BALCH & BINGHAM LLP

B&B REVIEW

Corporate and Securities

What's Inside . . .

Page 1
Background

Page 2
What Can Be Done To Manage Your Risk

Page 3
A Word About Insurance

For Further Information Contact . . .

Richard L. Pearson
205-226-3443
rpearson@balch.com

William E. Shanks, Jr.
205-226-3444
wshanks@balch.com

*Stephen A. Yoder**
205-226-8791
syoder@balch.com

* admitted in Pennsylvania and California only

Visit our website
www.balch.com

Address Change . . .
If you no longer wish to receive this update or have an address change, please contact:

Joy Rollins
205-488-5533
jrollins@balch.com

Officers and Directors Can Take Steps to Minimize Potential Fiduciary Liability in Connection With Employee Benefit Plans Holding Company Stock

There has been a trend in recent years toward plaintiff lawyers attempting to use ERISA to impose liability on officers and directors of public companies when there are allegations that their company failed to disclose material information that led to a decline in the value of the company's stock held in an employee benefit plan. Typically, company stock is held in defined benefit and defined contribution retirement plans, and in employee stock ownership plans.

These cases are troubling because in many situations the officers and directors who have been sued have not been responsible for management of the plan. Almost every recent high profile securities fraud case has also had separate ERISA breach of fiduciary duty claims brought, including Enron, WorldCom, K Mart, Qwest, Global Crossing and Krispy Kreme. In March 2005, a federal district court judge refused to dismiss a case brought by participants in an AOL Time Warner retirement plan, ruling that fiduciary status had been properly alleged against the corporate sponsors, the administrative committees of the plans, the trustee and other individual executives.

This article will explore what steps can be taken to manage this emerging risk for officers and directors.

BACKGROUND

Much of the director and officer litigation brought under ERISA in connection with a drop in the value of securities has centered on whether or not the individuals were fiduciaries under that law. This is because ERISA only imposes pecuniary liability on corporate officers and directors who are considered fiduciaries. If an individual exercises any discretionary authority or control in one or more of the following three areas, then he or she is a fiduciary:

- managing or administering a plan;
- providing investment advice; or
- investing plan assets.

Case law since ERISA was enacted in 1974 makes it clear that the definition of fiduciary is to be applied broadly in a "functional" way so that not only "named" fiduciaries will be held to fiduciary standards but also those who function as such without an official title. On the other hand, courts have held that merely making statements about plan benefits or having influence over plan management is not enough to impose fiduciary liability. Similarly, it is well-settled that certain actions taken as the sponsor, or "settlor", of an employee benefit plan are not fiduciary in nature, such as making a design change in a plan or terminating a plan.

Once fiduciary status is established, ERISA requires that four standards of conduct be met:

- duty of loyalty (sometimes called the "exclusive benefit rule", meaning that fiduciaries must act for the exclusive benefit of plan participants);
- duty of prudence;
- duty to diversify plan assets; and
- duty to follow the terms of plan documents unless to do so would otherwise breach the foregoing duties.

Visit Our Offices…

1901 Sixth Avenue North
Suite 2600
Birmingham, Alabama 35203

1710 Sixth Avenue North
Birmingham, Alabama 35203

2 Dexter Avenue
Montgomery, Alabama 36104

655 Gallatin Street
Huntsville, Alabama 35801

3535 Piedmont Road
14 Piedmont Center
Atlanta, Georgia 30305

1310 Twenty-Fifth Avenue
Gulfport, Mississippi 39501

401 East Capital Street
Suite 200
Jackson, Mississippi 39201

1275 Pennsylvania Avenue, N.W.
Washington, D.C. 20004

What Can Be Done to Manage Fiduciary Liability Risk

Board Role. Many employee benefit plans name the board of directors or a committee of the board as the "named fiduciary" with respect to the plans. This does not have to be the case and indeed should not be the case if in fact directors are not exercising diligence in overseeing the plans. On the other hand, even if board members are not named fiduciaries, they should do some monitoring of the performance of the plan's investments and other administration, as a matter of general fiduciary duty as directors.

CEO Role. The CEO's role with respect to employee benefit plans holding company stock should also be carefully reviewed. Just as many plans routinely give boards of directors broad duties, even more plans give broad duties to the CEO. Many times, however, a CEO's duties can properly be limited to functions which are those of the "settlor" described above, and therefore not fiduciary. However, a CEO may be rendered a fiduciary merely by having the power to appoint fiduciaries. Accordingly, management might want to re-think providing broad appointment power to the CEO. Finally, because the CEO should always be knowledgeable about the company's financial condition, it might be a problem for him or her to be a member of an administrative committee overseeing the investment of a plan's assets. Court decisions suggest that an individual might be able to avoid liability for the management of plan assets that included company stock if he or she had no knowledge about the company's precarious financial condition.

Finance Function Role. It is very common for employees in the finance function to be named to an administrative committee overseeing an employee benefit plan, or otherwise to participate in the oversight of the plan. Indeed, it is important for there to be good communication between those managing employee benefit plan assets and those in the finance function because of the effect that such plans can have on the financial results of the company. However, for the same reason that it might not be a good idea for the CEO to oversee investments in a employee benefit plan holding company stock, it also might not be a good idea for the senior-most financial employees to serve in such roles.

Communications to Employees on Company Financial Results. A particularly risky area for management arises when management communicates with employees about the company's financial performance. Court decisions provide support for dismissal of claims based on disclosure of false and misleading financial information where individuals were acting in their corporate, not fiduciary capacity. An example of acting in a corporate capacity would be communications at general company meetings not devoted to benefit information. On the other hand, court decisions make it more likely that individual officers will be found liable for false and misleading statements about the company's financial condition in the context of providing information relating to plan administration or benefits. In many cases, it may be advisable not to combine communications on general corporate issues with those on employee benefits.

Delegation of Fiduciary Duties. As noted above, a board should not delegate entirely its oversight of employee benefit plans. However, both at the board level and at the management level it is appropriate to assign fiduciary responsibilities to lower-level employees who nonetheless are capable of fulfilling the responsibilities under consideration. For example, a company might consider making the named fiduciary a "retirement committee" consisting of employees who have the requisite experience and skills to fulfill duties ranging from overseeing investment performance to deciding claim issues from participants, even if some or all are not members of senior management.

Personal Trading. Officers and directors should avoid personal trading in company securities during a time that might later be scrutinized as a time that they had knowledge or should have had knowledge about the company's financial condition. One of the allegations against the individual defendants in the AOL Time Warner case was that the individuals sold their own stock while allowing plan participants to continue to hold onto such investments.

Process for Investment Review of Company Stock. The administrative committee of an employee benefit plan holding company stock should also formalize a process for periodically reviewing the performance of the company's stock. Such review should be based on third-party research wherever possible. Even if a decline occurs in the stock price, members of the committee and others functionally involved in the investment management for the plan might be better protected from liability if they can at least demonstrate that they had a process in place for oversight.

Review Plan Documents and Create Written Process. We recommend that clients undertake a careful look at how fiduciary

duties have been assigned under their various employee benefit plans. As noted above, it might not be appropriate today automatically to assign fiduciary duties to the board, CEO or CFO. Companies should also consider adopting a brief "handbook" for the named fiduciaries of plans that clarifies duties and otherwise covers the topics above.

Privately-Held Companies. Officers and directors of privately-held companies should also take steps to manage their risk of fiduciary liability in connection with benefit plans holding company stock. For example, if there is a transaction between an ESOP and the company that is challenged in some way by employees, whether or not officers and directors will face personal liability will depend upon the wording of plan documents and whether their actions otherwise render them fiduciaries.

A Word About Insurance

Most companies carry separate "fiduciary" insurance coverage for the possible liability of officers and directors arising from the administration of employee benefit plans. Sometimes there might be separate coverage, but combined limits with the traditional D&O coverage. Management should expect that insurance carriers might soon be attempting to narrow the terms or amounts of fiduciary coverages because of the litigation trends described above. Or, at a minimum, carriers may seek to clarify that ERISA liability is expressly carved out of the traditional D&O coverage.

Disclaimer and Copyright

This publication is intended to provide general information. It is not intended as a solicitation, and in the event legal services are sought, no representation is made that the quality of legal services to be performed is greater than the quality of legal services performed by other lawyers. The listing of any area of practice does not indicate any certification of expertise in the area as listed. 2005. Balch & Bingham LLP. All rights reserved.