if the provisions of the plan are consistent with ERISA.[10] If the action called for by the plan provision is inconsistent with ERISA, the fiduciary is obligated to ignore the plan provision.

This principal is well illustrated by the position taken by the Department of Labor in its amicus brief in Tatum v. R.J. Reynolds Tobacco Company.[11] In Tatum, the plaintiff claimed that the fiduciaries of a 401(k) plan violated their fiduciary duties when they liquidated two investment funds that held Nabisco stock following the spin-off of R.J. Reynolds Tobacco Company. At the time of the liquidation, the Nabisco stock had slumped following the spin-off of the tobacco operations. Several months following the liquidation of the Nabisco investment funds, the Nabisco stock had rebounded. The defendants successfully filed a motion to dismiss with the trial court, alleging that they simply followed the provisions of the plan which required the elimination of the funds due to a recent plan amendment. The plaintiff appealed.

Additional support for this contention can be found in an advisory opinion issued by the Department of Labor. Department of Labor Advisory Opinion 2002-14A (December 18, 2002), which is available on the Department website (*www.dol.gov/ebsa*). Advisory Opinion 2002-14A addressed whether an expert was needed in choosing an annuity provider. In the Advisory Opinion, the Department stated that a fiduciary does not need to retain an independent expert if the fiduciary has a sufficient level of expertise or knowledge to meaningfully evaluate the claims paying ability and credit worthiness of an annuity provider.

[8] See, for example, Etter v. J. Pease Construction Co., 963 F.2d 1005, 1010 (7th Cir. 1992) (diversification requirement not violated where 90% of plan assets invested in single real estate investment which yielded 65% return); and Reich v. King, 867 F. Supp. 341, 344 (D. Md. 1994).

[9] ERISA § 407(d)(3) (A) and (B).

[10] The phrase "documents and instruments governing the plan" as used in section 404(a)(1)(D) encompasses more than the plan document itself. Investment management agreements or investment policies are also included. See Plan Fiduciaries' Responsibilities for Voting Proxies, Pension and Welfare Benefits Administration Interpretive Bulletin No. 94-2, Pens. Plan Guide (CCH) ¶ 19,971 (July 29, 1994) [hereinafter referred to as "Interpretive Bulletin 94-2]. See also Dardaganis v. Grace Capital, Inc., 664 F. Supp. 105, 108 (S.D.N.Y. 1987), aff'd, 889 F.2d 1237 (2nd Cir. 1989) (investment manager held responsible for violating provisions of investment management agreement).

[11] 2004 WL 2857376 (4th Cir. 2004).

On appeal, the plaintiff claimed that the amendment did not actually require the liquidation of the funds. The Secretary of Labor, in its amicus brief, also argued that if the amendment did require the liquidation of the funds, the fiduciaries had an obligation to ignore the language of the amendment if the liquidation would be imprudent.

The Fourth Circuit sidestepped the issue by concluding that the amendment did not require the liquidation of the funds. The position taken by the Department in its brief, however, clearly reveals that in the view of the Department certain fiduciary responsibilities cannot be avoided by plan amendments.

The requirements of section 404(a)(1)(D) are particularly important in the context of a 401(k) plan that permits or allows investments in employer securities. For example, 401(k) plans frequently provide that an employer's contributions will be made and continue to be invested in employer stock. A plan fiduciary may be required to disregard these provisions if allegiance to the plan language will violate the Prudent Person Rule or the Exclusive Benefit Rule.[12]

E. <u>Co-Fiduciary Liability</u>

Under ERISA section 405(a), a fiduciary may be liable for the acts or omissions of a co-fiduciary if the fiduciary knows that the person committing the act or omission is a fiduciary with respect to the same plan, participates knowingly in the act or omission and knows that the act or omission is a breach of fiduciary duty.[13] A fiduciary also may be held responsible for a breach committed by a co-fiduciary if the first fiduciary breached his or her own responsibilities under ERISA section 404(a), thereby enabling the second fiduciary to violate ERISA.[14] Finally, a fiduciary will be held responsible for a breach committed by a co-fiduciary if the fiduciary has knowledge of a breach committed by the co-fiduciary and fails to make reasonable efforts under the circumstances to remedy the breach.[15]

F. <u>Co-Trustees</u>

If a plan provides for co-trustees, plan assets are to be jointly managed unless the trustees agree (in accordance with the trust instrument) to allocate specific responsibilities, obligations and duties among themselves. If trustee duties are allocated in this fashion, a trustee to whom a duty has not been allocated is not liable for losses due to acts and omissions of the trustee to whom the duty has been allocated.[16]

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[12] See *In re* Enron Corp. Securities, Derivative & "ERISA" Litigation, 284 F. Supp. 2d 511 (S.D. Tx. 2003); *In re* Sprint Corp. ERISA Litigation, 2004 U.S. Dist. LEXIS 9622 (Kan. 2004).

[13] ERISA § 405(a)(1).

[14] ERISA § 405(a)(2).

[15] ERISA § 405(a)(3). "Reasonable efforts" can consist of rescinding the transaction, notifying the plan sponsor of the breach, filing suit in a federal district court or contacting the Department of Labor regarding the breach. The reasonableness of a fiduciary's efforts will be determined in light of the surrounding circumstances, including the nature of the breach and the fiduciary's responsibilities. Employee Benefits Law, ch. 5, at 296.

[16] ERISA § 405(b)(1)(B).

If plan assets are held in more than one trust, the trustee of only one of the trusts is not liable under ERISA's co-trustee rules for the acts and omissions of the trustee of any other trust.[17]

G. Allocation of Trustee Responsibilities

Section 403 of ERISA provides that the trustees of a plan must have the "exclusive authority and discretion to manage and control the assets of the plan."[18] As mentioned above, co-trustees may allocate so-called "trustee responsibilities" (which are responsibilities that relate to the management or control of plan assets) among themselves, but trustee responsibilities generally may not be allocated to others.[19] This general rule is subject to three exceptions.

Perhaps most importantly, a plan may provide that the trustee is subject to the direction of a named fiduciary who is not a trustee.[20] A plan also may permit the appointment of an investment manager with authority to manage, acquire or dispose of plan assets. If an investment manager is properly appointed, the plan trustee no longer has the responsibility for managing the assets controlled by the investment manager and is not liable for the investment manager's acts or omissions.[21] In addition, a plan trustee may follow the directions of plan participants if the plan and the directions comply with the requirements of ERISA section 404(c). The requirements of section 404(c) are discussed below.[22]

H. Allocating and Delegating Non-Trustee Responsibilities

Named fiduciaries may allocate responsibilities other than "trustee responsibilities" (i.e., they may allocate responsibilities that do not involve the management and control of plan assets) among themselves if the plan expressly provides a procedure for shifting non-trustee fiduciary responsibilities.[23] If named fiduciaries follow the plan's allocation procedures, they are not liable for the acts or omissions of the fiduciary assuming the transferred responsibilities. Named fiduciaries are liable to the extent they violate their own fiduciary responsibilities under ERISA section 404(a)(1) with respect to the actual act of allocation and they also remain subject to the general co-fiduciary liability rules discussed above.[24]

A named fiduciary also may delegate non-trustee fiduciary responsibilities to someone other than a named fiduciary if the plan so permits. Responsibilities typically delegated include the responsibility for day-to-day plan administration, the disbursal of plan benefits and claims

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17 ERISA § 405(b)(3)(A).

18 ERISA § 403(a).

19 ERISA § 405(c)(1).

20 ERISA §§ 403(a)(1) and 405(b)(3)(B).

21 ERISA §§ 402(c)(3), 403(a)(2) and 405(d)(1). In order for the trustee to be relieved of any responsibility, the "investment manager" must satisfy the requirements of ERISA section 3(38) and the delegation must be authorized by the plan documents. Whitfield v. Cohen, 682 F.Supp. 188, 196 (S.D.N.Y. 1988).

22 For a discussion of the responsibilities of a directed trustee, see section II L (Responsibilities of Directed Trustees) below.

23 ERISA § 405(c)(1).

24 ERISA § 405(c)(2).

review. If proper delegation procedures are followed, the named fiduciary will not be liable for the acts or omissions of the fiduciary to whom non-trustee responsibilities have been delegated.[25]

Plan fiduciaries (including fiduciaries to whom duties have been delegated by named fiduciaries) also may hire agents to perform ministerial tasks. If the fiduciary exercises prudence in the selection and retention of such agents, the fiduciary may rely on information, data, statistics and analysis provided by the agent without risking exposure.[26]

Any delegation of a fiduciary responsibility should be made with the Exclusive Benefit Rule clearly in mind. Responsibilities should never be delegated to friends, relatives or business acquaintances if such a delegation would conflict with the requirement that the fiduciary discharge his or her duties solely in the interest of participants and beneficiaries and for the exclusive benefit of those individuals.

I. ERISA's Prohibited Transaction Rules

ERISA supplements its general fiduciary responsibility requirements by specifically prohibiting certain transactions between a covered plan and related parties, referred to as "parties in interest."[27]

Under section 406(a) of ERISA, a plan fiduciary is specifically prohibited from engaging in certain transactions with a party in interest. The list of banned transactions includes: the sale, exchange or lease of property; the lending of money or other extension of credit; the furnishing of goods, services or facilities; or the transfer or use of plan assets. A plan fiduciary also is prohibited from acquiring or holding any securities issued by the plan sponsor other than "qualifying employer securities."[28]

The "self-dealing" prohibitions of section 406(b) also are quite significant. Section 406(b) prohibits a plan fiduciary from dealing with the assets of the plan in his own interest or for his own account or receiving any consideration for his personal account from any party dealing with the plan in a transaction involving plan assets.[29] The self-dealing provisions also prohibit a plan fiduciary from acting on behalf of a party whose interests are adverse to the interests of the plan or its participants.[30]

ERISA provides for certain exemptions from the prohibited transactions listed in section 406. ERISA section 408(a) provides for administrative exemptions (granted by the Secretary of Labor on a case-by-case basis) and statutory exemptions which permit certain classes of transactions.

If a transaction is a prohibited transaction under ERISA section 406 and an exemption is not available, the transaction must be "undone" or "corrected." The fiduciary also will be liable

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25 ERISA §§ 405(c)(1) and (2).
26 29 C.F.R. § 2509.75-8, FR-11 (1976).
27 ERISA § 406. The term "party in interest" is defined in ERISA section 3(14).
28 ERISA §§ 406(a) and 407(a).
29 ERISA § 406(b)(1) and (3).
30 ERISA § 406(b)(2).

to the plan for losses resulting from the prohibited transaction and will be required to disgorge any profits.[31]

Although section 406 of ERISA only imposes a duty on fiduciaries of covered plans, the Supreme Court has held that a non-fiduciary may be held liable under section 502(a)(3) of ERISA for participating in a prohibited transaction.[32]

Section 4975 of the Internal Revenue Code of 1986 (the "Code") also imposes an excise tax on "disqualified persons" participating in the transaction in an amount equal to fifteen percent of the amount involved in the transaction for each year in the "taxable period."[33] If the prohibited transaction is not corrected in a timely manner after the receipt of notice to do so from the Internal Revenue Service, a tax of 100% of the amount involved also may be imposed on the disqualified person. The term "disqualified person" includes, but is not limited to, plan fiduciaries.[34] A fiduciary acting only as such is not liable for any excise taxes imposed by Code section 4975.

II. RECURRING 401(K) PLAN ISSUES

The fiduciaries of a 401(k) plan, like the fiduciaries of any other employee benefit plan, are subject to all of the fiduciary standards referred to above. The application of these standards to situations that frequently confront 401(k) plan fiduciaries is described below.

A. Bundled Programs

Banks, brokerage houses, insurance companies, mutual fund companies and others now offer a wide assortment of packaged or "bundled" 401(k) programs that include a plan document, an investment program and plan administration services.[35] These bundled programs are available to large and small employers alike and often are marketed and "purchased" like many other financial products, with little or no thought given to the fiduciary responsibility provisions of ERISA. The employer that blithely purchases a 401(k) program with the same amount of diligence applied to the purchase of an auto insurance policy, however, may be making a grave mistake.

When an employer "purchases" a particular bundled 401(k) plan, the employer actually is making a series of decisions, several of which are subject to ERISA's fiduciary standards. By adopting a bundled program, the employer either is establishing a new plan or modifying an existing program. ERISA's fiduciary standards do not apply to the decision to adopt or amend a plan. At the same time, in choosing a bundled program the employer also is selecting the related

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31 ERISA §409(a).

32 Harris Trust & Savings Bank v. Salomon Smith Barney, Inc., 530 U.S. 238, 245 (2000).

33 IRC §4975(a).

34 IRC §4975(e)(2).

35 Investment companies and other service providers frequently team with each other in providing bundled programs. If these parties share or split fees, prohibited transaction concerns may come into play. See DOL Advisory Opinion 97-15A (May 22, 1997), reprinted in 24 Pens. & Ben. Rep. (BNA) 1327 (June 2, 1997) and DOL Advisory Opinion 97-16A (May 22, 1997), reprinted in 24 Pens. & Ben. Rep. (BNA) 1329 (June 2, 1997).

investment program. This decision (as well as certain other decisions that are intertwined with the selection of a particular bundled program) clearly is subject to ERISA's fiduciary standards, including the Prudent Person Rule.

B. Choosing the Investment Alternatives

In designing a 401(k) plan, one of the first issues that must be addressed is whether plan participants will be allowed to control the investment of their individual accounts. Years ago, few plans allowed participants any say in the investment of their accounts. All plan assets were invested by a trustee or investment manager and the participants shared in the gains or losses on a common pool of investments. Most plans now provide participants with the opportunity to direct the investment of their accounts. These programs typically allow plan participants to choose from an array of available investment funds.[36]

The individual or entity that selects the investment funds that will be made available to the plan participants is a fiduciary and must comply with the Prudent Person and Exclusive Benefit Rules described above. In this context, the Prudent Person Rule probably poses the most significant challenge. Whether a particular decision is or is not prudent depends on the circumstances, making it quite difficult to predict how a particular judge or the Department of Labor will view a fiduciary's decision.

Although there is no failsafe list of steps that, if followed, will assure compliance with the Prudent Person Rule, at a minimum, a well-advised fiduciary should consider taking all of the following actions before selecting investment funds --

- The fiduciary should become familiar with the available alternatives. For example, banks, insurance companies, brokerage houses and mutual fund companies all offer a wide array of products and the fiduciary should be aware of and consider the available options.

- The fiduciary should solicit information concerning several available competing programs.

- After the responses are received, the data should be assembled and analyzed.

- The costs and past investment performance of the competing programs should be compared, references should be checked and a considered decision should be made.

[36] In choosing between the old common pool approach and a participant directed investment program, an employer is not subject to ERISA's fiduciary responsibility standards. Instead the employer is exercising a "settlor function" and is free to design its plan in the fashion it deems appropriate. Once this basic decision is made, however, ERISA's fiduciary standards come into play.

Depending on the fiduciary's personal experience and qualifications, expert assistance may be helpful. But the fiduciary may not blindly rely on an expert's advice. The expert's advice is merely a tool that the fiduciary should use in its decision making process.[37]

In an effort to shield plan fiduciaries from claims of breach of fiduciary duty in connection with the selection of investment funds, some advisors recommend specifically designating particular funds in the plan document. The reason for this recommendation is that by designating the fund in the plan document, the fund selection process arguably becomes a "settlor function" rather than a fiduciary decision. Based on the position taken by the Department of Labor in its amicus brief in Tatum v. R.J. Reynolds Tobacco Company, which is discussed in Section I.D., one can assume that the Department will disagree with this analysis.

C. Monitoring the Investment Alternatives

Once the trustee, investment manager or investment funds are initially selected, the fiduciary must monitor their performance. At least annually and preferably quarterly, investment performance should be reviewed against standard market indices. Periodically, performance should be compared against the performance of competing programs, following an approach similar to the one used in making the initial selection. Once again, professional assistance may be necessary, depending on the experience of the fiduciary.[38]

The recent publicity concerning mutual fund abuses illustrates that the plan fiduciaries must focus on more than mere investment performance. Potential abuses by mutual funds and others also need to be taken into account. In a written statement issued on February 17, 2004, Ann Combs, the Assistant Secretary for Employee Benefits Security at the Department of Labor, provided much needed guidance for fiduciaries attempting to fulfill their responsibilities in the wake of an ever expanding list of allegations regarding prominent mutual fund families.[39]

According to Ms. Combs, if a plan holds mutual funds that have been charged with improprieties, the fiduciaries much consider the nature of the abuses, the potential impact of the abuses on the plan's investments, the actions taken by the fund to limit the potential for abuses in the future and any remedial action that should be taken to protect plan participants. In the absence of specific allegations, the plan fiduciaries should consider whether the investment funds held in their plans have procedures and safe guards in place to avoid abuse in the future. In any event, in deciding whether to take action with respect to a particular fund, plan fiduciaries need to be mindful of the Prudent Person Rule, should follow prudent procedures and should document their decisions.

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[37] In re: Unisys Savings Plan Litigation, 74 F.3d 420, 435-36 (3d Cir. 1996), cert. denied, 519 U.S. 810, 117 S.Ct. 56 (1996).

[38] For a good explanation of the duty to monitor, see In re: Sprint Corporation ERISA litigation, 2004 U.S. Dist. LEXIS 9622, * 60-62, (D. Kan. 2004).

[39] Ms. Combs' letter is available on the Department of Labor's website (*www.dol.gov/ebsa*).

D. Expenses

1. Amount

The expenses associated with investment options and various administration programs available for 401(k) plans can have a significant impact on the rate of return experienced by plan participants. In order to satisfy the Prudent Person Rule, the plan fiduciaries who are charged with the responsibility for selecting these products have an obligation to carefully identify all of the charges that will be incurred by the plan and assure that the charges are reasonable in light of the services provided and other available alternatives.[40]

The so called "mutual fund scandal" has caused an increased focus on plan expenses. Mutual fund fees come in many different forms and it is often quite a challenge for a plan fiduciary to fully understand all of the charges that might be exacted by a particular fund.

2. Paying Expenses From Plan Assets

Plan fiduciaries also have an obligation to assure that only appropriate expenses are charged against plan assets. In Advisory Opinion 2001-01, the Department of Labor provided guidance regarding the types of expenses that may be paid from plan assets.[41] Advisory Opinion 2001-01 builds on Advisory Opinion 1997-03.[42] The basic premise of both Advisory Opinions is that expenses associated with a so-called "settlor function" should be paid by the settlor or employer. Expenses associated with the implementation of the employer's decisions and the administration of the plan may be paid from the plan.[43]

Some of the expenses that may be paid from plan assets include the following:

- The cost of a plan amendment necessary to maintain the plan's tax qualified status (but not the cost for consulting services associated with choosing between alternative compliance strategies).
- Normal discrimination testing expenses (but not testing expenses associated with the design of various alternative benefit formulas or contribution allocation approaches).
- Expenses associated with requesting a determination letter from the Internal Revenue Service.
- Expenses incurred to amend a plan to assure compliance with an applicable law.

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[40] In 1998, the Department of Labor issued a participant's guide to 401(k) plan fees, *A Look at 401(k) Plan Fees*. The Department also prepared a more extensive study on 401(k) plan fees. Both the participant's guide and the study are available on the Department's website (*www.dol.gov/dol/ebsa*).

[41] DOL Advisory Opinion 2001-01A is available on the Department's website (*www.dol.gov/ebsa*).

[42] DOL Advisory Opinion 1997-03A is available on the Department's website (*www.dol.gov/ebsa*).

[43] On January 3, 2003, the Department of Labor provided additional guidance with the issuance of several fact patterns. The fact patterns are available on the Department's website (*www.dol.gov/ebsa*).

- Expenses incurred to determine the amount of plan assets that should be transferred to a successor plan in connection with a spin-off, if the expenses are incurred in connection with the implementation of a prior decision to spin-off the participants and assets. The result would be different if the expenses were incurred in connection with the plan sponsor's formulation of its decision to spin-off the assets.

- Benefit calculations for a particular participant.

- Expenses associated with plan communications.

- Once a plan is amended to implement a loan program or other plan feature, expenses attendant to operating or administering the feature.

- Ongoing expenses of an outside administration company.

- Other reasonable expenses of implementing a settlor decision.

On the other hand, the following types of expenses should not, as a general rule, be paid from the assets of a plan:

- Expenses associated with the initial decision to establish a plan as a qualified plan.

- Consulting services designed to assist an employer in choosing between alternative strategies for assuring compliance with applicable requirements.

- Plan design studies in the context of corporate combinations.

- Plan amendments other than qualification amendments. For example, an amendment that is intended to add a loan or hardship withdrawal feature to a plan should not be paid from plan assets.

- Plan amendments to provide for a spin-off in a corporate transaction.

- Amendments that relieve an employer of its responsibility to pay plan expenses.

- Any activities that take place in advance of or in preparation for a plan amendment.

- Cost projections to determine the financial impact of a proposed amendment.

- Any expenses that the plan documents obligate the employer to pay.

- Any calculations required for the employer's financial statements.

3. Allocating Expenses to Participants

In Field Assistance Bulletin 2003-3, the Department of Labor dealt with the allocation of proper plan expenses between and among the plan participants.[44] FAB 2003-3 addresses the allocation of expenses on a pro rata, rather than a per capita, basis as well as the extent to which expenses may properly be charged to an individual participant rather than the plan as a whole. The general theme of FAB 2003-3 is that "plan sponsors and fiduciaries have considerable discretion in determining, as a matter of plan design or a matter of plan administration, how plan expenses will be allocated among participants and beneficiaries."

If the plan sponsor has specifically indicated in the plan document that a particular expense is to be allocated on a pro rata or a per capita basis, a plan fiduciary has an obligation to follow that directive unless the fiduciary concludes that it is inconsistent with ERISA. If the plan document is silent with respect to the proper method of allocation, the fiduciary must make that determination in the exercise of its fiduciary responsibilities. In order to satisfy the Prudent Person Rule, the fiduciary must weigh the competing interests of the participants and assess the impact of the allocation methods on the participants. While a selected method may favor one class of participants over another, according to the Department "if a method of allocation has no reasonable relationship to the services furnished or available to an individual account, a case might be made that the fiduciary breached his fiduciary duties to act prudently and 'solely in the interest of the participants' in selecting the allocation method."

In FAB 2003-3, the Department also discusses the allocation of expenses to individual participants rather than the plan as a whole. Some of the expenses that may be charged to a participant individually rather than the plan as a whole are the following:

- The expenses associated with processing a qualified domestic relations order.
- The expenses associated with processing a hardship withdrawal.
- The expenses associated with calculating benefits payable under different plan distribution options.
- The expenses associated with processing a distribution.
- Plan administration expenses associated with the accounts of terminated participants.

In the final analysis, in deciding how to allocate the expenses that are properly chargeable to a plan, the plan fiduciaries are obligated to follow the Exclusive Benefit Rule and the Prudent Person Rule. FAB 2003-3 provides helpful guidance with respect to the performance of these obligations in particular situations.

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44 Field Assistance Bulletin 2003-3 (December 16, 2003) is available on the Department of Labor's website (*www.dol.gov/ebsa*).

E. Negative Elections

Prompted in part by a ruling from the Internal Revenue Service,[45] some employers have added "negative election" (also known as "automatic enrollment") features to their 401(k) plans. With a negative election program, a prospective plan participant is notified that a certain percentage of his compensation (e.g., 3%) will be withheld and will be contributed to a 401(k) plan on his behalf unless he elects otherwise. While these arrangements are acceptable from an Internal Revenue Code perspective, they do place some added burdens on the plan fiduciaries.[46]

With a negative election program, the participants who participate automatically likely will fail to issue any investment directions. As a result, plan fiduciaries will be responsible for the investment of the contributions made by these participants.[47] If the fiduciaries invest the contributions in an investment option that declines in value, the inadvertent participant may well be unhappy and assert a claim.

In order for a negative election program to pass muster under Revenue Ruling 98-30, plan participants must have an effective opportunity to elect to receive the contributions in cash, which necessarily means that the participants must receive an advance communication from the employer or some plan fiduciary. Of course, these communications must be accurate in order to satisfy the fiduciary's duty to avoid misinforming a plan participant.[48]

F. Conversions

A number of issues arise when an employer or another plan fiduciary decides to convert from one bundled product or one set of investment alternatives to another.

1. General Fiduciary Standards

Of course, in selecting the new bundled plan or investment package, the responsible plan fiduciary must analyze the underlying investment alternatives and comply with the general fiduciary standards described above, including most importantly, the Prudent Person Rule. If the conversion also involves a switch in plan administrative service providers, this selection, too,

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45 Rev. Rul. 98-30, 1998-25 I.R.B. 8.

46 A negative election program necessarily involves withholding the amount of the default contribution to the 401(k) plan from the participant's pay. A number of states prohibit withholding amounts from an employee's pay in the absence of a written payroll deduction authorization. Whether these state statutes are preempted by ERISA section 514 is unclear.

47 Another alternative is to designate a default investment option. As described below in Section II H 6 (Complying with the 404(c) Regulations -- Default Investments), whether default options are effective is questionable.

48 The fiduciaries also may have some duty to assure that the period of time during which the participant may elect to receive cash is adequate under the circumstances. On the other hand, a relatively good argument can be made that the establishment of the election procedure is a settlor function that is not subject to the fiduciary standards.

must pass muster under the Prudent Person Rule, the Exclusive Benefit Rule and the other fiduciary standards.[49]

2. Blackout Periods

The plan fiduciary also should consider the impact of any "blackout periods" on plan participants. Typically, whenever a plan converts from one set of investment funds to another, participants are precluded from taking any action (such as taking a loan from the plan or transferring amounts from one fund to another) for a period of time that is generally referred to as the "blackout period." A blackout period is inevitable and deciding to convert to a program that includes a reasonable blackout period certainly cannot be a breach of the fiduciary standards. The plan fiduciaries nonetheless should consider the impact of the blackout period on the plan participants and make every effort to minimize its length. Perhaps most importantly, the plan fiduciaries should make sure that the rules that will apply during the blackout period are carefully and accurately communicated to the plan participants well in advance of the commencement of the blackout period in order to enable the participants to take action before the period begins.

Section 101(i) of ERISA now requires plan fiduciaries to provide participants with advance notice of any blackout periods. Generally, the notice must be provided 30-days in advance of the blackout period.[50]

Plan fiduciaries also need to be careful to avoid the stubborn implementation of the blackout period. In In Re Enron Corp. Securities, Derivative & "ERISA" Litigation, [51] the plaintiff's criticized the directed trustee for continuing the blackout period in the face of rapidly declining stock values. The plaintiff's claim survived the trustee's motion to dismiss.

3. Mapping

If participants are allowed to direct the investment of their accounts between and among various investment funds, the conversion from the old investment alternatives to the new can be a challenge. One alternative is to collect new investment instructions from all of the participants. This approach, however, can be problematic. Because of inertia alone, many participants may

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[49] In one relatively recent case, the plaintiffs unsuccessfully attempted to claim that they were entitled to the continuation of a particular set of investment funds. Franklin v. First Union Corporation, 84 F. Supp. 2d 720 (E.D. Va.) (2000). The district court concluded that "plaintiffs do not have a vested right to their past investment choices under the Signet Plan that could not be overridden by a valid plan amendment." Id. at 732. Nevertheless, the district court also concluded that those participants who were not informed of the changes to the fund line-up might have a claim against plan fiduciaries for breach of their duty to provide accurate information concerning the investment choices. In the words of the district court, "the defendants had a duty to inform the plaintiffs of the changes in the investment funds in such a manner as to provide the plaintiffs the opportunity to make decisions regarding their options, as required by the regulations addressing § 404(c)." Id. at 736.

[50] The Department of Labor has issued regulations implementing the requirements of Section 101(i). 29 C.F.R. § 2520.101-3 (2002).

[51] *In re* Enron Corp. Securities, Derivative & "ERISA" Litigation, 284 F. Supp. 2d 511 (S.D. Tx. 2003).

fail to return the new investment instructions and the end result may be an unacceptable extension of the “blackout period.”

An alternative approach that is favored by many, if not most, employers and service providers is a technique called “mapping.” With “mapping,” each of the displaced investment options is compared to the new options. When the conversion takes place, amounts are then automatically transferred or “mapped” from the displaced option to the most comparable new option.

Although mapping may be the most administratively acceptable approach, it may deprive plan fiduciaries of any protection under section 404(c) following the completion of the conversion. Based on the regulations issued by the Department of Labor under ERISA section 404(c), many advisors believe that 404(c) relief is only available if the participant has exercised actual control over the investment of his or her account. With mapping, the participant never actually selects the new fund. Rather, the participant selected the displaced fund from which the participant’s account was transferred.

If the mapping concept is carefully explained to participants in ample time for them to make investment fund changes before the blackout period begins, it may be possible to argue that the mapping process results in a “silent direction” by the participant to transfer his account to the mapped successor funds.[52] Whether this “silent direction” argument will be successful is unclear.

G. Voting and Tender Decisions

The voting of any employer securities held by a 401(k) plan, and decisions concerning the tender of securities, also can prove troublesome.

If plan fiduciaries are responsible for voting and tendering employer securities, they must observe all of the fiduciary standards described above. Plan fiduciaries who also serve as officers or directors of the plan sponsor must be particularly mindful of the Prudent Person and Exclusive Benefit Rules as well as the conflict of interest prohibitions of ERISA section 406(b).

If the voting and tender decisions are passed through to the plan participants, the fiduciaries should carefully consider the positions taken by the Department of Labor in a series of advisory opinions. The plan fiduciaries also should consider the special employer security provisions described in Section II H 5 (Complying with the 404(c) Regulations — Employer Securities).

The Department of Labor initially took the position that plan fiduciaries may not automatically follow the directions of participants with regard to the voting or tender of shares allocated to the participant’s account. In an April 30, 1984 letter regarding the Profit Sharing Retirement Income Plan for the Employees of Carter Hawley Hale Stores, Inc., the Department advised the trustee of the plan that it could accept the participants’ directions only if the trustee

[52] See the discussion in Section II H 6 (Complying with the 404(c) Regulations -- Default Investments).

concluded that the participants had exercised independent discretion, had received complete and accurate information and had not been subject to coercion by the employer.[53]

In 1995, the Department changed its stance a bit. In a letter to Ian D. Lanoff, the Department rephrased its position with respect to a fiduciary's acceptance of participant directions.[54] According to the Lanoff letter, a fiduciary must follow a participant's directions unless the fiduciary is able to "articulate well-founded reasons why doing so would give rise to a violation of titles I or IV . . . ."[55]

H. Complying with the 404(c) Regulations

1. General

Most employers that adopt 401(k) plans allow the plan participants some say in the investment of their accounts by implementing a "Participant Directed Investment Program" pursuant to which participants are allowed to invest their accounts in an array of investment funds.

ERISA includes an eminently logical provision that serves as the legal underpinning for Participant Directed Investment Programs. This provision, which is found in section 404(c) of ERISA, provides as follows:

> (c) In the case of a pension plan which provides for individual accounts and permits a participant or beneficiary to exercise control over assets in his account, if a participant or beneficiary exercises control over the assets in his account (as determined under regulations of the Secretary) --
>
> > (1) such participant or beneficiary shall not be deemed to be a fiduciary by reason of such exercise, and
> >
> > (2) no person who is otherwise a fiduciary shall be liable under this part for any loss, or by reason of any breach, which results from such participant's or beneficiary's exercise of control.

Section 404(c) certainly seems to say that if a participant in a plan controls the investment of his or her account the plan fiduciaries are not responsible if the investment turns sour. Section 404(c) also says, though, that the Department of Labor has the ability to issue regulations defining the circumstances under which a participant will be deemed to have exercised control over the investment of his account. The rather exacting standards prescribed by these regulations have potentially limited the utility of section 404(c).

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53 Letter from Robert Monks, Administrator Office of Pension and Welfare Benefits Administration, to John Welch, Latham & Watkins, re Profit Sharing Retirement Income Plan for the Employees of Carter Hawley Hale Stores, Inc. (April 30, 1984), reprinted in 11 Pens. & Ben. Rep. (BNA) 633 (May 7, 1984). See also Letter from PWBA to unnamed trustee regarding unnamed plan, reprinted in 16 Pens. & Ben. Rep. (BNA) 390 (March 6, 1989).

54 Letter from Department of Labor to Ian D. Lanoff (Sept. 28, 1995), reprinted in 22 Pens. & Ben. Rep. (BNA) 2249.

55 Id. at 22 Pens. & Ben. Rep. (BNA) at 2250-51.

Under the regulations, a fiduciary is relieved of responsibility and liability for a participant's investment decision only if the participant has exercised meaningful, independent control over the investment of his account. The regulations go on to provide that for this standard to be met the participant must have the opportunity to:

- Choose from a broad range of investment alternatives and diversify investments within and among investment alternatives;
- Give investment instruction with a frequency which is appropriate in light of the market volatility of the investment alternatives; and
- Obtain sufficient information to make informed investment decisions.[56]

As will be explained below, these seemingly reasonable objectives may be quite difficult to satisfy in practice.

2. <u>Broad Range of Investment Alternatives</u>

To qualify for the relief offered by section 404(c), a 401(k) plan must afford participants the opportunity to invest in at least three different investment alternatives.

The investment alternatives must be sufficient to provide each participant the opportunity to diversify the investment of his or her individual accounts so as to minimize the risk of large losses, taking into account the nature of the plan, investments offered under the plan, and the portion of the participant's or beneficiary's accounts over which he or she is permitted to exercise control.[57] The goal is to afford each participant a reasonable opportunity to materially affect the potential return and the degree of risk. Frequently, the opportunity to invest in look-through investment vehicles (i.e., mutual funds or similar products) is the only prudent means to assure an opportunity to achieve appropriate diversification.[58] In these circumstances, at least three look-through investments must be offered as investment alternatives.

At least three of the investment alternatives (the "core investment alternatives") offered under the plan must meet all of the following requirements:

- Each core investment alternative must be diversified.
- Each core investment alternative must have materially different risk or return characteristics.
- When aggregated, the core investment alternatives must enable the participant or beneficiary by choosing them to achieve a portfolio with aggregate risk and return characteristics at any point within the range normally appropriate for the participant or beneficiary.

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56 29 C.F.R. § 2550.404c-1(b)(i) (1992).

57 29 C.F.R. § 2550.404c-1(b)(3)(i) (1992).

58 29 C.F.R. § 2550.404c-1(b)(3)(i)(C)(1992).

- Each core investment alternative, when combined with investments in the other alternatives, must tend to minimize through diversification the overall risk of the participant's investments.[59]

In practice, these requirements have prompted most advisors to conclude that a Participant Directed Investment Program must offer, at a minimum, a stock fund, a bond fund and a money market (or similar) fund.

3. Frequency of Investment Instructions (the "Volatility Rule")

Plans may impose reasonable restrictions on the frequency with which participants may give investment instructions, as long as the restrictions are uniform and nondiscriminatory.

The "volatility rule" included in the regulations requires that participants must have the opportunity to give investment instructions with respect to each investment alternative with a frequency that is appropriate in light of the market volatility to which the investment alternative may reasonably be expected to be subject. At a minimum, participants must be given the opportunity to give investment instructions no less frequently than once within any three-month period. For some alternatives, though, the volatility rule requires that more frequent switching be available.[60]

Participants also must be able to readily move from more volatile investment alternatives to a less volatile investment alternative. The regulations afford some flexibility by offering alternative means for handling transfers from volatile investments.

Participants must be given the opportunity to obtain written confirmation of their instructions.[61]

4. Information Requirements

Under the regulations, a participant is considered to exercise control over the assets in his account only to the extent that the participant has an opportunity to obtain sufficient information to make informed investment decisions.[62] Complying with these information requirements proves to be the downfall of many plans.

Certain information concerning the plan and the available investment alternatives must be furnished to all participants and certain other information must be furnished only when requested by a participant.

Information which is required to be furnished automatically to all participants includes:[63]

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59 29 C.F.R. § 2550.404c-1(b)(3)(i)(B) (1992).
60 29 C.F.R. § 2550.404c-1(b)(2)(i)(C) (1992).
61 29 C.F.R. § 2550.404c-1(b)(2)(i)(A) (1992).
62 29 C.F.R. § 2550.404c-1(b)(2)(i)(B) (1992).
63 29 C.F.R. § 2550.404c-1(b)(2)(i)(B)(1) (1992).

- An explanation that the plan is intended to constitute an ERISA section 404(c) plan and that plan fiduciaries may be relieved of liability for losses which are the result of participants' investment instructions.

- A description of the investment alternatives available under the plan, including a general description of the investment objectives and the risk and return characteristics of each alternative.

- Identification of any designated investment managers.

- An explanation of how to give investment instructions, any limits or restrictions on giving instructions and any restrictions on the exercise of voting, tender or similar rights.

- A description of any transaction fees or expenses which are charged to the participant's account.

- Immediately following an investment in an investment alternative subject to the Securities Act of 1933 (such as a mutual fund or other publicly traded investment), a copy of the most recent prospectus, unless the prospectus was furnished immediately before the participant's investment. In some cases, a "profile" is an adequate substitute for the prospectus.[64]

- Subsequent to an investment, materials provided to the plan relating to the exercise of voting, tender or similar rights, to the extent such rights are passed through to participants.

- A description of the information available on request and the name, address and phone number of the plan fiduciary responsible for providing that information.

As noted above, certain information must be provided only on request. Information which is required to be provided on request includes:[65]

- A description of the annual operating expenses borne by investment alternatives, such as investment management fees.

- Copies of any prospectuses, financial statements and reports and other information furnished to the plan relating to an investment alternative.

- A listing of assets comprising the portfolio of an investment alternative which holds plan assets, the value of such assets and, in the case of such assets which are fixed rate investment contracts issued by a bank, savings and loan association or insurance company, the name of the issuer of the contract, the term of the contract and the rate of return on the contract.

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64 DOL Advisory Opinion 2003-11A (September 8, 2003), which is available on the Department of Labor's website (*www.dol.gov/*ebsa).

65 29 C.F.R. § 404c-1(b)(2)(i)(B)(2) (1992).

- Information concerning the value of shares or units in investment alternatives available to participants, as well as information concerning the past and current investment performance of the alternative.

- Information concerning the value of shares or units in investment alternatives held in the account of the participant.

5. **Employer Securities**

In the case of a plan that offers an investment alternative that is designed to permit a participant to directly or indirectly invest in an employer security, section 404(c) relief is conditioned on the following requirements in addition to those set forth above:

- The employer securities must, among other things, constitute "qualifying employer securities" (as defined in ERISA section 407(d)(5)), be publicly traded on a national exchange or other generally recognized market and be traded with sufficient frequency and in sufficient volume to assure that directions to buy and sell may be acted upon promptly.[66]

- The plan must establish procedures intended to ensure the confidentiality of information relating to participant transactions involving employer securities, including the exercise of voting, tender and similar rights. These procedures must be reduced to writing and distributed to all participants and beneficiaries. Additionally, the plan must designate a plan fiduciary who is responsible for ensuring the adequacy of the procedures and for monitoring compliance with the procedures. The participants and beneficiaries must be given the name of the fiduciary so designated. Finally, the plan must appoint an independent fiduciary to carry out any activities that the designated plan fiduciary determines involve a potential for undue employer influence on participants with respect to their rights as shareholders.[67]

- Voting, tender and similar rights relating to employer securities must be passed through to the participants, as must information provided to shareholders generally.[68]

The fiduciaries of a plan that otherwise meets the requirements of section 404(c) will not lose the protection of section 404(c) merely because an employer security investment alternative fails to meet the conditions for section 404(c) relief. However, plan fiduciaries will not be relieved of liability for employer security investments, even if the investments are participant directed, unless the requirements for section 404(c) relief are satisfied with respect to the investments.

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66 29 C.F.R. § 2550.404c-1(d)(2)(ii)(E)(4) (1992).
67 Id.
68 Id.

6. Default Investments

A frequently encountered problem is how to deal with a participant who has not given any investment instructions. A common approach is to specifically state in the plan document that if a participant does not provide investment instructions, the participant's accounts will be invested in the most risk-free investment alternative available, such as a money market fund. Under the regulations, plan fiduciaries are not relieved of any liability for investing a participant's account unless the participant actually exercises control over the investment of the account.[69] As a result, many advisors have assumed that these "default" investment provisions are ineffective and have cautioned plan fiduciaries to prudently invest the accounts of any participants who have not given specific instructions. In light of the Eleventh Circuit's decision in Herman v. NationsBank Trust Company,[70] this position may be unnecessarily conservative.

The NationsBank case arose out of competing tender offers for the stock of Polaroid. One of the tender offers was made by Shamrock Acquisitions and the other was a self-tender by Polaroid. Both of the tender offers were described by NationsBank in a letter to plan participants, who were asked to instruct NationsBank regarding the tender of the shares allocated to them. The letter also informed the plan participants that a failure to respond would be treated as a "silent direction" not to tender the shares allocated to them.

In the Eleventh Circuit, the Department of Labor argued that NationsBank could not rely on the plan's silent direction provision to support its failure to tender the non-voted shares. Although the court noted the deference that should be given to the Department, it nevertheless rejected the Department's position. According to the Eleventh Circuit, as long as participants are clearly advised that the failure to issue any directions will be treated as a silent direction to not tender the stock, the trustee may honor the silent direction.

Based on NationsBank, if a plan provides the participant with adequate advance notice, a colorable argument can be made that a participant's failure to issue explicit instructions is a "silent direction" to invest the participant's account in the plan's default investment option. Whether this argument will be successful is unclear.

7. Disregarding Directions

As a general rule, in order for the regulations to be satisfied, the plan must provide that a participant's instructions will be honored by the plan fiduciaries. Nevertheless, the fiduciaries are allowed to disregard the participant's instructions in certain, limited circumstances.[71]

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69 29 C.F.R. § 2550.404c-1(d)(2)(i) (1992). Additional support for this conclusion can be found in paragraphs (a)(1) and (c)(2) of the same regulations and in the Preamble to the final regulations.

70 126 F.3d 1354 (11th Cir. 1997).

71 29 C.F.R. § 2550.404c-1(b)(2)(ii)(B) and (d)(2)(ii) (1992).

I. Open Option Plans

1. The "Open Option" Concept

As a general rule, an "Open Option" feature allows plan participants to select nearly any available investment, subject to minimal restrictions.[72] An Open Option feature usually is offered in tandem with an assortment of investment funds, but technically there is no requirement that specific investment funds be designated.

Small professional organizations have offered programs with Open Option features for years. Administrative problems and a general reluctance to allow participants who are, at best, novice investors the opportunity to have near complete control over the investment of their retirement funds has hindered the widespread use of Open Option programs by other types of employers. Advances in technology and plan administration systems are quickly resolving the administrative problems, though, and many small and large employers undoubtedly will consider the addition of an Open Option feature to their 401(k) plans in the future.

A literal reading of section 404(c) of ERISA certainly seems to suggest that plan fiduciaries should not have any liability for investments made by plan participants who utilize a plan's Open Option feature. The regulations, which are described in detail above, however, do pose a few potential hurdles for Open Option programs.

2. Opportunity to Exercise Control

As mentioned above, the relief offered by section 404(c) is available only if participants have the opportunity to exercise control over the investment of their accounts. According to the regulations, a participant does not have the ability to exercise control over the investment of his or her account unless the participant "has a reasonable opportunity to give investment instructions . . . to an identified plan fiduciary . . . ."[73]

Participants utilizing a plan's Open Option feature frequently work directly with the broker of their choice and plan fiduciaries rarely, if ever, know of the participant's decisions as they are made. This common, prevailing practice does not comply with the regulations and is ill-advised. Instead, a plan that includes an Open Option feature should implement procedures to assure that all investment instructions are channeled through a plan fiduciary.

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[72] An Open Option plan may limit a participant's selections to publicly traded securities and mutual funds. If an Open Option program limits the choices of participants too severely (e.g., the mutual funds offered by a particular fund family), the plan may actually be designating investment alternatives. In this situation, a plan fiduciary will be responsible for assuring the prudence of all of the available alternatives. In addition, the relief offered by section 404(c) is available only if a plan participant actually exercises control over his or her account. 29 C.F.R. § 2550.404c-1(d)(2)(i) (1992). If no designated investment funds are offered by a plan, some participants will decline to give any investment instructions, eliminating any 404(c) relief for the plan fiduciaries.

[73] 29 C.F.R. § 2550.404c-1(b)(2)(i)(A) (1992). The Preamble to the regulation makes it very clear that this requirement applies to all plans that seek the protection of section 404(c), "including those which do not designate investment alternatives, i.e., those plans which permit investments in any asset which is administratively feasible for the plan to hold and do not specifically describe any investment alternative." 57 Fed. Reg. at 46,908.

One possibility is to require that all investment directions be given to a plan fiduciary, who then will instruct a broker to execute the trades. While this approach clearly satisfies the requirements of the regulations, it is impractical and imposes a substantial paperwork burden on the plan fiduciary.

Another possibility is to select one or more brokers to serve as the plan's "designated brokers." If the designated brokers are charged with the responsibility of assuring that the instructions are proper, the brokers will arguably be plan fiduciaries and the requirements of the regulations will be met. If the brokers have no discretion, their fiduciary status is suspect. In this situation, the brokers, at most, are acting as the agents of a designated plan fiduciary. While this approach should satisfy the regulations, there is no published guidance on point.

3. Information Requirements

Under the regulations, a participant is considered to exercise control over the assets in his or her account only to the extent that the participant has an opportunity to obtain sufficient information to make informed investment decisions.[74]

A plan with an Open Option feature should be able to easily satisfy most of the applicable information requirements by including appropriate language in the summary plan description. One requirement that is easily and often overlooked, though, is the prospectus requirement, which is described as follows in the regulations:

> [I]n the case of an investment alternative which is subject to the Securities Act of 1933, and in which the participant or beneficiary has no assets invested, immediately following the participant's or beneficiary's initial investment, a copy of the most recent prospectus provided to the plan [must be provided to the participant]. This condition will be deemed satisfied if the participant or beneficiary is provided with a copy of such most recent prospectus immediately prior to the participant's or beneficiary's initial investment in such alternative . . .[75]

In the context of a plan that includes an Open Option feature, any investment a participant may acquire through the plan is an "investment alternative" and the prospectus requirement must be satisfied.[76] How can the plan fiduciaries possibly assure that this requirement is met, since in most cases they will not know when trades are executed or what investments are acquired?

Perhaps the most effective precautionary measures that plan fiduciaries can take to minimize the impact of a violation of the prospectus requirement is to carefully select the

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[74] 29 C.F.R. § 2550.404c-1(b)(2)(i)(B) (1992).

[75] 29 C.F.R. § 2550.404c-1(b)(2)(i)(B)(1)(viii) (1992).

[76] Every plan that seeks section 404(c) relief must describe the investment alternatives available under the plan. The Preamble to the final regulations states that this requirement is satisfied in the context of an Open Option feature by a general statement describing the available investments. In the Preamble, the Department does suggest that participants be encouraged to review pertinent information before investing.

designated brokers and obtain written commitments from each designated broker that it will comply with the prospectus requirement. But what happens if the plan fiduciaries prudently select a designated broker and the designated broker inadvertently fails to send a prospectus in a timely fashion?

If the designated broker is a plan fiduciary and the plan is properly drafted, the fiduciary allocation provisions of section 403 of ERISA and the co-fiduciary liability provisions of section 405 of ERISA may adequately protect those plan fiduciaries who are not charged with any investment responsibility by the plan documents.[77] The plan's "investment fiduciaries" (who for this purpose are the fiduciaries responsible for investing the accounts of participants who fail or refuse to issue investment instructions and who may or may not include the designated broker) may not be able to avoid liability.[78]

If the designated broker is not a fiduciary, the investment fiduciaries may have some liability if the prospectus requirement (or any other informational requirement) is not observed. Under the regulations, the relief provided by section 404(c) is not available unless all of the requirements of the regulations are satisfied. The Preamble also states that while a plan fiduciary may delegate the responsibility to provide the required information to others, the fiduciary remains responsible for assuring that the information requirements are in fact satisfied.[79] As a result, if a broker agrees to provide the prospectus, as required by the regulations, and fails to do so, the 404(c) relief available to the investment fiduciaries may be jeopardized.

4. <u>Frequency of Investment Instructions (the "Volatility Rule")</u>

The "volatility rule" included in the regulations and described above provides that participants must have the opportunity to give investment instructions with respect to each investment alternative with a frequency that is appropriate in light of the market volatility to which the investment alternative may reasonably be expected to be subject. In order to satisfy the volatility rule, a plan that includes an Open Option feature should allow participants to give investment instructions on a daily basis. Any other arrangement will fail to satisfy the requirements of the regulations.

5. <u>General Observations</u>

Compliance with the regulations is a challenge for any plan that allows participants to direct the investment of their accounts. Although the addition of an Open Option feature does

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77 The Employee Benefits Committee of the Tax Section of the American Bar Association formed a task force to consider a wide variety of issues arising in connection with Open Option plans. The task force considered this and other issues and submitted a request for clarification to the Department of Labor. The members of the task force included Jane Armstrong, Hilton S. Bell, William K. Bortz, John W. ("Jay") Boyd, Jeffrey N. Clayton, Richard A. Gilbert, Steven Glaser, Thomas R. Hoecker, R. Scott Kilgore, Fred C. Kneip, Kenneth Kneubuhler, Bernard F. O'Hare, David W. Rowan and Alan Tawshunsky. No formal response has been received, but various members of the task force did meet with the Department informally.

78 In these circumstances, the potential fiduciary liability presumably extends only to the decision to purchase the investment for which the prospectus was not provided.

79 57 Fed. Reg. at 46,906.

not significantly increase the compliance burden, the risks of noncompliance may become more significant.

The sponsor of the more typical or traditional Participant Directed Investment Program can limit the risk of noncompliance with the regulations somewhat by carefully selecting the investment options offered to its employees. If the investment options are selected with care, the risk of substantial, sustained losses is diminished significantly and this diminished risk in turn lessens the likelihood of participant suits and the importance of compliance with the regulations.

With an Open Option program, every participant is given the opportunity to invest in virtually anything. This added flexibility increases the chance of poor decisions, significant losses and the likelihood that plan fiduciaries will be the subject of a suit by a disgruntled participant. In order to provide the plan fiduciaries with the necessary protection, strict compliance with the regulations is well worth the effort.

J. The Unisys Case

1. General

In re: Unisys Savings Plan Litigation[80] (or "Unisys I") was the first reported appellate decision squarely dealing with the application of the fiduciary standards of ERISA to a Participant Directed Investment Program. The case arose out of the purchase of guaranteed investment contracts or "GICs" from Executive Life Insurance Company for the fixed income funds offered under savings plans sponsored by Unisys. When Executive Life failed, several different groups of participants in these plans brought 12 separate actions against Unisys and other plan fiduciaries. The separate actions were consolidated for purposes of pre-trial matters.

The plaintiffs claimed that when Unisys and the other plan fiduciaries selected the Executive Life GICs they violated the prudence and diversification requirements of section 404(a) of ERISA. They also claimed that Unisys violated its fiduciary duty to provide accurate information to plan participants.

Unisys convinced the trial court that it had satisfied its prudence, diversification and disclosure obligations and the trial court ruled in favor of Unisys by granting its motion for summary judgment.[81] The Third Circuit reversed and in the process provided its views on the application of the fiduciary standards of ERISA to participant directed account plans.[82]

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80 74 F.3d 420 (3d Cir. 1996).

81 1995 U.S. Dist. LEXIS 843 (E.D. Pa. 1995).

82 On remand, the district court, in essence, concluded that Unisys had satisfied its fiduciary duties. 1997 U.S. Dist. Lexis 19198, 1997 WL 732473 (E.D. Pa. 1997). The district court's decision was affirmed on appeal. 173 F.3d 145, 1999 U.S. App. Lexis 4863, 1999 WL 164435 (3rd Cir. 1999). The discussion of Unisys I is nonetheless instructive.

2. **Prudence**

Citing a number of cases decided in other contexts, the court observed that prudence is measured by "an objective standard, focusing on a fiduciary's conduct in arriving at an investment decision, not on its results, and asking whether a fiduciary employed the appropriate methods to investigate and determine the merits of a particular investment."[83] The evidence before the court in Unisys I suggested that rather than conducting an independent investigation, the fiduciaries may have relied solely on the perceived views of a consultant. The Third Circuit observed that blind reliance on a consultant's opinion is inadequate:

> While we would encourage fiduciaries to retain the services of consultants when they need outside assistance to make prudent investments and do not expect fiduciaries to duplicate their advisers' investigative efforts, we believe that ERISA's duty to investigate requires fiduciaries to review the data a consultant gathers, to assess its significance and to supplement it where necessary. In our view, a reasonable fact finder could infer from this evidence that Unisys failed to analyze the bases underlying Johnson & Higgins' opinion of Executive Life's financial condition and to determine for itself whether credible data supported Johnson & Higgins' recommendation that Unisys consider investing plan assets with the insurer. A reasonable fact finder could also conclude that Unisys passively accepted its consultant's positive appraisal of Executive Life without conducting the independent investigation that ERISA requires.[84]

3. **Diversification**

On the subject of diversification, the Third Circuit concluded that each investment fund offered to participants must be diversified in and of itself. Unisys argued that the diversification requirements were met as long as the plan as a whole was adequately diversified. Relying on the legislative history of ERISA, the Third Circuit rejected this argument. Since the risk of loss on the Executive Life contracts was not distributed throughout the plan, the Third Circuit concluded that it would be inappropriate to measure compliance with the diversification requirements by looking to the plan as a whole.

Based on the record before it, the Third Circuit could not determine whether the diversification requirements had been satisfied and it remanded the case for trial on this issue.[85]

4. **Duty to Disclose**

The Third Circuit then turned its attention to the plaintiffs' claims that Unisys had breached its disclosure obligations by distributing misleading information concerning the risks associated with investments in the GIC funds.

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[83] 74 F.3d at 434.

[84] 74 F.3d at 435-36. On remand, the district court found that Unisys had acted prudently and the Third Circuit affirmed. 173 F.3d at 154, 1999 U.S. App. Lexis at 20, 1999 WL at 6.

[85] On remand, the district court found that the Executive Life GICs made up approximately 20% of the fixed income fund and that this concentration did not violate the diversification requirements. The Third Circuit affirmed. 173 F.3d at 157, 1999 U.S. App. Lexis at 36, 1999 WL at 11.

The Third Circuit repeated its earlier findings that "a fiduciary may not materially mislead those to whom section 1104(a)'s [section 404(a) of ERISA] duties of loyalty and prudence are owed."[86] Quoting from one of its earlier decisions, the court went on to hold as follows:

> [The] duty to inform is a constant thread in the relationship between beneficiary and trustee; it entails not only a negative duty not to misinform, but also an affirmative duty to inform when the trustee knows that silence might be harmful.[87]

Applying these standards to the situation in Unisys I, the court concluded that a number of communications concerning the risks of investing in the GIC funds could have been misleading. For example, the early versions of plan communications stated that the GIC funds were designed to preserve capital and accumulate interest and that the GICs were "guaranteed" by the issuing insurance companies. Only after Executive Life began experiencing difficulties were revised prospectuses distributed that indicated that there was some risk of loss with these investments. The Third Circuit concluded that whether these communications were misleading and, if they were, whether the misrepresentations were material were issues that needed to be determined at trial.[88]

5. The Section 404(c) Defense

The court then addressed Unisys' contention that section 404(c) afforded it relief from any liability. In essence, Unisys claimed that even if it violated the prudence and diversification requirements in selecting Executive Life GICs for the funds, the losses suffered by the plaintiffs stemmed from their exercise of "control" over the investment of their accounts and, accordingly, Unisys was relieved of liability by reason of section 404(c).[89]

Accepting Unisys' basic premise, the court held that a fiduciary that breached its fiduciary duty could nonetheless escape liability if it could establish that the participant's exercise of control was the cause of the loss--

> [T]he statute's unqualified instruction that a fiduciary is excused from liability for "any loss" which "results from a participant's or a beneficiary's exercise of control" clearly indicates that a fiduciary may call upon section 1104(c)'s

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86 74 F.3d at 440.

87 74 F.3d at 441, (quoting Bixler v. Central Pennsylvania Teamsters Health and Welfare Fund, 12 F.3d 1292 (3d Cir. 1994)).

88 On remand, the district court found that the alleged disclosure problems were immaterial. The Third Circuit adopted a different approach, finding that the plaintiffs failed to prove that the alleged disclosure violation resulted in any damage to the plaintiffs. "The district court found that Meinhardt and the other class plaintiffs (1) already had actual knowledge of much of the information it is claimed that Unisys failed to disclose, (2) did not read the Plan documents, and (3) testified that they would not have withdrawn or transferred their money from the Fund even if they had known about Executive Life's problems." 173 F.3d at 159, 1999 U.S. App. Lexis at 38, 1999 WL at 12.

89 In footnote 27 of the Preamble to its regulations under section 404(c), the DOL takes the position that a participant's exercise of control is not the cause for a loss attributable to the imprudent construction or selection of an investment alternative. The regulations were not applicable to the Unisys case.

protection where a causal nexus between a participant's or a beneficiary's exercise of control and the claimed loss is demonstrated. This requisite causal connection is, in our view, established with proof that a participant's or a beneficiary's control was a cause-in-fact, as well as a substantial contributing factor in bringing about the loss incurred. See Willett v. Blue Cross and Blue Shield of Alabama, 953 F.2d 1335, 1343 (11th Cir. 1992) ("Section [1109] of ERISA establishes that an action exists to recover losses that 'resulted' from the breach of fiduciary duty; thus the statute does require that the breach of the fiduciary duty be the proximate cause of the losses claimed . . . ."); Brandt v. Grounds, 687 F.2d 895, 898 (7th Cir. 1982) (Under 29 U.S.C. § 1109, where "a fiduciary . . . who . . . breaches . . . shall be personally liable to make good . . . any losses resulting from each such breach," a casual connection is required between the breach of the fiduciary duty and the losses alleged). (Footnotes omitted.)[90]

Based on the record before it, the court could not conclude that Unisys had established its ability to rely on section 404(c) and it remanded the case for trial.[91]

K. Jenkins v. Yager

1. General

In Jenkins v. Yager,[92] the plaintiff participated in a combination profit sharing and 401(k) plan sponsored by her employer, Mid America Motorworks. Under the terms of the plan, the president of Mid America served as the trustee of the profit sharing portion of the plan and had complete investment authority and responsibility with respect to the profit sharing assets. The plan participants directed the investment of the assets held in the 401(k) portion of the plan by instructing the trustee to invest their accounts in any of four mutual funds selected by the trustee.

The four funds selected by the trustee performed poorly and the plaintiff filed a complaint alleging that the trustee breached its fiduciary duties under ERISA. The district court granted the defendant's motion for summary judgment and the plaintiff appealed.

2. Section 404(c) Safe Harbor

Before the Seventh Circuit, the trustee conceded that the plan did not meet the requirements of the section 404(c) regulations and that the trustee was not entitled to the protections offered by section 404(c). The plaintiff then argued that section 403(a) of ERISA

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90 74 F.3d at 445.

91 In Unisys I, the Third Circuit did not find that Unisys had violated any of its duties to the plan participants or that the section 404(c) defense was unavailable. Rather, the court simply concluded that the standards for summary judgment had not been satisfied because genuine issues of material fact needed to be resolved at trial in order to determine if Unisys had breached its duties and whether the prerequisites for section 404(c) relief had been satisfied. In light of the Third Circuit's comments regarding the prudence and disclosure requirements and its recitation or summarization of the factual background of the case, Unisys' chances of success on remand appeared to be slim at best. Nevertheless, after a trial, the district court ruled in favor of Unisys. As noted above, the Third Circuit affirmed the district court's decision.

92 444 F.3d 916 (7th Cir. 2006).

requires the trustee of a covered plan to have "exclusive authority and discretion" to manage the assets of the plan, subject to two exceptions.[93] Since neither of these exceptions applied and the plan did not comply with the requirements of the section 404(c) regulations, the plaintiff claimed that the trustee bore the responsibility for any investment losses suffered by plan participants.

The Seventh Circuit disagreed. Characterizing section 404(c) as a "safe harbor," the Seventh Circuit went on to state that "we see no evidence that these provisions necessarily are the only possible means by which a trustee can escape liability for participant-directed plans."[94]

After discussing the Department of Labor's regulations under section 404(c), the Seventh Circuit held that ERISA "permits a plan trustee to delegate decisions regarding the investment of funds to plan participants even if the plan does not meet the requirements for the section 404(c) safe harbor."[95] According to the Seventh Circuit, if the protection afforded by section 404(c) is not available, "the actions of the plan trustee, when delegating decision-making authority to plan participants, must be evaluated to see if they violate the trustee's fiduciary duty."[96]

3. <u>Analysis of Fiduciary Duty</u>

The Seventh Circuit then discussed the trustee's duty to comply with the Prudent Person Rule, described above. In this portion of its opinion, the court distinguished between the claims advanced with respect to the 401(k) portion of the plan and the profit sharing portion of the plan. In assessing the trustee's prudence in the context of the 401(k) portion of the plan, the court focused on the trustee's actions in monitoring the funds and providing information to plan participants.

With respect to the monitoring of the funds, the Seventh Circuit noted that the trustee had received information on a regular basis from an advisor to the plan and that the trustee reviewed reports received from the advisor each year. On the basis of that information alone, the Seventh Circuit concluded that the trustee had satisfied his duty to monitor the performance of the funds.

The Seventh Circuit also concluded that the trustee had not violated the Prudent Person Rule by retaining the same four mutual funds for the 401(k) portion of the plan from 1991 through the period at issue in the case even though three of the four funds lost money. The trustee testified that his strategy was to pick conservative funds and hold them for the long-term. The Seventh Circuit noted that "[n]othing in the record suggests that it was not reasonable and prudent to select conservative funds with long-term growth potential and to stay with those mutual funds even during years of lower performance."[97]

The court then turned its attention to whether the trustee had violated "his duty in allowing plan participants to direct their investments."[98] The court's analysis with respect to this

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93 Under section 403(a), a trustee may accept directions from a named fiduciary. Similarly, an investment manager may be appointed to manage the assets of the plan.

94 444 F.3d at 923.

95 Id. at 924.

96 Id.

97 Id. at 926.

98 Id.

last issue is interesting. In assessing whether the trustee breached his fiduciary duty by allowing the participants to invest their accounts, the court looked solely to the information that the trustee provided to the participants. The court noted that the trustee arranged annual informational meetings during which a plan advisor distributed materials concerning the performance of the funds. The court also noted that this same information was available to all participants in the company break room. On the basis of that information alone, the court concluded that the trustee had provided the necessary information to allow participants to direct the investment of their accounts and, as a result, had not violated his fiduciary duty to provide adequate information.

The plaintiff claimed that, since the trustee was not entitled to the protections of section 404(c), the trustee had an obligation "to review each participants' [sic] investment directions throughout the year to ensure they were appropriate . . . ."[99] The Seventh Circuit rejected this claim, citing an earlier Seventh Circuit decision for the proposition that fiduciaries are not obligated to review each individual participant's individual circumstances.

4. Conclusions

If Jenkins is correct, it provides a very comfortable fallback position for plan fiduciaries who fail to satisfy all of the technical requirements of the section 404(c) regulations. In fact, one might wonder whether it is necessary to even try to comply with the detailed section 404(c) regulations. Since no other circuits have yet had the opportunity to consider this precise issue, however, plan fiduciaries are ill-advised to ignore the technical requirements of section 404(c) on the basis of this case alone.

L. Responsibilities of "Directed Trustees"

ERISA Section 403(a)(1) permits a trustee to follow the "proper directions" of another fiduciary as long as the directions are "in accordance with the terms of the plan" and are "not contrary to this Act." Section 405(b)(3)(B) also provides that a trustee will not be liable for following directions referred to Section 403(a)(1).

The scope of the responsibilities of a so-called "directed trustee" has been the subject of some debate. Some courts have held that a directed trustee bears no liability for following directions unless the directed trustee has actual knowledge that the directions are contrary to the plan or ERISA.[100] Other courts have taken the position that a directed trustee will be held responsible if the directed trustee "knows or should know" that the direction is improper.[101]

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99 Id.

100 *See* Koch v. Dwyer, 1999 WL 528181, *10 (S.D.N.Y. 1999); Kling v. Fidelity, 270 F. Supp. 2nd 121, 131-132 (D. Mass 2003) (citing Koch). *See also, in re* McKesson HBOC, Inc. ERISA Litigation, 2002 WL 31431588, *12 (N.D. Cal. 2002) (dismissing claim against directed trustee but allowing plaintiff to amend complaint because plaintiff had not alleged sufficient facts to show that directed trustee had knowledge that the directions were imprudent).

101 See FirstTier Bank v. Zeller, 16 F.3d 907, 910-913 (8th Cir. 1994); *In re* Enron Corp. Securities, Derivative & "ERISA" Litigation, 284 F. Supp. 2d 511, 584 (S.D. Tex. 2003); *In re* WorldCom, Inc. ERISA Litigation, 263 F.Supp. 2d 745, 761-63 (S.D.N.Y. 2003); *In re* Sprint Corp. ERISA Litigation, 2004 U.S. Dist. LEXIS (Kan. 2004). The most thorough analysis of directed trustee obligations to date can be found in the district court's decision in Enron.

In Field Assistance Bulletin 2004-3,[102] the Department of Labor expresses its views on the duties of a directed trustee. The Department starts its analysis by noting that a directed trustee is always a "fiduciary," a conclusion that is not shared by all. The Department then notes, however, that Section 403(a)(1) "significantly limits" a directed trustee's responsibilities as a fiduciary.

As noted previously, a directed trustee is subject to the "proper directions" of another named fiduciary. According to the Department, a direction is proper only if it is "made in accordance with the terms of the plan" and "not contrary to [ERISA]." The Department then concludes that "when a directed trustee *knows or should know* that the direction from a named fiduciary is not made in accordance with the terms of the plan or is contrary to ERISA, the directed trustee may not, consistent with its fiduciary responsibilities, follow the direction."

According to the Department, in order to assure that the directions are consistent with the terms of the plan, a directed trustee has a duty to request and review all documents governing the plan. Not surprisingly, if a directed trustee either fails to request documents or fails to review them, and as a result follows an improper direction, the trustee will be held responsible.

In the FAB, the Department also addresses the trustee's responsibility to assure that directions are consistent with ERISA, noting that a directed trustee may not follow a direction if the directed trustee *knows or should know* that the direction would result in a prohibited transaction or violate the Prudent Person Rule.

With respect to prohibited transaction concerns, if the directed trustee receives written representations that the directing fiduciary has implemented procedures in order to avoid prohibited transactions, the Department's view, as expressed in the FAB, is that the directed trustee is justified in relying on representations from the directed fiduciary that those procedures have been followed, unless the directed trustee knows the representation is false.

Similarly, in the FAB, the Department notes that the named fiduciary issuing the directions to the directed trustee has the "primary responsibility for determining the prudence of a particular transaction . . . ." The Department goes on to state as follows:

> Accordingly, as the courts and the Department have long recognized, the scope of a directed trustee's responsibility is significantly limited. A directed trustee does not, in the view of the Department, have an independent obligation to determine the prudence of every transaction. The directed trustee does not have an obligation to duplicate or second-guess the work of the plan fiduciaries that have discretionary authority over the management of plan assets and does not have a direct obligation to determine the prudence of a transaction. (citations omitted.)

The Department then proceeds to discuss a directed trustee's obligation to question transactions involving publicly traded securities. According to the Department, the directed trustee's obligation to question these transactions is very limited:

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[102] Field Assistance Bulletin 2004-3 is available on the Department's website (*www.dol.gov/ebsa*).

If a directed trustee has material non-public information that is necessary for a prudent decision, the directed trustee, prior to following a direction that would be affected by such information, has a duty to inquire about the named fiduciary's knowledge and consideration of the information with respect to the direction. For example, if a directed trustee has non-public information indicating the company's public financial statements contain material misrepresentations that significantly inflate the company's earnings, the trustee could not simply follow a direction to purchase that company's stock at an artificially inflated price. Generally, the possession of non-public information by one part of an organization will not be imputed to the organization as a whole (including personnel providing directed trustee services) where the organization maintains procedures designed to prevent the illegal disclosure of such information under securities, banking or other laws. (footnotes omitted.) If, despite such procedures, the individuals responsible for the directed trustee services have actual knowledge of material non-public information, the directed trustee, prior to following a direction that would be affected by such information, has a duty, as indicated above, to inquire about the named fiduciary's knowledge and consideration of the information with respect to the direction. Similarly, if the directed trustee performs an internal analysis in which it concludes that the company's current financial statements are materially inaccurate, the directed trustee would have an obligation to disclose this analysis to the named fiduciary before making a determination whether to follow a direction to purchase the company's securities. The directed trustee would not have an obligation to disclose reports and analyses that are available to the public."

The FAB also comments on a directed trustee's duty to question the prudence of a direction to purchase publicly traded securities. In the view of the Department, a directed trustee will only rarely have an obligation to question these directions as long as the directions are to purchase securities at the market price. The Department in the FAB also provides the following cautionary note:

"In limited, extraordinary circumstances, where there are clear and compelling public indicators, as evidenced by an 8-K filing with the Securities Exchange Commission (SEC), a bankruptcy filing or similar public indicator, that call into serious question a company's viability as a going concern, (footnote omitted) the directed trustee may have a duty not to follow the named fiduciary's instruction without further inquiry."

The Department also notes that when directions to purchase company stock are given by a corporate employee following a formal charge by state or federal regulators of financial irregularities, the directed trustee "taking such facts into account, may need to decline to follow the direction or may need to conduct an independent assessment of the transaction in order to assure itself that the instruction is consistent with ERISA."

Although the FAB, as noted above, adopts the "knows or should know" standard, the FAB's discussion of a directed trustee's responsibilities should provide some comfort to directed trustees. Relying on the FAB, the district court in In re Worldcomm, Inc. ERISA Litigation granted the motion for summary judgment filed by the directed trustee.[103] The court reached a similar result in Difelice v. US Airways, Inc.[104]

M. The Duty to Inform

In a number of recent cases involving employer securities, the plaintiffs have successfully defended a motion to dismiss their claims that appointing fiduciaries have a duty to inform their appointees of information relevant to their decisions.[105]

This theory was first advanced in the Enron litigation. In Enron, the plaintiff's claimed that Enron, its compensation committee and Kenneth Lay were liable "as co-fiduciaries for their failure to inform the Administrative Committees about Enron's actual financial status . . . ."[106] The court found these claims to be adequate to state a claim under Section 502(a)(3) of ERISA.

The district court reached a similar decision in In re Sprint Corp. ERISA Litigation.[107] Like the plaintiffs in Enron, the plaintiffs in Sprint claimed that Sprint and its directors violated the provisions of ERISA by failing to disclose pertinent information regarding Sprint's financial condition. They went on to claim that these same defendants breached their fiduciary duties by failing to inform the Administrative Committee members regarding the imprudence of purchasing Sprint stock. The district court addressed this claim in the following passage of its opinion:

> Whether the director defendants had a related duty to disclosure information to the committees presents a more novel issue. It seems this allegation, if true, could have determined the level of scrutiny the director defendants should have given to their appointees. In any event, the court finds it unnecessary to precisely define the contours of the duty to monitor at this early phase of the litigation, especially given the regulatory directive that the appropriate monitoring procedure 'may vary in accordance with the nature of the plan and other facts and circumstances relevant to the choice of the procedure.' This issue is one that would more appropriately be resolved on the facts of the case. Suffice it to say that, for purposes of resolving the Sprint defendants' motion at this procedural juncture, the court simply rejects the Sprint defendants' argument that the directors were free to appoint the committee members, and then turn a blind eye to the appointees' performance of their duties (citations omitted).[108]

The Sprint court seems to view the duty to inform as stemming from the duty to monitor. In other words, if a fiduciary has the responsibility for appointing another fiduciary and

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103 354 F.Supp. 2d 423 (S.D. N.Y. 2005).

104 397 F.Supp. 2d 735 (E.D. Va. 2005).

105 *In re* Sprint Corporation ERISA Litigation, 2004 U.S. Dist. LEXIS 9622 *64 (KAN. 2004); *In re* Enron Corporation Securities, Derivative & "ERISA" Litigation, 284 F. Supp. 2d 511, 661-662 (S.D. Tx. 2003).

106 *In re* Enron Corp. Securities, Derivative & "ERISA" Litigation, 284 F. Supp. 2d at 661-662.

107 *In* re Sprint Corp. ERISA Litigation, 2004 U.S. Dist. LEXIS 9622 (D. Kan. 2004).

108 2004 U.S. Dist. LEXIS at *63-64.

monitoring that other fiduciary's performance, the first fiduciary has an obligation to make sure that the second fiduciary considered the relevant issues in performing its duties.

In Field Assistance Bulletin 2004-3, discussed above, the Department of Labor reached a similar result from the opposite direction. In the FAB, the Department dealt with the responsibilities of a directed trustee. According to the Department, if the directed trustee "has material non-public information that is necessary for a prudent decision, the directed trustee, prior to following a direction that would be affected by such information, has a duty to inquire about the named fiduciary's knowledge and consideration of the information with respect to the direction." The Department went on to note that "if . . . the individuals responsible for the directed trustee services have actual knowledge of material non-public information, the directed trustee, prior to following a direction that would be affected by such information, has a duty, as indicated above, to inquire about the named fiduciary's knowledge and consideration of the information with respect to the direction. Similarly, if the directed trustee performs an internal analysis in which it concludes that the company's current financial statements are materially inaccurate, the directed trustee would have an obligation to disclose this analysis to the named fiduciary before making a determination whether to follow a direction to purchase the company's securities."

N. <u>Missing Participants</u>

In Field Assistance Bulletin 2004-2,[109] the Department of Labor provided much needed guidance concerning the steps a fiduciary should take to locate missing participants, and make distributions to missing participants, in the context of a terminating defined contribution plan.

As expected, the FAB emphasizes that fiduciaries must proactively attempt to locate missing participants and requires the use of various search methods listed in the guidance. If, following the use of appropriate measures, the fiduciary is unable to locate the participant and the plan is terminated, the fiduciary may "distribute" the participant's account. The distribution may be accomplished by rolling the amount distributable to the participant into an individual retirement account. If the fiduciary is unable to find an IRA provider who will accept the rollover, the fiduciary may distribute the account into an interest bearing savings account established in the name of the participant or transfer the account pursuant to the applicable state's unclaimed property laws. Based on conversations with Department of Labor representatives, the use of a state's unclaimed property regime is only appropriate in the context of a terminated plan.

O. <u>Automatic Rollovers</u>

The Economic Growth and Tax Relief Reconciliation Act of 2001 introduced the "automatic rollover" concept. Essentially, these automatic rollover rules require plans to roll involuntary cash outs of $1,000 or more into an individual retirement account unless the

[109] Field Assistance Bulletin 2004-2 is available on the Department's website (*www.dol.gov/ebsa*).

participant requests a distribution. The Department of Labor has now issued regulations that provide guidance with regard to automatic rollovers.[110]

The new Department of Labor regulations provide plan fiduciaries with protection from potential liability arising in connection with the designation of an institution to receive an automatic rollover and the initial investment selections as long as the standards set forth in the regulations are met. In general, in order to qualify for the protection provided by the regulations, the present value of the distribution may not exceed $5,000. In addition, a number of other requirements must be met. For example, the institution establishing the IRA must be a bank, insurance company, financial institution or other IRA approved provider. The plan administrator also must enter into a written agreement with the IRA provider that satisfies specified requirements. In addition, the summary plan description must describe the automatic rollover rules, provide a description of the investments to be made in connection with the automatic rollover, and meet certain other requirements.

P. Educating Participants

1. The Need for Education

Plan sponsors are not legally required to provide investment education to plan participants. The regulations under section 404(c) call for the provision of information concerning the available investment alternatives, but the regulations do not require the sponsor or anyone else to teach the participants how to use that information.

Despite the lack of an affirmative duty to educate, many plan sponsors have wisely ventured into this area. Uneducated participants are likely to make mistakes. Some participants might risk everything in aggressive stock funds while other participants may completely avoid risk by investing in low return money market funds. A third group of participants may attempt to time the market and, like most market timers, will eventually switch between the available alternatives at precisely the wrong time. If a significant number of plan participants make these common investment mistakes, the employer's retirement program will prove to be inadequate, leading to a disgruntled and frustrated workforce that may demand a better (and more expensive) retirement plan.

Poor investment decisions by participants also could increase the likelihood of claims against plan fiduciaries. Participants who have experienced lackluster or disastrous investment results are much more likely to look for someone to blame than participants who have done reasonably well. To the extent that an investment education program improves investment performance, then, it also may serve to reduce the risk of fiduciary liability claims.

Oddly enough, a desire to minimize fiduciary liability actually may have chilled the educational efforts of some employers. These employers have expressed the concern that by providing an educational program to their employees they may be providing investment advice

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[110] 29 C.F.R. § 2550.404a-2(2004). The new rules are effective for cash outs made on or after March 28, 2005.

and subjecting themselves to fiduciary liability. An Interpretive Bulletin issued by the Department of Labor should ease these concerns.[111]

2. Educator as Fiduciary

Selecting and monitoring the educators is a fiduciary act and the employer or other fiduciary responsible for the selection must act prudently and comply with all of the other fiduciary requirements of ERISA. If the investment education program is well designed and controlled, though, the provision of the education will not be a fiduciary act or lead to added fiduciary liability exposure.

ERISA section 3(21)(A) defines "fiduciary" broadly to include anyone who:

- Exercises discretionary authority or control respecting the management of the plan or the management or disposition of its assets;
- Provides investment advice for a fee or other compensation; or
- Possesses any discretionary authority or responsibility regarding the administration of the plan.

Whether investment education is a fiduciary act will depend on whether the educator provides "investment advice" for a fee. Under regulations issued by the Department of Labor, an investment educator will be considered to be rendering investment advice and will assume the fiduciary mantle only if the educator provides advice as to the value of securities or other property or makes recommendations as to the advisability of investing in or purchasing or selling plan assets.[112] Even if the educator steps over this line, the educator will not be considered to be rendering investment advice unless he also:

- Directly or indirectly has discretionary authority or control (regardless of whether the control or authority is pursuant to an express agreement or arrangement) with respect to the purchase or sale of plan investments for the participant; or
- Renders advice to the participant on a regular basis pursuant to a mutual agreement, arrangement or understanding with the participant that the advice will serve as a primary basis for the participant's investment decisions and that the educator will provide individualized advice based on the participant's particular needs.

If the courts accept the Department's regulations as a proper interpretation of the statute, an employer should be able to construct an investment education program in which the educator is not a fiduciary. The Interpretive Bulletin confirms this interpretation of the regulations and provides safe harbors that an employer may use in designing its investment education program.

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[111] Department of Labor Interpretive Bulletin 96-1, Participant Investment Education, 61 Fed. Reg. at 29586 (June 11, 1996), reprinted in 23 Pen. & Ben. Rep. 1594 (BNA) (June 17, 1996).

[112] 29 C.F.R. § 2510.3-21(c)(1)(i).

3. Safe Harbors in General

According to the Interpretive Bulletin, an investment education program is not "investment advice" if it is limited to providing plan information, general financial and investment information, asset allocation models and interactive investment materials. These materials may be provided in any medium (orally, in writing or through video or computer programs), in any form (individually or in a group meeting) and in any combination.

4. Plan Information

The investment education program may include any materials that inform the participants about the plan or the benefits of plan participation as well as all of the information required by the section 404(c) regulations concerning the available investment alternatives. The Interpretive Bulletin recognizes that information is not "advice" and that providing information alone should not lead to fiduciary status.

5. General Financial and Investment Information

General financial and investment information also may be furnished to the participants without risking fiduciary status. This category of information includes materials dealing with risk and return, diversification and dollar cost averaging concepts as well as the historic differences in return on different asset classes, the effects of inflation, investment time horizons, retirement income needs and the assessment of risk tolerance.

As with general plan information, this general financial and investment information is not "advice."

6. Asset Allocation Models

An investment education program also may offer model asset allocation portfolios of hypothetical individuals. In order to avoid the characterization of this material as "advice," several precautions must be observed:

- All of the models must be based on generally accepted investment theories that recognize the historic returns of various asset classes.
- The material facts and assumptions must be stated.
- If the model matches one of the plan's investment alternatives with a particular asset class, and other similar investment alternatives also are available, the model must be accompanied by a statement that apprises the participants that other similar investment alternatives are available and advises them how to obtain information on the other alternatives.
- The models must be accompanied by a statement that in applying any particular asset allocation model to his or her circumstances the participant should consider other assets, income and investments.

With all of this information in hand, the participant is in a position to analyze the relevance or appropriateness of the model to his or her circumstances. As a result, by furnishing this information the educator is not making a recommendation or furnishing advice.

7. Interactive Investment Material

Computer software and other materials that enable the participant to estimate future retirement income needs and how various asset allocation models will help the participant meet those needs also may be included as part of an investment education program. These interactive materials must be accompanied by all of the precautionary information required for asset allocation models. In addition, there must be an objective correlation between the asset allocations generated by the program and the information supplied by the participant.

8. Other Information

In the Interpretive Bulletin, the Department is careful to note that an investment education program also may offer other information to participants. Whether the provision of a particular item or type of information will lead to the conclusion that the educator is providing investment advice will require a facts and circumstances analysis.

9. Risk to the Employer

Does an employer assume some fiduciary liability by offering an investment education program? Certainly. As noted above, the employer or other fiduciary that selects the educator must comply with ERISA's prudence and other fiduciary requirements in selecting, monitoring and continuing the appointment of the educator.

By carefully designing the program to limit the sanctioned materials to those described in the safe harbors outlined in the Interpretive Bulletin and expressly restricting the activities of the educator to the provision of sanctioned materials and information, though, the risk assumed by the employer should be insignificant. In fact, the risk may be less than the risk unwittingly assumed by allowing an uneducated or uninformed group of participants to invest their retirement funds.

Q. Providing Investment Advice

Recognizing that investment education may not provide participants with all of the assistance they need, some employers are taking the next step and are offering participants access to investment advisors. In this context, the advisors clearly are fiduciaries under ERISA, making them subject to all of ERISA's fiduciary standards, including the prohibited transaction rules. When it selects the advisor, the employer or other responsible plan fiduciary is exercising a fiduciary function. As a result, it must satisfy the Prudent Person Rule in selecting the advisor and monitoring the advisor's performance.

The investment advice package often comes in the form of a computer program. Participants input relevant information and they are then provided with specific investment fund recommendations. The selection of an electronic investment advice program requires the same type of fiduciary due diligence as the selection of an individual investment advisor. Plan fiduciaries responsible for selecting the advice program are performing a fiduciary function and must take care to satisfy the Prudent Person Rule. At a minimum, the fiduciaries should understand the investment methodology underlying the investment advice program and assure themselves that the advice being provided is consistent with accepted investment theories. One good approach is to input information for a number of hypothetical participants and then test the advice given against the advice that would be given under similar circumstances by a skilled investment advisor.

If the investment advice program is offered by a mutual fund or other financial institution that also provides some of the investment options utilized by the plan, prohibited transaction concerns need to be taken into account. The entity providing investment advice, as noted above, is a plan fiduciary. As a result, the provisions of section 406(b) of ERISA, which are discussed above, need to be taken into account. In order to avoid these concerns, some financial institutions have sought prohibited transaction exemptions or advisory opinions from the Department of Labor with respect to their particular programs.[113] Some mutual funds have taken the position that they can provide investment advice without violating section 406(b). This position certainly seems to be inconsistent with the Department's views.

R. Providing Investment Management

A further refinement on education and advice is actual investment management. A number of mutual fund companies and others are now offering programs in which independent professional investment managers will make the fund allocation decisions for plan participants. Typically, these programs require that plans offer a certain number of funds in various categories. Participants then either sign up for the service or the service applies unless the participant opts out. Participants typically are charged a basis point fee for utilizing the service.

The appointment of an investment manager is governed by ERISA section 402(c)(3). Under section 402(c)(3), the investment manager must be appointed by a "named fiduciary." Section 405(d)(1) of ERISA then relieves the plan trustee from any liability for the acts or omissions of the investment manager. In Harris Trust & Sav. Bank v. Salomon Bros., Inc., the district court concluded that section 405(d)(1) also provides protection to the named fiduciary who appoints the investment manager.[114]

Like the fiduciary who designs or offers an investment advice program, plan fiduciaries who make investment management available to the participants are obligated to act prudently in selecting and monitoring the managers. A good example of the process that should be followed by the fiduciary was set forth by the district court in Whitfield v. Cohen.[115] According to the court in Whitfield, a fiduciary charged with the responsibility to appoint investment managers should follow a process similar to the following:

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113 See, for example, Advisory Opinion 2001-09A (December 14, 2001) which is available on the Department's website (*www.dol.gov/ebsa*). Advisory Opinion 2001-09A related to a program proposed by SunAmerica Retirement Markets, Inc.

114 Harris Trust & Sav. Bank v. Salomon Bros., Inc., 832 F. Supp. 1169 (N.D. Ill. 1996), rev'd in part on other grounds, 184 F. 3d 646 (7th Cir. 1999), cert. granted, 528 U.S. 1068 (2000) and judgment rev'd on other grounds, 530 U.S. 238 (2000).

115 682 F. Supp. 188 (S.D.N.Y. 1988).

1. Evaluate the person's qualifications including:

    a. His experience in the particular area of investments under consideration and with other ERISA plans.

    b. His educational credentials.

    c. Whether he is registered with the Securities and Exchange Commission under the Investment Advisors Act of 1940.

    d. An independent assessment of his qualifications by means of

        (i) A widely enjoyed reputation in the business of investments;

        (ii) Client references; and/or

        (iii) The advice of a professional third-party consultant.

    e. His record of past performance with investments of the type contemplated.

2. Ascertain the reasonableness of his fees.

3. Review documents reflecting the relationship to be entered into.

4. Ensure adequate, periodic accountings in the future.[116]

III. LIABILITY CONCEPTS

Any plan fiduciary who breaches ERISA's fiduciary responsibility provisions is personally liable for losses resulting from the breach. Also, the plan fiduciary must disgorge any profits realized through the use of plan assets in violation of his or her fiduciary obligations.[117]

A. <u>Loss to Plan Unnecessary</u>

ERISA section 409(a) requires that the fiduciary return to the plan all profits made by virtue of the use of plan assets, even if no losses have been incurred by the plan.[118]

B. <u>Good Intentions</u>

As the Fifth Circuit has stated, "a pure heart and an empty head are not good enough."[119]

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[116] Whitfield v. Cohen, 682 F. Supp. 188, 193 (S.D.N.Y. 1988).

[117] ERISA § 409(a).

[118] See Leigh v. Engle, 727 F.2d 113, 138 (7th Cir. 1984), in which the court found that although the trust had enjoyed a 72% return on its investment, the fiduciaries had wrongfully risked plan assets in furtherance of their own takeover interests rather than acting solely in the interest of plan participants. The fiduciaries had profited by virtue of simultaneously holding shares of stock in the targets and were required to disgorge their profits.

C. Punitive Damages

Although ERISA section 409(a) provides for "other equitable or remedial relief as the court may deem appropriate," a participant may not obtain punitive damages from a fiduciary under section 409(a).[120]

D. Civil Penalty

The Secretary of Labor can assess a civil penalty in the case of "any breach of fiduciary responsibility . . . or any knowing participation in such a breach or violation by any other person."[121] The civil penalty is equal to 20% of the "applicable recovery amount," which is defined in the statute as the amount recovered pursuant to any settlement agreement with the Department of Labor or any court order in an action instituted by the Department of Labor. The penalty may be waived or reduced if the Secretary determines that the fiduciary acted in good faith or in cases of severe financial hardship.

Note: This paper is intended to provide general information concerning the application of ERISA's fiduciary standards to 401(k) plans. This paper should not be relied on as legal advice or as a legal opinion on any specific facts or circumstances. You are urged to consult legal counsel concerning your situation and any specific legal questions you may have.

119 Donovan v. Cunningham, 716 F.2d 1455, 1467 (5th Cir. 1983) cert. denied, 467 U.S. 1251, 104 S. Ct. 3533 (1984).

120 See Massachusetts Mutual Life Ins. Co. v. Russell, 473 U.S. 134, 105 S.Ct. 3085 (1985), in which a majority of the Court reasoned that ERISA section 409 is intended to protect the interests of the plan as a whole and not the interests of particular individuals.

121 ERISA § 502(l)(1)(A) and (B).