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To Disclose or Not to Disclose. That is the Question for the Corporate Fiduciary Who is also a Pension Plan Fiduciary Under ERISA: Resolving the Conflict of duty

by Shelby D. Green*

CEO Ken Lay: "Now is the time to buy Enron shares."

I. Introduction

The fall of the Enron Corporation in 2001 was a collapse of breathtaking proportions. A giant among the nation's enterprises would be reduced to shambles. There were many losers along with the company, including most prominently the employee-shareholders, whose pension plans consisted largely of Enron stock.¹ Why did they follow such a foolish course? Because that is what the company required and urged--even on the eve of the collapse.²

The public reaction was a massive sell off of Enron stock, causing a plunge in the stock price from a high of \$90 to \$1, in just months, eventually

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¹ Sharon Reece, "Enron: The Final Straw & How to Build Pensions of Brick, 41 Dug. L. Rev. 69 (2002).

² It seems that the company had entered into several clear conflict of interest transactions with an officer, which were hopelessly losing propositions for the company, but beneficial for the officer, but which were not disclosed on the company's regular books. When the deals were finally brought to light, it was revealed that the company had overstated its revenues by some \$ billion. There were several other such shenanigans going on with the company that contrived to present a false image of the company's financial state. See Reece, *supra* note 2, at ----.

sending the company into bankruptcy. But alas, Enron does not stand alone in the annals of fallen corporate giants; many others would and continue in Enron's wake.³ In virtually all these cases, non-employee shareholders commenced suit seeking to hold corporations and their directors liable under the securities laws for accounting misdeeds.⁴ Employee-shareholders have also sued companies and

³ [newspaper articles announcing the scandals] A General Accounting Office study found that between 1997 and 2002, 10 percent of the listed corporations in the country restated their financial statements at least once, that financial information originally certified by their independent auditors as correct and in compliance with Generally Accepted Accounting Practices "GAAP" turned out to be false. U.S. Gen. Acct'g Office, Rept to the Chairman, Cmte on Banking, Housing & Urban Affairs, U.S. Senate, Financial Statement Restatements: Trends, Market Impacts, Regulatory Responses and Remaining Challenges 4 (2002).

⁴ In the aftermath of the scandals, came the Sarbanes-Oxley Public Company Accounting Reform and Investor Protection Act of 2002, law which imposed new and rigorous accounting review procedures. Among other things, the Act established a new regulatory body with jurisdiction over auditing standards (requiring registration of public accounting firms); required review by a corporation's audit committee of all audit and non-audit services provided to the company, prohibited accounting firms from providing a variety of non-audit services (including bookkeeping, financial information systems design and implementation, appraisal or valuation services, fairness opinions, actuarial services, internal audit outsourcing services, management functions or human resources, broker or dealer, investment adviser or investment banking services, legal services and expert services unrelated to the audit), required the company to set up an audit committee composed entirely of independent board members, one of whom is qualified as a financial expert; required the audit committee to have direct responsibility for the appointment, compensation, and oversight of the work of the independent auditor of the company, with authority to engage independent counsel and other advisers, requiring the audit committee to establish procedures for the receipt and evaluation of anonymous submission by employees of concern regarding "questionable accounting or auditing matters." The act also mandates that both CEO's and CFO's make detailed certifications, in connection with each filing of a company's periodic reports, including that the signing officer has reviewed the report, based on the officer's knowledge, the report does not contain any material misstatement or omission and "the financial statements and other financial information included in the report, fairly present in all material respects the financial condition and results of operation of the issuer as of and for, the periods presented in the report." The signing officers are responsible for establishing and maintaining internal controls and design such internal controls as necessary to ensure that material information relating to the issuer is made known to such officers during the reporting period and have disclosed to the company's auditors and to the audit committee all significant deficiencies in the design or operation of internal controls as well as any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls. Another part of the act bars an issuer from directly or indirectly extending credit or making, renewing, or arranging for a "personal loan" to any director or executive officer. The act also

insiders who were pension plan fiduciaries to recover for losses to their pension plans. They alleged breach of fiduciary duty by the plan trustees in continuing to fund the plan with the company's stock and for not divesting the plan of the company's stock despite knowledge of its worthlessness. What the employee-shareholders allege the pension plan fiduciaries should have done would place them in a fine legal dilemma. To divest a pension plan of the company's stock on the basis of inside information about the company's financial irregularities would mean trading it to a purchaser on the open market without the same information. The plan pension fiduciary is thus in a double bind: as a pension plan fiduciary, it has a duty under the law to act to protect the assets of the plan, but as an insider of the corporation whose shares are being traded, it has a duty not to trade on the basis of material non-public information. To trade without disclosing would violate the Securities Exchange Act of 1934. The failure to trade would seem to

called for new disclosure of changes in financial condition or operations on a "rapid and current basis", including all off-balance sheet transactions, arrangements, obligations (including contingent obligations) and other relationships that might have a 'material current or future effect' on the financial health of the company. The act instructs the SEC to develop a new disclosure document called an "internal control report", which report must be set forth in the company's annual report to the SEC, which "shall state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting. Section 404(a). This report must also contain management's assessment of the effectiveness of the internal control structure and procedures, which the audit firm must then attest to. Section 406 also requires the SEC to issue rules requiring public companies to disclose if it "has adopted a code of ethics for senior financial officers" or to justify why it has failed to do so. "Code of ethics" is defined as such standards as are "reasonably necessary to promote honest and ethical conduct including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships, "full and fair disclosure, and "compliance with applicable governmental rules and regulations." **SECTION-----**

violate the duties imposed by the Employee Retirement Income Security Act of 1974 (“ERISA”).⁵

The courts considering what appears to be an irreconcilable conflict of duty and liability have themselves taken conflicting views. The rulings on both sides of the issue are unsatisfying in that they offer no clear policy basis for one position over the other and provide the fiduciary and insider little guidance on the proper course to take.

This article examines this seemingly irreconcilable conflict faced by the fiduciary of a pension plan who is also a corporate fiduciary, to disclose or not disclose material, inside information to plan participants, that would be used by the plan participants to divest investments in company stock, but without disclosing the same to persons on the other side of these trades. The article begins with a general discussion of the regulation of trade in securities and the history of the insider trading laws under the Securities Exchange Act of 1934. Then in Part III, I discuss the soundness of the prohibition against insider trading, In Part IV, I discuss the duties imposed on pension plan fiduciaries and how they appear to conflict with the corporate fiduciary’s duty to disclose material non-public information or to abstain from trading. In Part V, I discuss the varying positions taken by the courts that have considered the issue. Finally in Part VI, I discuss ways of reconciling the two duties.

⁵ 29 U.S.C. § 1109.

II. The Regulation of Trade in Securities

The need for regulation of trade in securities is based upon the perception that securities are different from most other commodities. Securities are intangibles, and thus not susceptible to the kind of physical and concrete examination one would conduct for an investment, say, in real estate or precious jewels. With intangibles, the value of an investment must necessarily depend on information from the company and from persons with access to company information about them, e.g., company plans, operational philosophy, management skill and experience. But, human nature being what it is, a seller of an item, is inclined to intentionally and otherwise to emphasize or exaggerate positives and conceal or gloss over negatives. Hence, the need for some standards for truthfulness.

Another oft-stated reason for regulating securities is that the securities market is critical in a capitalist economy that allocates scarce capital among competing users, such that any serious disruption could cause a national depression.⁶ Considering the very large incidence of investment in securities by the American citizenry, public distrust of the securities market as a result of pervasive fraudulent practices could have serious consequences for the economy as a whole.

A. Formal Disclosure as a Basic Requirement of the Securities Laws

⁶ CHOPER, COFFEE, & GILSON, CASES AND MATERIALS ON CORPORATIONS 308 (6th ed. 2004).

The Securities Act of 1933 was passed by Congress in the wake of the stock market crash of 1929 and during the first 100 days of Roosevelt's New Deal Plan. It was intended to achieve "truth in securities" by regulating the initial public offering process of securities by corporations. The Congressional hearings leading up to the enactment revealed numerous instances in which high risk and sometimes worthless securities were offered by underwriters and dealers to uninformed investors, with only minimal or no disclosure.⁷ The "truth in securities" law had two basic objectives: to require that investors be provided with material information concerning securities offered for public sale and to prevent misrepresentation, deceit, and other fraud in the sale of securities.⁸

Thus, the basic strategy of the 1933 Securities Act was to specify mandatory disclosure documents-- the prospectus and registration statement.⁹ The act prohibits the sale or offer for sale of any security that has not been registered with the SEC. Registration is intended to provide adequate and accurate disclosure of material facts concerning the company and the securities it

⁷ H.R. Rep. No. 85-73, 73d Cong., 1st Sess. 2 (1933). In recommending passage of the bill to the 1933 act, Roosevelt emphasized that by putting "the burden of telling the whole truth on the seller", the proposed act "should give impetus to honest dealing in securities and thereby bring back public confidence." At the time Roosevelt made this statement, the concern about public confidence was great. "New corporate securities which had equaled \$6.5 billion in 1927, \$6.9 in 1928, and \$9.8 billion in 1929, had fallen to \$644 million in 1932 (and would equal \$380 million in 1933)." Seligman, at----. In recent times, between 1952 and 1983, there was a decided reduction in the number of small investors in the stock markets, some say the result of the widely held belief that institutional investors received "inside information" that small investors did not have. Seligman, at ----.

⁸ Securities and Exchange Commission: The Work of the SEC (June 1997), <http://www.sec.gov>.

⁹ Securities Act of 1933, 15 U.S.C. §77e (2004). Section 5 prohibits the use of any "prospectus" (broadly defined to mean in effect any writing that promotes or offers for sale securities) unless permitted by SEC rule, until the registration statement is deemed effective by the SEC.

proposes to sell, enabling investors to make a realistic appraisal of the merits of the securities and then exercise informed judgment in determining whether to purchase them.¹⁰ While registration requires, but does not guarantee, the accuracy of facts represented in the registration, it prohibits false and misleading statements under penalty of fine or imprisonment.¹¹ At the same time, the law does not preclude the sale of stocks in risky or poorly managed or unprofitable companies or even harebrained schemes. It only requires enough information so that the investor, were he astute could see that it is so.¹²

The act also precludes the use of any other written materials to initially offer securities by a corporation, except as permitted by SEC rule (i.e., by the prospectus) and not until a registration statement filed by the corporate issuer is deemed effective. This means that if noncomplying written materials are used

¹⁰ Registration requires a description of the company's properties and business; description of the security to be offered for sale and its relationship to the company's other capital securities; information about the management of the registrant; and financial statements certified by an independent public accountant. Registration statements are subject to examination for compliance with the disclosure requirements. If the statement appears to be materially incomplete or inaccurate, the registrant is informed and usually given an opportunity to file correcting or clarifying amendments. But the Commission may conclude that material deficiencies in some registration statements appear as a result of deliberate attempt to conceal or mislead, or that deficiencies do not lend themselves to correction through the informal letter process. In such cases, the Commission may hold a hearing to determine whether the issuance should be stopped. CHARLES O'KELLY & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS (4th ed. 2003); See Regulation S-K: Standard Instructions for Filing Forms..., 17 C.F.R. §§ 229.303 (instructions 1-3)(1998).

¹¹ Work of the SEC, *supra* note -, at ---. Liability under the Act for material omissions or false statements is strict for the issuer and based on negligence for secondary participants (including members of the board, underwriters, accountants, who to escape liability had to prove they exercised "due diligence" under the circumstances. 15 U.S.C. § 77k (2004). The act effectively shifted the burden of proof on the issue of negligence to the defendants.

¹² Indeed, it is unlawful to represent that the Commission approves or disapproves of securities on the merits. 15 U.S.C. § 77w (2004).

prior to the effective date of the registration statement of if any oral selling of the securities occurs by the corporation or its agents, the investor has an absolute right to rescind, even if full disclosure had been made.¹³ The effect of this prophylactic rule is that there is a period of enforced silence by the corporation and then the prospectus becomes the exclusive selling document.

The Securities Exchange Act of 1934 was designed to require periodic and continuous disclosure by certain companies,¹⁴ although unlike the prospectus, these periodic reports¹⁵ are not required to be distributed to investors or shareholders, but are only filed with the SEC. Nor, are these periodic reports aimed at the ordinary investor, but at analysts and professional traders, because they are factually dense, highly technical and quantitative, and not readily accessible to the average lay investor.¹⁶ The idea is that information contained in

¹³ 15 U.S.C. § 77l (2004).

¹⁴ The companies are those who list securities on a national securities exchange; those with gross assets over a specified level (currently \$10 million); those with a class of equity securities held by at least 500 persons; and those who file a 1933 Act registration statement that has become effective. 15 U.S.C. § 12(g) (2004).

¹⁵ The most important of the periodic disclosure is the annual report on Form 10-K, which must contain audited financial statements as well as a detailed description of the corporation, including percentage breakdowns of its various lines of business. In addition, quarterly reports on Form 10-Q containing unaudited financial information, must be filed for each of the corporation's first three quarters. Finally, reports of current material developments must be filed on Form 8-K, within ten days after the end of the month in which the event occurs.

¹⁶ However, the SEC does require corporations to provide a "basic information package", containing essential financial information and a qualitative discussion of recent performance and known events and uncertainties likely to impact future performance, as part of its Management's Discussion & Analysis of Financial Condition and Result of Operations. ("MD & A"). SEC Regulation S-K, 17 C.F.R. §229.303(a)(3)(ii). The MD & A provides "soft" or "forward looking" information, such as projections of future earnings, predictions about when key new products will reach the market; estimates of the adverse impact in future earnings, fluctuations or a recession in a given foreign country. CHOPER, COFFEE, & GILSON, CASES & MATERIALS ON CORPORATIONS 314 (6th ed. 2004). The MD & A is made available to the shareholders subject

these reports will reach the average investor only through a filtration process, where experts sift through, and analyze verify the information and the price is adjusted accordingly.

B. Ad Hoc Disclosure Required Where Corporation has Chosen to Speak

Apart from the specific formal requirements of the securities acts (including the periodic filings), it seems fairly well-settled that corporations and corporate insiders have no general duty to disclose all non-public material information that it has about the corporation to shareholders.¹⁷ However, where

to the SEC's proxy solicitation rules, as part of the annual report required to be included in any solicitation of proxy. **CITE PROXY SOLICITATION RULES**

¹⁷ *Grossman v. Novell, Inc.*, 120 F.3d 1112 (10th Cir. 1997); *Financial Industrial Fund, Inc. v. McDonnell Douglas Corp.*, 474 F.2d 514 (10th Cir. 1973)(timing of disclosure of earnings statement within board's discretion, where information not ripe); *Segal v. Coburn Corp. of America* [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH ¶ 94,002 (E.D.N.Y. 1973))(corporation not required to disclose decision to withdraw from a line of business where public disclosure "might have impaired the collectability of the paper----- disturbed credit relations, and forced a precipitous liquidation of the business"); *Reiss v. Pan American World Airways, Inc.*, 711 F.2d 11, 14 (2d Cir. 1983)(disclosure not required of "fluid" merger negotiations where disclosure would have subjected corporation to securities fraud action had the merger collapsed); *see also Basic v. Levinson*, 485 U.S. 224 (1988)(implicitly finding no general duty to disclose, but finding liability where corporation chose to speak untruthfully). A corporation though not under an original duty to disclose or speak publicly, after having done so, may be under a duty to update an earlier statement, for instance where material changes have occurred that result in facts that would have been material to a reasonable investor. *Weiner v. Quaker Oats*, 129 F.3d 310 (3d Cir. 1997)(corporation had duty to update its original debt to capitalization ratio to disclose sharp rise in light of probability of costly acquisition of another company); *but see Backman v. Polaroid*, 910 F.2d 10 (1st. Cir. 1990)(where disclosure was in fact misleading when made and speaker thereafter learns of this, there is a duty to correct; when a prior disclosure "becomes materially misleading in light of subsequent events, if it had a forward looking intent, correction or further disclosure may be called for; however original statement projecting earnings were precisely correct, even if forward looking, remained correct thereafter, giving rise to no duty to provide additional information as to decline in projected earnings). *See also TimeWarner, Inc. Securities Litig.*, 953 F.2d 259, 267 (1993)(no duty to disclose lack of success in finding strategic partner because original statements lacked definite positive projections, only suggestions of hope; but duty to disclose alternative method of raising capital where information rendered prior statements about particular method materially misleading. The stock exchanges require listed companies to

a corporation makes a disclosure voluntarily or involuntarily, “there is a duty to make it complete and accurate.”¹⁸ Corporations rightfully may be reluctant to make voluntary disclosures for a number of reasons. Premature disclosure can often be harmful to the corporation and shareholders; it may misinform the market and injure those who buy or sell based upon the disclosure. And, if disclosure is not full and accurate, it could result in liability to the corporation for injuries resulting to those who relied. Disclosure might also result in adverse reactions by potential and existing lenders and suppliers.

There may also be a duty to speak that results from a fiduciary relation between an insider when he is trading in the corporation’s shares.¹⁹ But absent such circumstances, it is not incumbent upon the corporation to provide any information to shareholders merely because a reasonable investor would very much like to have the information. Instead, the SEC has left it up to the

promptly disclosed to the affected securities markets material nonpublic information. See NYSE rule-----.

¹⁸ *Helwig v. Vencor, Inc.*, 251 F.3d 540, 561 (6th Cir. 2001)(actor required to “provide complete and non-misleading information with respect to the subjects on which he undertakes to speak”); *Rubin v. Schottenstein*, 143 F.3d 263 (6th Cir. 1998)(even absent a duty to speak, a party who discloses material facts in connection with securities transactions “assumes a duty to speak fully and truthfully on those subjects) *Starkman v. Marathon Oil Co.*, 772 F.2d 231, 241 (6th Cir. 1985)(); *Roeder v. Alpha Industries, Inc.*, 814 F.2d 22, 26 (1st Cir. 1987)(); *Gross v. Summa Four, Inc.*, 93 F.3d at 992(1st Cir. 1996)(); *Glazer v. Formica Corp.*, 964 F.2d 149, 156-57 (2d Cir. 1992)(); *Sailor v. Northern Staler Power Co.*, 4 F.3d 610, 611 (8th Cir. 1993)(“ A duty arises, however, if there has been inaccurate, incomplete or misleading disclosures); *Rubenstein v. Collins* 20 F.3d 160, 170 (5th Cir. 1994)(“under 10b-5, a duty to speak the full truth arises when a defendant undertakes a duty to say anything.”); *In re Time Warner, Inc. Securities Litig.*, 953 F.3d 259, 267 (2d Cir. 1993) duty to update opinions and projections if the original opinions or projections have become misleading as a result of intervening events).

¹⁹ See discussion *infra* at text accompanying notes --- to ----.

corporation in the interval between periodic reports to decide whether to make any disclosures.

As it stands, corporations often make “forward looking statements”, which purport to reflect predictions about earnings, revenue and future economic performance.²⁰ If things do not turn out as predicted, a corporation is only liable if the statements were material and the corporation had actual knowledge that they were false and misleading, and the statements were not identified as “forward looking” or contained other cautionary language.²¹

C. Anti-Fraud Rule as a Necessary Complement to Mandatory Disclosure

Early on, it was thought that mandatory disclosure alone was inadequate to protect investors. This is because “[i]n securities markets, only a limited amounts of information can be verified at all.”²² Investors cannot “inspect” a business venture in a way that enables them to deduce future profits and risks.”²³ Instead, it is necessarily the case that the investor must rely on others to sift through and decipher company information. Indeed, they “do not even want to inspect; they seek to be passive recipients of an income stream...”²⁴ But, companies also have an interest in truthful disclosure. A firm that wants the highest possible stock price at its initial offering will take all cost-justified steps to make stock

²⁰ 15 U. S. C. §78u-5(i)(1).

²¹ *Id.*; see also *Helwig v. Vencor, Inc.*, 251 F.3d at 561 ().

²² *Id.* at 674.

²³ *Id.* at 674-75.

²⁴ *Id.* at 675.

valuable in the aftermarket. This it does by a believable pledge to continue disclosing.²⁵

An anti-fraud rule is a necessary complement to the federal mandatory disclosure regime not solely because of the disinclination of investors to investigate, but also because some companies may be sufficiently short-sighted to ignore the identified benefits.²⁶ An anti-fraud rule reduces the costs of verifying information, by making it more costly for low-quality firms to mimic high-quality ones by making false disclosures.²⁷ To be sure, an anti-fraud rule has its costs too—including enforcement (investigation, prosecutorial, judicial staff) as well as the costs of over-enforcement or inaccurate enforcement.²⁸

D. Anti-fraud Provisions Under Section 10(b) and Rule 10b-5

Various sections of the 1934 Act impose liability upon issuers and their officers for making false and misleading statements or omitting to state a material fact necessary to make statements true.²⁹ The dilemma of the pension plan fiduciary and corporate insider being explored here, would be covered by Section 10(b) of the 1934 Act.³⁰ It provides that

²⁵ *Id.* at . Since the 1934 Act, firms not required to disclose (either because there were not covered or not listed on a state exchange) have routinely provided voluminous information to purchasers.

²⁶ Easterbrook and Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 Va. L. Rev. 669 (1984).

²⁷ *Id.* at .

²⁸ *Id.* at .

²⁹ Section 11, 12, 17.

³⁰ 15 U.S.C. § 78j(b)(2004).

“it shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce or of the mails, or any facility of any national securities exchange
*** (b) to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may proscribe as necessary or appropriate in the public interest or for the protection of investors.”

Pursuant to Section 10(b) the Commission has adopted Rule 10b-5³¹ which makes

it unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) to employ any device, scheme or artifice to defraud, (b) to make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which they were made, not misleading, or (c) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit on any person, in connection with the purchase or sale of any security.”

What kind of conduct falls within the prohibitions of Section 10(b) and Rule 10b-5? The statute and regulation are interpreted to make insider trading fraudulent, i.e., the failure of an insider to disclose to his buyer or seller of securities, material, non-public information. Two theories of insider trading under these laws have emerged from the courts. Under the “traditional” or “classical theory”, Section 10(b) and Rule 10b-5 are violated when a corporate

³¹ 17 C.F.R. § 240.10b-5.

insider trades in the securities of his corporation on the basis of material, non-public information, without disclosing that information to the party on the other side of the transaction. “Trading on such information qualifies as a ‘deceptive device’ under §10(b)... because ‘a relationship of trust and confidence exists between shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation.’”³² That relationship... “gives rise to a duty to disclose [or to abstain from trading] because of the ‘necessity of preventing a corporate insider from *** tak[ing] unfair advantage of *** uninformed *** stockholders.’”³³

At common law, trading on inside information over the stock exchange was not regarded as unlawful or a breach of fiduciary duty by a director to a shareholder because directors were deemed to owe fiduciary duties to their corporations, not to individual shareholders.³⁴ However, as an exception, the “special facts” doctrine articulated an affirmative duty to disclose material, non-public facts in face-to-face dealings between an insider and a shareholder.³⁵ In *Strong v. Repide*,³⁶ the Supreme Court ruled that even if a director has no general duty to disclose facts known to him before he purchases shares, there are cases where by reason of special facts, such a duty exists. There, the special facts were

³² *United States v. O’Hagen*, 521 U.S. 642, 651-52 (1997).

³³ *O’Hagan*, 521 U.S. at 652, citing *Chiarella v. United States*, 445 U.S. 222, 228-229 (1980).

³⁴ *Goodwin v. Agassiz*, 283 Mass.358, 186 N.E. 659 (Sup. Jud. Ct. 1933).

³⁵ Roberta S. Karmel, *Outsider Trading on Confidential Information--A Breach in Search of a Duty*, 20 Cardozo L. Rev. 83, 87 (1998), discussing *Strong v. Repide*, 213 U.S. 419 (1909).

³⁶ 213 U.S. 419 (1909).

that the defendant, a director of the corporation and large stockholder, was also in full charge of negotiations for the sale of certain lands held by the corporation to the United States government, which sale would result in increased value to the corporation. The defendant was able to come to an agreement with the government if and when he chose to do so. These facts he failed to disclose, concealing his identity as a purchaser, and dealt in a roundabout fashion with the person appointed by the shareholder to sell her shares, who believed there was no prospect that a sale of the land would be consummated.³⁷ Shortly, after the sale of shares, the sale of the land was in fact consummated. The Court explained

“[i]f it were conceded, for the purpose of the argument, that the ordinary relations between directors and shareholders in a business corporation are not of such fiduciary nature as to make it the duty of a director to disclose to a shareholder the general knowledge which he may possess regarding the value of the share of the company before he purchases any from a shareholder, yet there are cases where, by reason of special facts, such duty exists.³⁸

In the case, those special facts were that the director was not only such, but held three-fourths of the shares of the company's stock, as well as at the time, being administrator general of the company with large powers and engaged in the negotiations which finally led to the sale of the company's lands at a price which greatly enhanced the value of the stock. By being the chief negotiator, no one knew as well as he the probability of the sale of the lands.³⁹ The director's

³⁷ *Id.* at 431-33.

³⁸ 213 U.S. at 431.

³⁹ *Id.* at 432.

conduct in working through an agent and paying for the stock using a check of a third party was strong evidence of an intent to defraud the shareholder.⁴⁰

In the first significant SEC enforcement action under Section 10(b) and Rule 10b-5, *In re Cady, Roberts & Co.*,⁴¹ the SEC held an insider liable for trades in the open market based upon two rationales: the existence of a relationship affording access to insider information intended to be available only for a corporate purpose and the “inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.”⁴² The rule that emerged was that corporate insiders had a duty under the antifraud rules to refrain from trading so long as they were privy to material information that was not public. This meant that there should be parity of information among market participants and anyone in possession of material inside non-public information was required to either disclose it to the investing public or abstain from trading in or recommending the securities concerned while such information remained undisclosed.⁴³ The Second Circuit, in *SEC v. Texas Gulf Suphur*,⁴⁴ affirmed the rule and developed a further justification for it, the equal access to information theory”, that the securities disclosure rules should be construed to promote the “justifiable expectation of the securities marketplace that

⁴⁰ *Id.* at 433.

⁴¹ 40 SEC 907 (1961).

⁴² 40 S.E.C. 907, 912 (1961).

⁴³ *SEC v. Texas Gulf Suphur*, 401 F.2d 833 (2d Cir. 1968)(en banc), *cert. denied*, 404 U.S. 1005 (1971).

⁴⁴ 401 F.2d 833 (2d Cir. 1968)(en banc), *cert. denied* 404 U.S. 1005 (1971).

all investors trading on impersonal exchanges have relatively equal access to material information.”⁴⁵ For these reasons, the duty to disclose or abstain from trading applied not only to insiders, but to anyone in possession of material non-public information.⁴⁶ However, these theories were later rejected by the Supreme Court in *Chiarella v. U.S.*,⁴⁷ where the court held that not all instances of unfairness amounts to fraud. Instead, although Section 10(b) is a catchall provision, what it catches must be fraudulent conduct. Thus, as the Court conceived it, fraud occurred where there was a false statement of a material fact, knowingly made, with an intent that the hearer rely to his detriment. In the case of nondisclosure, fraud occurs only if there is nondisclosure when there is a duty to speak. A duty to speak arises in the case of a fiduciary relationship or similar relationship of trust and confidence between the parties. In *Chiarella*, a printer whose company printed documents used in impending tender offers, and who bought shares based upon the information deciphered from these documents, did not engage in fraudulent conduct toward the sellers of those shares by his silence in the absence of any fiduciary relationship or relationship of trust and confidence with the company whose shares were traded or with the shareholders.⁴⁸

⁴⁵ 401 F.2d at 848.

⁴⁶ *Id.* at 84.

⁴⁷ 445 U.S. 222 (1980).

⁴⁸ The scholarly debate on the merits, efficacy, efficiency, and fairness of insider trading rules is legion. In general, see Henry G. Manne, *Insider Trading and the Stock Market*, 233 (1966)(arguing insider trading should be permitted as a form of executive compensation; that insider trading is a victimless crime, that insider trading does not cause the trades by the parties on the other side of the transaction); Dennis W. Carlton & Daniel R. Fishel, *The Regulation of Insider*

How does the classical theory apply where the fiduciary is selling, as opposed to purchasing the company's stock on the basis of material, non-public information? This is another anomaly in the classic insider trading theory, where the insiders are selling shares based on bad news to persons who theretofore were not shareholders of the company. This would seem to involve the classic arm's length transaction, involving no fiduciary duty on the part of the insider sellers. The Court in *Chiarella* stated that it would not follow its own logic to such a result.⁴⁹ In *In re Cady, Roberts*,⁵⁰ a broker-dealer was held liable for selling stock on the basis of material information received from corporate insiders to persons who previously were not stockholders in the corporation. The SEC embraced the reasoning of Judge Learned Hand that "the director or officer assumed fiduciary relation to the buyer by the very sale; for it would be a sorry distinction to allow him to use the advantage of his position to induce the buyer into the position of a beneficiary although he was forbidden to do so once the buyer had become

Trading, 35 Stan. L. Rev. 857(1983)(arguing -----); Donald C. Langevoort, *Rereading Cady, Roberts: The Ideology and Practice of Insider Trading Regulation*, 99 Colum. L. Rev. 1319, 1326 (1999); David Haddock & Jonathan Macey, A Coasian Model of Insider Trading, 80 Nw. U. L. Rev. 1449 (1986)(arguing that insider trading represents a cost borne in the first instance by market makers and passed along to other outsiders in the form of widened risk spreads); Ian B. Lee, *Fairness and Insider Trading*, 2002 Colum. Bus. L. Rev. 119 (2002)(arguing that notions of fairness require disclosure of material information and necessary for efficient market).

⁴⁹ 445 U.S. 222 (1980).

⁵⁰ 40 S.E.C. 907 (1961).

one.”⁵¹ The result is an extension of fiduciary obligations before the fiduciary relationship has been established. Such a view runs counter to fiduciary principles normally prevailing, but works to achieve the identified end behind the prohibition on using inside information.⁵²

1. Outsider Trading by Tippees

After *Chiarella*, the SEC did not fully concede the rejection of the parity of information and equal access to information theories, but argued that those persons who acquired material non-public information from corporate insiders (tippees) also acquired the fiduciary duties of their inside sources merely by receiving inside information from them; that they stand in the shoes of their sources. But this argument too was rejected by the Supreme Court in *Dirks v. SEC*.⁵³ There, the court ruled that a tippee is only derivatively liable for trading on the basis of material non-public information when the tippee knows or should have known that the disclosure of the information by the insider was improper and the tipper received some personal benefit from the disclosure. That benefit could be direct as cash or indirect as a reputational advantage which could translate into a personal gain in the future, or it could be evidence of a

⁵¹ *Grafz v. Calughton*, 187 F.2d 46 (2d Cir.), cert. denied 341 U.S. 920 (1951), quoted in *Cady Roberts*, 40 SEC at 914, n.23, quoted in *Chiarella v. United States*, 445 U.S. 222, 227 (1980); see also *United States v. Chestman*, 947 F.2d 551, 565, n.2 (2d Cir. 19--).

⁵² **CITE RESTATEMENT**

⁵³ *Langevoort*, *supra* note , at ----. In *Dirks*, an insider, one Secrist, disclosed to Dirks, a stock analyst, that massive fraud was occurring at the company, Equity Funding. Dirks passed the information along to some of his clients, who dumped \$16 million worth of Equity Funding stock.

“relationship between the insider and the recipient that suggests a quid pro quo. Even an attempt to make a gift of confidential information to a trading relative or friend can suffice, that being the same as the insider trading and giving the proceeds to the relative or friend. Thus, after *Dirks*, absent a showing of improper disclosure or improper benefit enuring to the tipper/insider, no Section 10(b)(5) or Rule 10b-5 liability results from tippee trading. Nor would liability arise to outsiders, such as Chiarella, who acquired and misused information from sources other than the issuer and its insiders.”⁵⁴

In the *Dirks* case, the Supreme Court thus refined the fiduciary principle for the purposes of the disclose or abstain rule by stating that the essential element of insider trading liability is the attempt by an insider-fiduciary to derive some personal benefit from information entrusted to him. Tipper “liability could then be rationalized as a means of prohibiting insiders from being able to do indirectly (profit personally in some pecuniary, reputational, or gift-giving way from the conveyance of information to others) what they are precluded from doing directly (profit by trading).”⁵⁵ Tippee liability, in turn, would be limited to those situations in which the tippee had notice of the insider’s self-serving behavior and could be seen as intentionally assisting it (as a participant after the fact).”⁵⁶

⁵⁴ *Switzer*

⁵⁵ *Id.* at ---.

⁵⁶ *Id.* at ---. In *Dirks*, the Supreme Court, found *Dirks* was not liable because he had no independent duty to Equity Funding--he was neither a traditional insider (officer, director), nor a temporary insider (an investment advisor, accountant), nor did he have a derivative duty through

As the court explained, “Section 10(b) is not an all-purpose breach of fiduciary duty ban.⁵⁷ Instead, it “trains on conduct involving manipulation and deception.” This manipulation or deception, i.e., fraud, “is consummated ... when...[the fiduciary] uses the information to purchase or sell securities” and thereby “gains no-risk profits,” if the information is put to an “other” use, no breach has occurred for purposes of the securities laws.⁵⁸ In other words, Section 10(b) “does not catch all conceivable forms of fraud involving confidential information, rather it catches fraudulent means of capitalizing on such information through securities transactions.”⁵⁹ Adherence to an approach of imposing liability merely because the outsider “harmed” the principal in some way, however, would mean the outsider potentially could be liable for insider trading where not even the slightest intent to trade on securities existed when he disclosed the information. Hence, the requirement that all tippers both insiders and outsiders must intend to benefit from the disclosure of confidential information.⁶⁰

Then, what about remote tippees? Is it sufficient that the insider derive a personal benefit from the immediate tippee or must it be shown that there was one from the remote tippee as well. “[T]he false logic in *Dirks* is the assumption that

Secrist, since the latter did not disclose the fraud for an improper purpose and did not receive any improper personal benefit for the disclosure.

⁵⁷ *O’Hagan*, 521 U.S. at 655.

⁵⁸ *Id.* at 656-57.

⁵⁹ *Id.* 656.

⁶⁰ *Id.*, cited in *SEC v. Yun*, 327 F.3d 1263, 1278 (11th Cir. 2003).

the tipper-tippee liability question can be viewed simply as a derivative form of the basic question of trading liability. It is much more accurate to say that what is wrong with tipping is it violates a fiduciary duty of impartiality-- duty not to discriminate unfairly among investors or classes of investors. A tip unjustifiably favors one shareholder over others, which alone provides the justification for holding both tipper and tippee liable for any resulting profits.”⁶¹

2. Rule 14e-3

The SEC responded to the potential loopholes and limitations left after *Chiarella* and *Dirks* by adopting Rule 14e-3.⁶² The rule provides that if any person has taken a substantial step or steps to commence, or has commenced a tender offer, it shall be unlawful for any person who is in possession of material information relating to such tender offer, who knows or has reason to know the information comes from either the offering person or the target company, or any insider (officer, director, partner or employee or any other person or such issuer of shares of corporations whose shares are sought), to purchase or sell or cause to be purchased or sold any of the securities, until the information is publicly disclosed. This prohibition applies without regard to the existence of any common law fiduciary relationship between the trader and the corporations whose shares are traded or the shareholders, as required under Rule 10b-5. The Supreme Court upheld the power of the SEC to adopt such a rule despite this omission on the

⁶¹ *Id.* at ---.

⁶² 17 C.F.R. § 240.14e-3.

theory that the SEC's prophylactic rulemaking power under Section 14(e) was much broader than under Section 10(b); that the SEC could adopt measures to prohibit acts not themselves fraudulent under common law or Section 10(b) if the prohibition was reasonably designed to prevent acts and practices that are fraudulent.⁶³

If Rule 14e-3 seemed to plug a loophole in the theory of insider trading, it also resulted in the erratic treatment of insider trading by according different treatment to tender offers than in other transactions.⁶⁴

E. Fraud on the Source of the Information

The other theory of insider trading is the misappropriation theory, which holds that a person commits fraud "in connection with" a securities transaction, and thereby violates §10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information. "Under this theory, a fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that

⁶³ *O'Hagan*, 521 U.S. 642 at 671-73.

⁶⁴ For example, in *SEC v. Switzer*, 590 F. Supp. 756, 758 (W.D. Okla. 1984), a famous football coach overheard a discussion by a corporate insider about an impending tender offer, bought shares in the target company then sold them in response to the tender offer announcement, at a profit. He was convicted under insider trading laws, but his conviction was overturned as the trading took place before the adoption of Rule 14e-3 and thus governed by *Chiarella*. Since he had no duty to the corporation or the shareholders from whom he purchased his stock, he was not liable under Rule 10b-5. But if Rule 14e-3 applied, his conviction would have stood.

information.”⁶⁵ “In lieu of premising liability on a fiduciary relationship between the company insider and purchaser or seller of the company’s stock, the misappropriation theory premises liability on a fiduciary-turned-trader’s deception of those who entrusted him with access to confidential information.”⁶⁶ The anomaly here is that, one avoids liability under the misappropriation theory by disclosing an intent to trade to the source of the information before trading, since this disclosure avoids the deception.⁶⁷ But this still leaves the party on the other side of the transaction exposed and subject to injury if disclosure is also not made to her. Since disclosure to the source of the information does nothing directly to avoid the harm to the individual trader on the other side, some other justification or explanation for the misappropriation theory must be found. It may be concerns about the integrity of the market, “absent an acceptable broad prohibition on insider trading, investor confidence in the integrity of the ... trading markets would diminish, threatening their depth and liquidity.”⁶⁸

F. Selective Disclosure under Regulation FD

Until recently, selective disclosure of material nonpublic information by corporate insiders to institutional investors, analysts and other market insiders was not proscribed by statute or regulation, absent a showing that the selective disclosure was made for the purposes of a personal benefit to the insider doing the

⁶⁵ *O’Hagan*, 521 U.S. at 652.

⁶⁶ *O’Hagan*, 521 U.S. at 652.

⁶⁷ *O’Hagan*, 521 U.S. at 655.

⁶⁸ Langevoort, *supra* note , at 1325, citing *O’Hagan*, 521 U.S. at 658.

disclosing. In effect, selective disclosure was a form of lawful tipping and tippee trading by select persons based upon this material nonpublic information was not actionable. In August 2000, the SEC enacted Regulation FD.⁶⁹ The SEC was concerned with the apparent unfairness of this selective disclosures. The SEC sought to address several concerns underlying selective disclosure, including that issuers often disclosed important nonpublic information, such as advance warnings of earnings results, to securities analysts and/or institutional investors before making the information public, with the result that the investing public was not on an equal footing with market insiders and would therefore lose confidence in the integrity of the market place. Further, selective disclosure looked very much like tipping inside information, although the practice was not covered by the then state of insider trading theory. Also, the SEC saw a threat to the integrity of the markets by insiders selectively disclosing information in hopes of favorable reviews by analysts. Finally, recent technological advances in communications meant no impediments to timely public disclosure.⁷⁰ The rule provides that “when an issuer, or person acting on its behalf, discloses material nonpublic information to [selective] persons..., it must make public disclosure of that information.”⁷¹ If the selective disclosure was intentional, the issuer must publicly

⁶⁹ Selective Disclosure and Insider Trading, Exchange Act Release No. 43,154 [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶86,319, and 83,676 (August 15, 2000), 17 C.F. R. § 243.100(a).

⁷⁰ *Id.* at 83, 677-78. See generally, Marc I. Steinberg, *Insider Trading, Selective Disclosure, and Prompt Disclosure: A Comparative Analysis*, 22 U.Pa. J. Int’l Econ. L. 635, 648-59 (2001).

⁷¹ *Id.* at 83, 676., 17 C.F. R. § 243.100(a).

disclose the information simultaneously by filing or furnishing a Form 8-K to the SEC or in a manner reasonably designed to provide broad distribution of the information. If the disclosure was unintentional, the issuer must disclose the information to the public promptly, but in no event after the later of 24 hours or the opening of the next day's trading on the New York Stock Exchange.⁷²

III. The Soundness of the Policy Behind the Prohibition Against Insider Trading

Why prohibit insider trading? What is the harm caused by it? There are at least three commonly offered justifications for the prohibition of insider trading: 1) to ensure fairness and equity-- based on the "inherent unfairness involved where a party takes advantage of [inside] information, knowing it is unavailable

⁷² *Id.* at ----. Violation of the rule results in civil enforcement action by the SEC, but the rule itself does not impose any Section 10(b) antifraud liability on the issuer or establish a private right of action. The regulation applies by its express terms to "a person acting on behalf of an issuer", defined as a senior official of the issuer or any other officer, employee, or agent of an issuer who regularly communicates with any of the enumerated recipients of information. However, a senior official is not insulated from liability by directing non-covered personnel to make the proscribed disclosures, but would be liable under Section 20(b) of the Exchange Act. The regulation expressly excludes a "person who owes a duty of trust or confidence to the issuer", such as a temporary insider; a "person who expressly agrees to maintain the disclosed information in confidence"; a credit rating agency, "provided the information is disclosed solely for the purpose of developing a credit rating and the entity's ratings are publicly available"; and with certain exceptions, in connection with "a securities offering registered under the Securities Act." *Id.* at ---
----- . While not expressly mentioned, disclosures to the media or communications to government agencies are not covered by the regulation. *Id.* at ----- . Among other things, "material information" includes information on earnings; mergers, acquisitions, tender offers, joint ventures, or changes in assets; new products or discoveries, or developments regarding customers or suppliers; changes in control or management; change in auditors; events regarding the issuer's securities; bankruptcies or receiverships, and other such information that likely would be significant to a reasonable investor. *Id.* at ----- .

to those with whom he is dealing;”⁷³ 2) to promote the flow of information to the market, allowing it to better perform its function of evaluating securities and allocating capital, the “integrity of the market” theory ; and 3) to protect the property rights of the corporation whose information is the basis for insider trading--“information intended to be available only for a corporate purpose and not for the personal benefit of anyone.”⁷⁴ All three justifications, though, have been debated. First, the unfairness is questioned on the assertion that insider trading does not cause trading by persons on the other side of the transaction, that they would have been in the market anyway ⁷⁵ that it is a victimless offense.⁷⁶

Professor Langevoort describes the restriction on insider trading as “largely

⁷³ *In re Cady, Roberts*, 40 SEC 907, 912.

⁷⁴ *Id.* at 912; *See generally*, Kenneth Scott, *Insider Trading, Rule 10b-5, Disclosure and Corporate Privacy*, 9 J. Legal Studies 801 (1980).

⁷⁵ *See* Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 11 Sup. Ct. Rev. 309 (1981). Easterbrook argues that even if insiders causes some investors to sell in advance of the price rise that follows disclosure of material information, and insider trading reduces the likelihood that an active trader will obtain the highest possible price, investors might still not be harmed. If there is a chance that they will be short-changed as a result of insiders’ purchases, shareholders will respond by bidding less for the stock in the first place; the lower price compensating for the ex ante risk. Easterbrook explains: “If the discount accurately reflects the odds, then it is hard to see any unfairness in the process.” And, “because all traders, at any given time, deal at the same price, the self-protective moves of sophisticated traders protect the unsophisticated as well.” The stockholders who lose out in one round of insider trading are compensated by the increased gains they obtain if their shares (purchased at a small discount) are not scooped up by insiders and thus appreciate more in other cases.” But the fallacy in this argument is in the “ifs” and the assumption that purchasers are knowledgeable about the frequency of insider trading; are sufficiently astute to discount the value of the shares; and that shareholders know the odds.

⁷⁶ Manne argued that insider trading harms no one because the people who buy when insiders are selling and those who sell when insiders are buying, actually benefit from insider trading, since they would have traded anyway and most likely at a less favorable price in the absence of insiders’ trades, the theory being that the insiders’ trades exerted a downward pressure on the stock price, resulting in a lower purchase price to the outside investor and a smaller loss after announcement of the information resulting in a decline in the stock price; and even assuming that insider trading did expose outside investors to the risk of losses, the market price would adjust to ensure that investors continued to receive an appropriate return.

emotional in its genesis, a political response to the demand for an appearance of equity in both the securities marketplace and society generally.”⁷⁷ He points out that “[i]t is hard to make the case that the typical investor is systematically better off, as far as his or her own particular trading opportunities are concerned, as a result of an insider trading prohibition. Yet, the political rhetoric of insider trading legislation and enforcement is largely directed to such investors (if not the public at large).”⁷⁸ Professor Langevoort believes insider trading laws are of the “same ideological roots underlying other legal rules that purport to neutralize some of the excessive advantages of economic power, size, and status, in order to satisfy those who feel unfairly disadvantaged by the absence of power, size, or status.”⁷⁹

Some have criticized *Chiarella* in recognizing that anonymous trading on an impersonal exchange or in the over the counter market, which contains no communicative content as to possession of non-public information or anything else, could be said to be fraudulent as to persons who are trading contemporaneously in the sense of causing detrimental reliance. Professor

⁷⁷ Donald C. Langvoort, *Setting the Agenda for Legislative Reform: Some Fallacies, Anomalies, and Other Curiosities in the Prevailing Law of Insider Trading*, 39 Ala. L. Rev. 399 (1988).

⁷⁸ *Id.* at ----. Professor Langevoort explains that professional investors are far more likely to benefit from insider trading prohibition since they are “next in line” with respect to an opportunity to trade immediately upon disclosure. While that group might well exercise some political pressure for insider trading regulation, this alone would not seem to explain completely the regulation. Instead, it seems the public fascination with recent insider trading scandals has prompted the political reaction, legislators taking advantage of political gain from a regulatory response. *Id.* at ----, n.6

⁷⁹ *Id.* at ----.

Langevoort argues that it is hard to conceive of the conduct as deceptive;⁸⁰ that the anonymous trade on the open market or the over-the-counter market, does not conjure up the elements of common law fraud where the trading is without communicative content. Under the common law, it had long been the case that an agent was required to disclose all material information when transacting with his principal. Functionally, the common law approach was designed to avoid the detrimental reliance that might result from the trust actually placed in the agent by the principal. In such face to face bargaining situation, self-serving conduct by the fiduciary may in fact be deceptive.⁸¹ But not so in the open market trading where shareholders have no idea with whom they are trading, “and offers to purchase or sell carry no communicative content.”⁸² Professor Langevoort asks “is it a relevant concept when trading is in the anonymous marketplace?” Thus, according to him, it is doubtful in what sense the trading has the capacity to mislead those trading contemporaneously, “[f]inding the deception resulting from the duty to disclose is conclusory, and begs the question of how the imposition of such a duty prevents deception.”⁸³ In response to Langevoort, one could say that purchasers of shares on an anonymous market are relying on a representation by the seller by his failure to disclose, that the market price reflects all available

⁸⁰ See Daniel C. Langevoort, *Setting the Agenda for Legislative Reform: Some Fallacies, Anomalies, and Other Curiosities in the Prevailing Law of Insider Trading*, 39 Ala. L. Rev. 399 (1988).

⁸¹ Langevoort, *supra* note----, at ----.

⁸² *Id.* at ---.

⁸³ *Id.* at ---.

information necessary to setting a price, when in fact the insider/trader knows otherwise. Therein lies the deception. At the same time, Professor Langevoort argues that the rule requiring some sort of fiduciary relationship is underinclusive, as the common law contained numerous circumstances where “an affirmative disclosure was required where societal precepts of honesty and fair dealing demanded it.”⁸⁴ Professor Langevoort states that such a restrictive approach was probably not a misreading of the common law, “but rather the false assumption that such a limited rule would give the law clarity by providing due notice to those who trade in securities.”⁸⁵ But the cost is “a wedge [that] now separates the intuitive sense of when instances of trading on the basis of material nonpublic information are abusive and the doctrinal framework used to decide specific cases involving such trading.”⁸⁶ It seems a more coherent basis for the prohibition is founded on notions of fairness that insiders should not profit from information obtained from their positions while the beneficial owners of the corporation are disadvantaged,⁸⁷ and on the need to protect the integrity of the market; proscribing trading while in possession of material non-public information is to make investors confident that they can trade securities without being subject to

⁸⁴ *Id.* at ---.

⁸⁵ *Id.* at ---.

⁸⁶ *Id.* at ---.

⁸⁷ *Id.* at ---.

informational disadvantages.⁸⁸ Under *Chiarella*, however, there are relational limits to these ends, although the classical theory of insider trading applies not only to directors, officers and certain employees, but also to attorneys, accountants, consultants, and others who temporarily become fiduciaries of a corporation, as well as their tippees.⁸⁹

But, in Professor Langevoort's view, "the refinement [by the *Dirks* analysis] of the insider trading prohibition further separated doctrine from reality. "The intuitive sense of why the friend of a company's chief executive officer should not trade on the basis of information imparted to him during a golf outing has little to do with the determination that the officer has somehow gained something from the conversation."⁹⁰ Yet, this seems to be the reasoning under *Dirks*. Then, what if the issuer itself repurchases its securities in the open market while possessing material nonpublic information indicating that a prevailing market price is too low. "Assuming the managers of the corporation who cause the repurchase have no significant ownership interest in the corporation, does the fact that they act solely in what they perceive to be the corporation's best interests

⁸⁸ Joel Seligman, *The Reformation of Federal Securities Law Concerning Non public Information*, 73 Geo. L.J. 1083 (1985)(arguing that the basis of the integrity of the market policy is both historical and theoretical, citing to President Roosevelt's statement at the time of passage of the 1933 securities bill, that by "putting the burden of telling the whole truth on the seller," the proposed act "should give impetus to honest dealing in securities and thereby bring back public confidence." The assumption was that investors would be more willing to purchase securities when compulsory disclosure of material information reduced the incidence of fraud, increased the reliability of estimates of firm value, and reduced the volatility of securities price swings. *Id.* at --

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⁸⁹ *O'Hagan, citing Dirks v. SEC*, 463 U.S. 646, 655, n.14 (1983).

⁹⁰ *Id.* at ---.

(i.e., no personal benefit being sought) preclude the imposition of liability?”⁹¹

The answer should be no, but *Dirks* could be read to hold the opposite.⁹²

Second, under the integrity of the market theory, it is argued that “proscribing trading while in possession of material nonpublic information is necessary to ensure the integrity of the market. The assumption is that investors will be more willing to purchase securities when compulsory disclosure of material information eliminates the informational advantages held by insiders, reduces the incidence of fraud, increases the reliability of estimates of firm value, and reduces the volatility of securities price swings. Investors will choose investments which they perceive offers the least risk.”⁹³ Such investor confidence has a larger economic consequence-- reducing the risk premium that issuers would have to pay, thereby increasing the funds available for economic growth and reducing the volatility of market price swings (caused by investor ignorance of material information), which will tend to increase the allocative efficiency of the market.⁹⁴

⁹¹ *Id.* at ---.

⁹² *Id.* at ---.

⁹³ Seligman, *supra* note at ---.

⁹⁴ Seligman, *supra* note at 1118. Faster dissemination of material information as would be required by mandatory disclosure, improves allocative efficiency in that information on firms with promising probable future earnings will cause the prices of these securities to rise; and the market price for securities of firms with less promising prospects will decline. Thus, the market allocates its resources towards investments with the greatest prospects. Seligman, at 1119. Easterbrook asserts that the market price of stock will not move unless other traders guess that insiders are trading based upon inside information; that while “purchases often convey information to the market about the prospects of the firms, if the information indicates the firm’s prospects are better than those previously perceived, the price of the shares rises.” But “large purchases give the

Some argue that insider trading provides a corrective function to the market's pricing mechanism; the market reacting to trading, causing the price of shares gradually to reflect the information that was not public.⁹⁵ The argument is that given that vast amounts of information are quickly available about corporate issuers and electronic communication is instantaneous, the market themselves will provide an adequate corrective for temporary informational advantage that insiders may have by promptly reporting the trading that occurs.⁹⁶ Furthermore,

market a good deal of information. Traders find out or infer why one person is buying so much, and the new knowledge causes prices to adjust. For this reason, large transactions for technical, portfolio-adjustment reasons should have no effect on price, while smaller purchases based on new information should have an effect, even a dramatic one. This seems the pattern in the market. The insider's trading thus may lead to price adjustments, but only to the extent that insider's secret has leaked to the market or been inferred by traders." Easterbrook at ---.

Some scholars have identified a tension between the first two justifications for insider trading that the SEC continues to strive to resolve. Allocative inefficiency results where the stock is inaccurately priced, because capital is directed away from its most efficient use and distributive unfairness results where an "insider" takes advantage of information made available for corporate purposes and trades with an unknowing party on the other side. Yet, it is arguable that this transfer may increase allocative efficiency by causing the price of the security to move in line with what it would be valued in a fully informed market. To prevent distributive unfairness, the securities laws seek to equalize access to material informational advantages, but only to the extent the informational advantages result from a violation of a duty owed to another, the corporation or the other trading party. This encourages investors to pay more for the same securities because there is less risk that they will be exploited by those trading with informational advantages, which in turn ensures corporations receive a higher price for the stock, and thus have a lower cost of capital, thereby fostering allocative efficiency. The tension arises because if a rule of equal access is strictly enforced, there is less incentive to search for new information (because the party who finds it may not be able to use it lawfully). This reduced incentive for market participants may result in allocative inefficiency because the market price of a security may be a less reliable indication of what a firm's value would be in a fully informed market. If market prices are less certain or fluctuate widely, investors may lose confidence and invest otherwise. CHOPER, COFFEE, & GILSON, *supra* note at 308.

⁹⁵ See Carlton & Fischel, *supra* note ---, at ---.

⁹⁶ See H. MANNE, *INSIDER TRADING AND THE STOCK MARKETS* (1966); Manne, *Insider Trading and the Law Professors*, 23 Vand. L. Rev. 547 (1970).

significant empirical evidence has shown that insider trading does not have a significant impact on market prices.⁹⁷

Other scholars, however, find valid policy bases for the regulation of unfair informational advantages, even in the impersonal, high speed securities markets. There is the argument that there is the moral hazard, that if permitted to trade, insiders will have an incentive to delay disclosures so as to increase their opportunities to profit from the market's ignorance, thus harming outsiders who trade.⁹⁸ If it is the case that insiders will only buy stock when it is undervalued and sell when it is overvalued, there can be no question of harm to uninformed investors.⁹⁹ There is harm to unknowledgeable shareholders which is caused by insider trading, because it deprives a blameless shareholder or potential shareholder of the profits he or she otherwise would have enjoyed or make them poorer by spending more than the stock is worth.¹⁰⁰ Management might also

⁹⁷ Seligman, *supra* note --- at ---.

⁹⁸ Lee, *supra* note ----- at 160.

⁹⁹ *Id.* at 160. Lee goes on to refute Manne's argument that outside investors are not harmed because they would have traded anyway, finding Manne's distinction between time-function and price-function trading not meaningful, since at the critical time, of even a time-function trade, any investor whose decision to buy, sell or hold, is at all sensitive to price, is injured because such trader may find a match in the market only because of the presence of insiders generating additional supply or demand on the other side. *Id.* at 164. Lee also refutes Manne's argument that insider trading causes an adjustment in the market price of shares traded, arguing that the fact that some investors may have been aware of insider trading does not answer the complaint of less sophisticated investors who are unaware of the existence and extent of insider trading. *Id.* at 167.

¹⁰⁰ Seligman, *supra* note---, at ---. Seligman gives the example of an insider who knows that a mineral discovery will double the firm's stock price from \$10.00 per share to \$20 per share. If the insider buys stock at \$10 per share from existing shareholder A, the insider has not harmed A, since A was willing to sell at \$10 per share in any event. But potential shareholder B, who would have bought shareholder A's shares at \$10 per share, has been harmed. At the least, potential shareholder B must pay a higher price for other shares than the shares otherwise would have

seek to manipulate corporate press releases and other communications with the press in order to accentuate stock volatility. Further, managers might be inclined to adopt riskier new businesses ventures than they otherwise would have, on the thinking that whether the new venture succeeds or fails is irrelevant so long as they can trade their stock before news of failure becomes public.¹⁰¹ This may very well describe the goings on in Enron in its final months where the board of directors deviated from its very strict ethics policy about self-dealing transactions allowing Faslow to deal with the company in off-book transactions that were a drain on company revenues. Ken Lay, kept urging public investment in the company's shares, all the while disposing of millions of shares in his own accounts, not disclosing what he knew about the underlying fraud and impending collapse.

The third, rationale for the prohibition on insider trading, that is to protect the information rights of the corporation has been debated on the ground that state common law rules on theft and conversion are sufficient to address the corporate business property concern. Also, it is said that express provisions in employment and other written contracts could more efficiently limit the use of

commanded. At the most, potential shareholder B may find the new price too high and may not purchase at all, thereby losing the profit he or she otherwise would have enjoyed as the stock price rose from \$10 to \$20. But Seligman's example is too narrow. Would shareholder A, even though inclined to sell, have sold to the insider at \$10, if she had the same information as the insider? The rational seller would hold out for more.

¹⁰¹ Joel Seligman, *Reformulation of Securities Law Concerning Non-Public Information*, 73 Geo. L. J. 1083 (1985).

such information by insiders. Indeed, some have argued that insider trading should be allowed as a form of executive compensation of social value, because it encourages entrepreneurship and rewards analytic research and initiative.¹⁰² However, there are many forms of performance-related or stock-price-based compensation schemes available that do not depend on the executive's capital resources or skills or use of information to calculate the amount earned. Nor, is it the case that the information is the result of entrepreneurial innovation as opposed to the fortuity of being an insider and privy to valuable information.¹⁰³

What if the corporation were to authorize insider trading? If the essence of the liability is the misuse of corporate information for personal gain, it would seem to follow that the board of directors of a corporation (or managers with delegated authority) could properly insulate all subordinates from liability-- absent a showing of conflict of interest-- by declaring that all insider trading is not a breach of fiduciary duty, but rather a part of executive compensation. Once again, according to Professor Langvoort, "this sort of privatization would effect a radical break with our intuitive notion of the correct solution."¹⁰⁴

Strudler and Orts,¹⁰⁵ argue that moral principles justify the prohibition on insider trading; that the focus on fairness and economics concepts were not

¹⁰² *Id.*

¹⁰³ Kenneth Scott, *Insider Trading, Rule 10b-5, Disclosure, and Corporate Privacy*, 9 J. Legal Studies 801, --- (1980).

¹⁰⁴ *Id.* at ---.

¹⁰⁵ Alan Strudler and Eric Orts, *Moral Principles in the Law of Insider Trading*, 78 Tex. L. Rev. 375 (1999).

complete theories. They argue that the traditional insider trading theory, premised on breach of fiduciary duty owed by the insider to the corporation's shareholders rests on an incorrect legal assumption. Technically, corporate directors, officers, and employees do not owe fiduciary duties to shareholders, but rather to the corporation as a legal entity.¹⁰⁶ The traditional theory further cannot account for all of the relevant cases that the Supreme Court recognizes as insider trading, for instance, "outsider trading."¹⁰⁷ Then, there is the case of the insider who sells shares to a person who is not yet a shareholder of the insider's firm. Because the prospective purchaser had no relationship with the firm before the transaction, the corporation insider violates no corporate fiduciary duty. To say that the prospective shareholder will soon be a real shareholder, and it is therefore fair to extend the corporate fiduciary obligations to soon-to-be shareholders, is an extension, but one that is "an evasion".¹⁰⁸ Though it would be unfair to allow an insider to trade on this basis, the traditional insider trading theory cannot adequately explain the nature of this unfairness.¹⁰⁹

Strudler and Orts also criticize the equal access and parity of information theories. Under the parity of information rationale, fraudulent insider trading occurs when one party to a securities transaction possesses significantly better

¹⁰⁶ *Id.* at 390.

¹⁰⁷ *Id.*

¹⁰⁸ *Id.* at 391-92.

¹⁰⁹ *Id.* at 392.

information than does the other party to the transaction.¹¹⁰ But, this theory is questionable where it does not explain why taking advantage of an acute asymmetry of information is wrong in the trading of securities, or why the use of unequal information amounts to fraud.¹¹¹ It may be wrong under very limited circumstances, but it is not inherently wrong. The early rationale espoused in *In re Cady, Roberts*,¹¹² is misguided, they say. First, securities markets depend by their very nature upon some traders having better information than others; markets are not perfectly efficient and a relatively efficient securities market requires a “critical mass of person believing that it is worthwhile to try to beat the market” with better information.¹¹³ Thus, even the most efficient markets will therefore be characterized by a dynamic flux in the distribution of information, not by equality of information.¹¹⁴ Second, information disparity may arguably be desirable on economic grounds where it is likely to encourage the development of traders specializing in particular industries and companies. Society should encourage people and business to seek out valuable information by establishing disclosure rules that provide incentives to invest time and effort to search for such information.¹¹⁵ Third, and most importantly, the reason to reject the equal information rationale is that an informational advantage may be morally deserved

¹¹⁰ *Id.* at 400.

¹¹¹ *Id.*

¹¹² [cite]

¹¹³ *Id.* at 401.

¹¹⁴ *Id.* at 401.

¹¹⁵ *Id.* at 402.

or at least morally neutral.¹¹⁶ If one works hard to discover or produce valuable information, or otherwise legitimately acquires a right in information, then one deserves to enjoy the benefits, including the right to use that information to a bargaining advantage.¹¹⁷ However, Strudler and Orts qualify their license to use information in cases where the acquisition of the information is illicit. They argue though, that the illicit acquisition rationale¹¹⁸ also does not provide a complete justification for the prohibition on insider trading. First, the economic consequences are disputed and perhaps unknowable; the relevance of economic concerns cannot be established without determining whether insider trading morally wrongs those who are its alleged victims; an intuitive sense of fairness is too vague and unreliable to serve as a basis of legal decisionmaking. The illicit acquisition rationale requires a moral principle or set of principles more precise than a simple appeal to an intuitive sense of fairness.¹¹⁹ Yet, not every wrong is a fraud and the theory does not connect the wrongful acquisition of the information to a victim in a securities transaction.¹²⁰ The wrong is probably best understood as a violation of a principle proscribing unjust enrichment.¹²¹ But a prohibition based on notions of unjust enrichment would prove too much, covering instances in which any ill-gotten advantage, such as embezzlement not misuse of

¹¹⁶ *Id.* at 402.

¹¹⁷ *Id.* at 402-03

¹¹⁸ discussed by Chief Justice Burger in *Chiarella*, 445 U.S. 222.

¹¹⁹ *Id.* at 405-06

¹²⁰ *Id.*

¹²¹ *Id.* at 406.

information, would be securities fraud. The point of unjust enrichment is to block a person from enjoying a wrongfully obtained benefit by forcing people to disgorge ill-gotten gains, the point of the law of fraud is to protect people from becoming victims of trickery or deception. An adequate moral theory of securities fraud in insider trading must show not merely why corrective actions should be taken against someone who wrongfully gains from using stolen information in a securities transaction, it must also show an essential link between taking such corrective action and vindicating the rights of a victim of securities fraud.¹²² Unjust enrichment fails in this regard. At the heart of securities fraud by insiders trading is the idea of deception. A person who has been defrauded is a victim of deceit.¹²³ Yet, trading on the basis of information obtained by luck is not actionable, nor morally wrong. Because either disclosure rule gives someone a benefit and someone a loss, equitable considerations are compromised no matter which rule is adopted. Strudler and Orts offered an alternative basis for the prohibition against insider trading, based upon an “equitable disclosure rationale”. They argue that nondisclosure violates the other party’s autonomy in making a fully informed decision. Insider trading liability should be premised on the moral wrong of improperly acquiring inside information to a misuse that is inconsistent with the autonomy of the person with whom the wrongdoer trades.¹²⁴ They argue

¹²² *Id.* at 408.

¹²³ *Id.*

¹²⁴ *Id.* at 428-29.

that there is nothing wrong with a rule that permits people who are lucky enough to stumble on valuable information from using the information to their advantage on the market. Shifting the focus away from fiduciary duty between insider and trader on the other side to fiduciary and the party regarding his autonomy trading is wrong not because of the wrong to the source of the information, but because the conversion and misuse of otherwise legitimately possessed information compromises the autonomy of public investors.¹²⁵ Strudler and Orts, perhaps make too much of the two asserted rationale for the prohibition against insider trading, since both have been rejected by the Supreme Court.¹²⁶ Further isn't a trader who is denied an autonomous decision deceived? Isn't the point of Section 10(b) and Rule 10b-5 to ensure an informed intelligent, hence autonomous investment decision? Beyond this should federal securities laws be concerned with the individual autonomy of investors?

The debate over the merits of the prohibition of insider trading takes on a wholly different dimension when it is asserted by employee-shareholders that not all trading on the basis of material non-public information should be prohibited, that is, they should be permitted to dispose of company stock on this basis when necessary to safeguard their pension plans funded primarily by company stock. They would extend the rationale for not prohibiting trading in the absence of a duty, to not prohibiting trading where there is a dual duty, such as that owed by a

¹²⁵ *Id.* at 429.

¹²⁶ *Chiarella*, 445 U.S. 222; *Dirks*; *O'Hagan*, 521 U.S. 642.

plan fiduciary who is also a corporate insider privy to material non-public information.

IV. ERISA and Fiduciary Duty to Plan Participants

In 1974, Congress adopted the Employer Retirement Income Security Act,¹²⁷ designed to regulate employee investment, pension, and health benefit plans by setting certain minimum standards for participation, vesting, and funding, and imposing various fiduciary duties on those who manage such plans.¹²⁸ Under ERISA, “Congress sought to protect and strengthen the rights of employees, enforce uniform fiduciary standards, and encourage employers to create and maintain benefit plans for their employees.”¹²⁹

A. Defined Contribution Plans and Defined Benefit Plans Under ERISA

There are two basic types of pension plans contemplated by ERISA: defined-benefit and defined-contribution plans. Defined-benefit plans pay fixed or determinable benefits. The benefits ordinarily are described in a formula which specifies the amount payable in monthly or annual installment to participants who retire at a certain age. As long as the plan and the employer contributing to the plan remains solvent, and the plan continues to be operated,

¹²⁷ 29 U.S.C. § 1000-1461.

¹²⁸ *Wright v. Oregon Metallurgical Corp.*, 360 F.3d 1090 (9th Cir. 2004); *Levy v. Chandler*, 287 F. Supp.2d 831, 834 (E.D. Tenn. 2003).

¹²⁹ *Id.*

vested participants will receive the benefits specified. In the event that investment results of the plan do not meet expectations, the employers usually will be required, on the basis of actuarial computations, to make additional contributions to fund the promised benefits. If, on the other hand, the plan's earnings are better than anticipated, the employer may be permitted to make contributions that are less than the projected amounts.¹³⁰ The employer determines the amount of its future pension obligations and sets aside the funds needed to meet those obligations.¹³¹

A defined-contribution plan, on the other hand, does not pay any fixed or determinable benefits. Instead, benefits vary depending upon the amount of contributions, the investment success of the plan, and allocations made of benefits forfeited by non-vested participants who leave their employment.¹³² Often, a defined contribution plan is supplemented by a matching contribution from the employer. The joint contributions are then allocated to employees' individual

¹³⁰ 29 U.S.C. § 1002(35); *see also* SEC Release No. 33-6188, 1980 WL 29482, at *6-7 (Feb. 1, 1980).

¹³¹ David Millon, *Symposium: Enron and its Aftermath: Worker Ownership Through 401(k) Retirement Plans: Enron's Cautionary Tale*, 76 St. John's L.Rev. 835, 837 (2002). *See also* Sharon Reece, *Enron; The Final Straw and How to Build Pensions of Brick*, 41 Dug. L. Rev. 69 (2002)

¹³² 29 U.S.C. § 1002 (34); *see also* SEC Release No. 33-6188, 1980 WL 29482, at *6-7 (Feb. 1, 1980). With defined contribution plans, the employer maintains individual accounts for each participant, those accounts reflecting each participant's share of the underlying trust assets and are adjusted annually to take into account plan contributions, earnings, and forfeitures. In contrast, defined benefit plans do not maintain separate individual accounts, except to the extent necessary under the Internal Revenue Code to record benefits attributable to voluntary contributions by employees. *Id.*

account.¹³³ Under most defined-contribution plans, the employee, not the employer, decides how their contributions will be invested. This power applies to both the employee contributions and those made by the employer.¹³⁴ The trend in recent years had been toward establishing defined contribution plans and away from defined-benefit plans.¹³⁵ This trend is remarkable in that the two types of plans differ in the allocation of investment risk.

Under the defined-benefit plan, the employer obligates itself to a defined payout, which means that if it sets aside insufficient funds or if those funds are invested in securities that perform poorly, the employer bears the risk and may find itself unable to meet its commitment under the plan.¹³⁶ In contrast, under a defined-contribution plan, the employee who directs investments, will realize benefits based upon the value created by those investment choices.¹³⁷ The 401(k) plan, named for the Internal Revenue Code provision under which employees are allowed to defer taxation on contributions to qualified pension plans, is the most common type of defined contribution pension plan and the primary vehicle for retirement security in this country-- approximately forty million Americans

¹³³ *Id.* at 838.

¹³⁴ *Id.*

¹³⁵ *Id.*; see also Lorraine Schmall, *Defined Contribution Plans After Enron*, 41 Brandeis L. J. 891, 894, 905-06 (arguing that defined contribution plans should not be considered pension plans because the constant risk of loss obviates a secure retirement). Defined Benefit plans but not defined contribution plans are also insured by the Pension Benefit Guaranty Corporation, a federal agency that steps in to pay a percentage of private benefits when the plans terminate pension with a sufficient asset. <http://www.pbgc.gov>.

¹³⁶ *Id.*; Schmall, *supra* note , at 894.

¹³⁷ *Id.*

participate in such plans.¹³⁸ Defined contribution plans also include Employee Stock Ownership Plans (“ESOP”), a plan that primarily invests in shares of stock of the employer.¹³⁹

Typically, the defined contribution plan gives the employee a menu of diversified mutual funds and other investment options selected by the employer, which can include the employer’s own stock. The employer’s matching contribution can and is typically in the form of company stock and under many such plans, this is the only option.¹⁴⁰ When this occurs, typically, the employee will not be allowed to sell those shares and reinvest the proceeds until he or she reaches a defined age, often fifty, fifty-five, or sixty.¹⁴¹ Diversification is not required under ERISA for defined-contribution plans, but is required for defined benefit plans, and such plans may not hold more than ten percent of plan assets in company stock.¹⁴² In creating ESOP’s Congress sought to develop plans that would function as both “employee retirement benefit plan and a technique of

¹³⁸ *Id.*

¹³⁹ 29 U.S.C. § 1102(a). An employer desiring to set up an ESOP will execute a written document to define the terms of the plan and the right of beneficiaries under it. 29 U.S.C. § 1102(a). The plan document must provide for one or more named fiduciaries “to control and manage the operation and administration of the plan. *Id.* at 1102(a)(1). A trust will be established to hold the assets of the ESOP. *Id.* at 1103. The employer may then make tax-deductible contributions to the plan in the form of its own stock or cash. If cash is contributed, the ESOP then purchases stock in the sponsoring company, either from the company itself or from existing shareholders.

¹⁴⁰ *Id.* At Enron, the defined contribution plan permitted only matching contributions in the company’s stock.

¹⁴¹ *Id.* At Enron, that age was fifty. Sharon Reece at 94.

¹⁴² 29 U.S.C. § 1107(a)(2).

corporate finance' that would encourage employee ownership of a company.¹⁴³ As a result of these dual purposes, ESOPs are not intended to guarantee retirement funds and they place employee retirement assets at a greater risk than the typical diversified, ERISA-regulated plan.¹⁴⁴

It was reported that for all plans offering company stock as an option, the average amount of plan assets allocated to that investment option is nearly forty-two percent; that number is higher at some companies.¹⁴⁵ At Enron, it was nearly two-thirds.¹⁴⁶ This over-investment is unduly risky and may result not only from the naiveté of the employee-investor, but from encouragement from management as occurred in Enron.¹⁴⁷ Employee naiveté in the overinvestment in the company stock may be based upon unrealistic expectations of growth based on the historical growth rate of the company.¹⁴⁸ Yet, a stock price collapse, even one that is not a total collapse, may have disastrous consequences for the employee

¹⁴³ *Kuper v. Iovenko*, 66 F.3d 1447, 1457 (1992).

¹⁴⁴ *See Moench v. Robertson*, 62 F.3d 553, 568 (3d Cir. 1995). The duty to diversify is discussed more fully *infra*.

¹⁴⁵ Million, *supra* note ----, at 839, *citing* Shlomo Benartzi & Richard H. Thaler, Naïve Diversification Strategies in Defined Contribution Savings Plans, 91 Am. Econ. Rev. 79, 90 (2001).

¹⁴⁶ *Id.* at 838; *citing* Patrick J. Purcell, *The Enron Bankruptcy and Employer Stock in Retirement Plans*, at 3 (CRS Report for Congress) (Jan. 22, 2002), at <http://www.house.gov/boosman/issues/crsrsenron.pdf>.

¹⁴⁷ *Id.* at 840. An Enron, in August 2001, CEO Ken Lay told employees, "Now is the time to buy Enron shares", Joann S. Lublin, *Managers & Managing: As Their Firms Toppled, Some CEOs Propered*, Wall St. J. Europe, Feb. 27, 2002), at A8. In September, 2002, he reiterated that the stock was a great bargain. Allan Sloan, *One Enron Lesson: Some Insider Trading Falls Outside the Timely-Reporting Rule*, Wash. Post., Mar. 5, 2002, at E3 (noting that Lay did not tell employees he had sold significant portions of his own holdings). Meanwhile, Lay himself sold shares worth twenty million dollars during the same period, without disclosure.

¹⁴⁸ *Id.* at 840.

plan participant.¹⁴⁹ A recent paper attempted to quantify the cost of over-investment of pension plan assets in company stock: under reasonable assumptions, the study concluded, company stock in a non-diversified portfolio may actually be worth as little as forty-two percent of its market value.¹⁵⁰ At the same time that the employer's stock represents a large percentage of the employee's pension trust, the same investment represents only a small percentage of the company's total outstanding shares-- at Enron only two percent--meaning that employees have little or no power within the corporation by virtue of shareholder status.¹⁵¹

B. Fiduciaries Under ERISA

Congress mandated that private pension plan assets be held in trust for the exclusive benefit of plan participants and beneficiaries.¹⁵² This mandate has the corollary effect of imposing personal liability upon pension plan fiduciaries for

¹⁴⁹ *Id.* at 842; Schmall, *supra* note , at 913(“ an estimated \$1.3 billion of the [Enron] plan's \$2.1 billion in pension assets consisted of now-worthless Enron stock”).

¹⁵⁰ *Id.* at 842, *citing* Lisa Meulbroek, *Company Stock in Pension Plans: How Costly Is It?*, 6 (unpublished manuscript). ERISA also created this Pension Benefit Guarantee Corporation (“PBGC”) which ensures minimum pension benefits for defined benefit plans if the employer becomes unable to pay the pension; there is no insurance for defined contribution plans. Recently it was announced that the PBGC was underfunded by some \$ billion dollars. [N.Y.Times Article re U.S. Airways.]

¹⁵¹ *Id.* at 842. The author goes on to discuss the pros and cons of proposed legislation to limit the amount of investment in company stock, including pros: individual self-realization from stock ownership; decisionmaking in the workplace, reduction of labor-management conflict and certain efficiency benefits and cons that considering Enron, none of these reasons is compelling. *Id.* at 853.

¹⁵² 29 U.S.C. § 1103(a); 1102(a)(1).

violation of their duties to plan participants.¹⁵³ But, unlike under the securities laws, where it can safely be said that directors and officers are fiduciaries of the corporation, the question of who is a fiduciary under ERISA is not readily determined by reference to title within the corporate sponsor of a pension plan. “The ‘threshold question’ in an action charging breach of fiduciary duty under ERISA is ‘not whether the actions of some person employed to provide services under a plan adversely affected a plan beneficiary’s interest, but whether that person was acting as a fiduciary (that is, performing a fiduciary function) when taking the action subject to complaint.’”¹⁵⁴ A fiduciary may be either a named fiduciary or a *de facto* fiduciary. In any event, fiduciary status is to be construed liberally, consistent with ERISA policies.¹⁵⁵

1. Named Fiduciary

A named fiduciary is one “named in the plan instrument, or identified as a fiduciary (A) by a person who is an employer or employee organization with respect to the plan or (B) by such an employer and such as an employee organization acting jointly.”¹⁵⁶ The corporate sponsor itself may be a named or functional fiduciary under a plan, where it is given the power and discretion “to establish and change the investment alternatives among which participants may

¹⁵³ 29 U.S.C. § 1109 (fiduciary shall be personally liable to make good to such plan any losses to the plan resulting from each such breach).

¹⁵⁴ *Edgar v. Avaya*, 2006 U.S. Dist. LEXIS 23151, *9 (D. N.J. April 24, 2006).

¹⁵⁵ *Id.* at 665.

¹⁵⁶ 29 U.S.C. § 1102(a)(2).

direct the investment of their accounts; and review the status of the investment policy and the selection and performance of the investment alternatives offered under the plan.”¹⁵⁷ Typically, the employer, its board of directors and chief executive officer will be named fiduciaries with power of management and investment over plan assets. As this language shows, under ERISA, a fiduciary need not be an independent party.

Also, there may be a plan administrator or administration committee (made up of members of the employer’s board of directors) and an investment committee (usually appointed by the employer) with the power of general administration of the Plan, including allocating the assets of the Fund among separate accounts, monitoring the diversification of the Fund and ensuring compliance with ERISA. Usually, there is a plan Trustee with direct management, investment and disposition powers over the plan’s assets.¹⁵⁸ The power to appoint, retain, or remove the trustee typically resides in the named fiduciary, a power itself resulting in the fiduciary duty to monitor the acts of the trustee.¹⁵⁹

2. Functional or *De facto* Fiduciary

¹⁵⁷ *Worldcom*, 263 F. Supp. 2d at 745, 757.

¹⁵⁸ See e.g., *In re Electronic Data Sys. Corp. “ERISA LITIGATION”*, 305 F. Supp. 2d 658 (E.D. Tex. 2004).

¹⁵⁹ *In re Enron*, 284 F.Supp.2d 511, 659 (Tex. 2003); *Electronic Data Sys. Corp. “ERISA LITIGATION”*, (duty to monitor appointees on fiduciaries with appointment power; **OTHER CASES P. 18 lexis AND DOL bulletin in EDS.**

Alternatively, a person may be deemed a fiduciary on the basis of his or her functional authority and control relative to the plan.¹⁶⁰ Under this functional or *de facto method*, “[a] person is a fiduciary with respect to a plan to the extent (i) he exercises any discretionary authority or discretionary control respecting the management of such plan or exercises any authority or control respecting management or disposition of its assets; (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan or has any discretionary authority or discretionary responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan.”¹⁶¹ “A fiduciary within the meaning of ERISA must be someone acting in the capacity of manager, administrator, or financial adviser to a plan.”¹⁶² This means that a fiduciary is one who exercises discretionary control over some aspect of the management or administration of an ERISA plan, or any control whatsoever over plan assets.¹⁶³ Fiduciary status is to be determined by looking at the actual authority or power demonstrated, as well as the formal title and duties of the parties at issue.¹⁶⁴ Yet,

¹⁶⁰ 29 U.S.C. § 1102(21)(A); *In re XCel Energy, Inc. Securities Derivative & ERISA Litigation*, 312 F. Supp. 2d 1165 (D.Minn. 2004); *see also Mertens v. Hewitt Assoc.*, 508 U.S. 248, 262 (1993).

¹⁶¹ 29 U.S.C. § 1002(21)(A)(i),(ii), (iii).

¹⁶² *Pegram v. Herdrich*, 530 U.S. 211 (2000).

¹⁶³ *Bd. of Trs. of Bricklayers & Allied Craftsmen Local 6 of N.J. Welfare Fund v. Wettlin Assocs., Inc.*, 237 F.3d 270, 273 (3d Cir. 2001).

¹⁶⁴ *In re Enron Corporation Securities, Derivative & “ERISA” Litigation v. Enron Corporation*, 284 F. Supp. 2d 511, 544 (S.D. Tex. 2003), *citing Landry v. Air Line Pilots Ass’n Inter. AFL-CIO*, 901 F.2d 404, 418 (5th Cir. 1990), *cert. denied* 498 U.S. 895 (1990) (emphasis in original).

“a person is a fiduciary only with respect to those aspects of the plan over which he exercises authority or control.”¹⁶⁵ Because ERISA defines a fiduciary “in functional terms of control and authority over the plan,”¹⁶⁶ an individual may be a fiduciary in some of his or her actions, but not in regard to others.¹⁶⁷ “A fiduciary’s obligations can apply to managing, advising, and administering an ERISA plan....”¹⁶⁸

Where a person actually exercises any authority or control over the management or disposition of the assets of the plan, formal or delegated discretion to do so is not required for a finding that that person is a fiduciary.¹⁶⁹

¹⁶⁵ *Bannistor v. Ullman*, 287 F.3d 394, 401 (5th Cir. 2002), quoting *Sommers Drug Stores Co. Employee Profit Sharing Trust v. Corrigan Enter., Inc.*, 793 F.2d 1456, 1459-60 (5th Cir. 1986); *Electronic Data Systems “ERISA Litigation*, 305 F.Supp.2d at 665, citing *Enron*, 284 F. Supp. 2d at 544, in turn citing *Bannistor v. Ullman*, 287 F.3d 394, 401 (5th Cir. 2002).

¹⁶⁶ 263 F. Supp. 2d at 757, citing 29 U.S.C. § 1002(21), citing *Mertens*, 508 U.S. at 262.

¹⁶⁷ See e.g., *Akers v. Palmer*, 71 F.3d 226, 230 (6th Cir. 1995).

¹⁶⁸ *Pegram v. Herdrich*, 530 U.S. 211, 223 (2000).

¹⁶⁹ *In re Enron Corporation Securities, Derivative & “ERISA” Litigation v. Enron Corporation*, 284 F. Supp. 2d 511, 544 (S.D. Tex. 2003), citing *Bd. of Trs. of Bricklayers and Allied Craftsmen Local 6 of New Jersey Welfare Fund v. Wettlin Assocs.*, 237 F.3d 270, 273 (3d Cir. 2001), quoting *IT Corp. v. General Am. Life Ins. Co.*, 107 F.3d 1415, 1421 (9th Cir. 1997), cert. denied, 522 U.S. 1068 (1998); *FirsTier Bank, N.A., v. Zeller*, 16 F.3d 907, 911 (8th Cir.) (fiduciary duty imposed if one exercises discretionary authority or control over plan management, but also whenever one deals with plan assets), cert. denied sub nom. *Vercoe v. FirsTier Bank, N.A.*, 513 U.S. 871 (1994); *Board of Trustees of Western Lake Superior Piping Industry Pension Fund v. American Benefit Adm’rs, Inc.*, 925 F. Supp. 1424, 1429 (D. Minn. 1996); In *Electronic Data Systems “ERISA Litigation*, 305 F.Supp.2d 658 (E.D. Tex. 2004). Plaintiffs alleged specifically that defendant EDS was a functional ERISA fiduciary. Plaintiffs alleged that “EDS was in fact the ultimate decision-maker with respect to all fiduciary functions other than those effectively delegated to the Trustee...” EDS was thus responsible for *all* the fiduciary functions at issue here, including the selection of investment options for the Plan, communications with participants, and the monitoring of other fiduciaries.” Taking the allegations as true, the court found that complaint had sufficiently pleaded that EDS was an ERISA fiduciary. *Id.* at 666. Plaintiffs allegations that defendants were named fiduciaries and also that the plan documents did not effectively delegate the named fiduciaries’ duty to other persons or entities, and also that even if the plan was read as effectively delegating fiduciary responsibilities and that defendants were functional fiduciaries in that the defendants in fact, selected and monitored the investment options and actually exercised

The text of ERISA makes no distinction between the functional definition of a trustee and the formal designation of a fiduciary named by the plan document or by following the procedure in those documents for designating a fiduciary. As such, the liability section of ERISA applies to both.¹⁷⁰

3. Two Hats

Can individual officers of a corporate plan fiduciary be personally liable for breach of fiduciary duty under ERISA? While ERISA's definition of fiduciary is "to be broadly construed," an individual cannot be liable as an ERISA fiduciary solely by virtue of her position as a corporate director, officer, shareholder or manager.¹⁷¹ Instead, one is a fiduciary only "to the extent that he

the fiduciary functions of managing plan investments; that the Board defendants were functional ERISA fiduciaries; that they had the authority to appoint other fiduciaries and had "final review and authority over all fiduciary actions taken and decisions made by the Administration Committee Defendants, were sufficient to show that defendants exercised fiduciary duties beyond the appointment duty by reviewing the Administration Committees' fiduciary functions. Defendants argued that only the Investment Committee, and not EDS, the Board Committee, BAC, nor CEO Brown, could be liable for failing to prudently manage the plan assets, because the Plan allocated all investment responsibility to the Investment Committee. The court rejected that argument pointing out that defendants had not appreciated the difference in the types of fiduciary authority at issue. Plaintiffs alleged not only that defendants were named fiduciaries, but also functional fiduciaries, liable to the extent they actually exercised control over investment decisions or the investment of plan assets, such that delegation of fiduciary duty was irrelevant to defendants' liability. Moreover, the court found that as a matter of law, courts of the Fifth Circuit had imposed a duty to monitor appointees on fiduciaries with appointment power. *Id.* at 666. The defendants apparently did not dispute that the Administration Committee and Investment Committee defendants were functional ERISA fiduciaries, since they were primarily responsible for exercising the traditional fiduciary functions, managing the day-to-day Plan operations, as well as exercising discretionary authority and control over disposition of Plan assets and Plan administration.

¹⁶⁹ *Id.* at 671, citing *Goyne & Delany Co. v. Selman*, 98 F.3d 1457, 1465 (4th Cir. 1996); *Martin v. Feilen*, 965 F.2d 660, 669-70 (8th Cir. 1992); *Enron*, 284 F. Supp. 2d 511, 553, 661.

¹⁷⁰ 284 F. Supp.2d at 545-46.

¹⁷¹ *Sommers I*, 793 F.2d 1460 (); *Dynergy* at 899.

acts in such capacity, in relation to the plan.”¹⁷² A plan administrator is a fiduciary, as well as individual officers of the corporate employer to the extent they exercised authority or discretion over plan assets.¹⁷³ Courts have recognized that a corporation and its board may wear two “hats”-- that of employer and of ERISA fiduciary. ERISA liability arises only from actions taken or duties breached in the performance of ERISA obligations.¹⁷⁴ Some courts have recognized the conceptual difficulties in imposing personal liability in such instances where the corporation can only act through its officers. The traditional rule is that a corporate officer is not personally liable for his actions while acting within the course and scope of his employment. Some courts have held that an individual corporate employee must have individual discretionary role in the plan administration to be liable as a fiduciary under ERISA.¹⁷⁵ They are not liable solely by reason of holding office.¹⁷⁶ Other courts stressing the functional definition of a fiduciary under ERISA, have held that the individuals within the corporations who actually exercised the fiduciary discretionary control or

¹⁷² *Dynergy* at 899.

¹⁷³ *Enron*

¹⁷⁴ *Pegram*, 530 U.S. at 225-26; *Worldcom*, 263 F. Supp.2d 745, 760 (S.D.N.Y. 2003)(holding member of board of company, which was the plan administrator with the power to appoint individuals, including “any” Worldcom officer as fiduciary were not fiduciaries by virtue of their powers under state law to manage the corporation)

¹⁷⁵ 284 F.Supp. 2d at 567, *citing Confer v. Custom Engineering Co.*, 952 F.2d 34, 37 (3d Cir. 1991)(“when an ERISA plan names a corporation as a fiduciary, the officers who exercise discretion on behalf of the corporation are not fiduciaries within the meaning of [29 U.S.C. § 1002] 3(21)(A)(iii) unless it can be shown that these officers have individual discretionary roles as to plan administration.”); *Hull v. Policy Management Systems Corp.*, (D.S.C. Feb. 9, 2001)(absence of investment powers in plan documents, and evidence that director made any investment decision meant director was not a fiduciary).

¹⁷⁶ *Id.* at 568, *citing* Department of Labor regulations at 29 C.F.R. § 2509.75-8 at D-5 (1991).

authority in their official capacity may also be personally liable, depending on the facts of the particular case.¹⁷⁷ Thus, where the plan document empowered only the “Plan Committee” to make investment decisions, and only gave the board of directors the authority to cause the corporate sponsor to make contributions to the Plan, to appoint and remove members of the Plan Committee, and to terminate the Plan in whole or in part, the board of directors of the corporate sponsor of the plan would not be held to be fiduciary regarding investment decisions.¹⁷⁸ Similarly, in the case of defined contribution plans, that the Board of Directors whose responsibilities did not include the selection of investments, but merely the selection of the members of the Plan Committee, where they otherwise did not control investment decisions or communicate Plan information, was not a

¹⁷⁷ *Id.* at 568, citing *Kayes v. Pacific Lumber Co.*, 51 F.3d 1449, 1459-61 (9th Cir. 1995)(rejecting the Third Circuit rule in *Confer* that an officer who acts on behalf of a named fiduciary corporation cannot be a fiduciary if he acts within his official capacity and if no fiduciary duties are delegated to him individually, since such a rule would allow a corporation to “shield its decision-makers from personal liability merely by stating in the plan documents that all their actions are taken on behalf of the company and not in a fiduciary capacity.”); *Stewart v. Thorpe Holding Co. Profit Sharing Plan*, 207 F.3d 1143, 1156 (9th Cir. 2000)(“where, as here, a committee or entity is named as the plan fiduciary, the corporate officers or trustees who carry out the fiduciary functions are themselves fiduciaries and cannot be shielded from liability by the company.”); *Rankin v. Rots*, 278 F.Supp. 2d 853 (E.D.Mich. 2003)(Although company, Kmart, was named plan Administrator, Kmart, in that status had the authority to appoint an investment manager or managers with regard to an Investment Fund and may employ one or more persons to render advice with regard to any of the company’s responsibilities under the plan; and could delegate any of the such powers to any person or persons or committee or committees, whether existing or newly-created, thus making those appointed fiduciaries and so also the members of the board under the plan documents which gave a level of control to the board and finance committee, to the extent they exercised discretionary authority or control respecting management or disposition of assets and by appointing individuals to the employee benefits plans investment committee, giving rise to a duty to monitor those appointed).

¹⁷⁸ *Hull v. Policy Management Systems Corporations*, 2001 U.S. Dist. Lexis 22343 (D. S.C. 2001). The court also refused to find a general duty to supervise the activities of the Plan committee. *Id.* at *18.

fiduciary under the plan.¹⁷⁹ However, while Board members, not named as fiduciaries, to the extent that they served on the compensation committee of the corporate sponsor of the plan, which under the plan was responsible for investment policy for the plan, the selection of Trustees and investment advisors and managers for overall investment policy, could be regarded as plan fiduciaries.¹⁸⁰

Where also, any officer, the president and chief executive officer, had authority to perform the company's functions as plan administrator and investment fiduciary, and other officers, such as the employee benefits director, who exercised day-to-day authority or control regarding management of the plan, management or disposition of the Plan's assets, and administration of the Plan, they could be held as fiduciaries under ERISA.¹⁸¹ Further, where the evidence

¹⁷⁹ *Hull v. Policy Management Systems Corporations*, 2001 U.S. Dist. Lexis 22343 (D. S.C. 2001); *In re Williams Companies ERISA Litigation*, 271 F. Supp.2d 1328 (ND. Okla. 2003); but see *In re CMS Energy ERISA Litigation*, 2004 U.S. Dist. LEXIS 8713 (E.D. Mich. March 31, 2004)(refusing to dismiss complaint against individual board members where plan provided that company shall be responsible for the general administration of the plan and for carrying out the provisions thereof...[and the] Board of Directors [of one employer] shall appoint such persons, who may be Members under the plan, as it determines at any time to act as Plan Administrators in all dealings under the plan, where even though individual board members were not named fiduciaries, whether they had discretion or responsibilities would be determined by evidence developed in the litigation).

¹⁸⁰ *In re Mckesson HBOC, Inc. ERISA Litiga.*, 2002 U.S. Dist. Lexis 19473, *33 (N.D. Cal. 2002). Also, in that case, the Master Trust conferred on the board the authority and responsibility for determining the investment policy to be implemented by the Compensation Committee. Though there appeared to be a conflict between the Master Trust, giving the Board investment responsibility and the Plan Documents, giving the Compensation Committee that authority, giving fiduciary a broad reading, the court concluded that it could not rule that the board was not a fiduciary regarding investment policies on a motion to dismiss.

¹⁸¹ *Worldcom*, 263 F. Supp.2d 745, 760 (S.D.N.Y. 2003), There the court found that Worldcom had and did exercise discretionary authority or discretionary control over the management of the Plan, the disposition of the Plan's assets, and the administration of the Plan. Under the plan, any

suggests that the board of directors had the authority to appoint other fiduciaries and had “final review and authority over all fiduciary actions taken and decisions made by the administration committee, individual board members can be held liable as fiduciaries, by that fact and based upon a failure to monitor appointees.¹⁸²

4. Delegation of Duties to Other Fiduciaries

ERISA provides a safe harbor from liability for a named fiduciary to the extent it has allocated or designated its fiduciary responsibilities to another.¹⁸³ Named fiduciaries typically delegates to investment committees or plan administrators such duties as the administration of the plan, including day to day administration, investment of the plan’s assets and authority to interpret the provisions of the plan. However, notwithstanding the safe harbor, a named

Worldcom officer could be appointed to perform Worldcom’s functions as Plan Administrator and Investment Fiduciary, although Worldcom did not appoint any officer. The chief executive officer did exercise discretionary authority or discretionary control, regarding management of the Plan. *Id.* at 759. Of Worldcom employees, only the employee benefits director, who exercised day to day authority or control regarding management of the plan, management or disposition of the Plan’s assets, and administration of the Plan, and to have provided direction to the Plan’s Trustee was a fiduciary. The allegations against the defendant directors were otherwise insufficient to establish that they were fiduciaries, where the complaint only alleged that they signed documents filed with the SEC and the mere holding of office to direct the management of the corporation was not sufficient. *Id.* at 760.

¹⁸² *In re Electronics Data System Corp. “ERISA” Litig.*, 305 F. Supp.2d 658 (E.D.Tex. 2004); *In re Xcel Energy, Inc Securities, Derivative & ERISA Litigation*, 312 F. Supp.2d 1165, 1176 (D. Minn. 2004).

¹⁸³ 29 U.S.C. § 1105(c)(2). This section provides-----.

fiduciary may be liable for continuing the allocation or designation if the continuation is not prudent.¹⁸⁴

5. Directed Trustee

A directed trustee is defined under ERISA as one who is required to invest funds and follow in every material way directions by the plan administrator.¹⁸⁵ However, the directed fiduciary or trustee is not absolved from a duty of inquiry regarding investment of plan assets, where it adheres to directions when public information of which it knows or should know calls into question the wisdom of the instructions.¹⁸⁶

¹⁸⁴ See e.g., *In re Westar Energy, Inc. ERISA Litigation*, 2005 U.S. LEXIS 28585 (D. Kansas, September 29, 2005)(named fiduciary which allocated investment decisions to Investment and Benefits Committee could be liable for continuing the allocation and failing to remove fiduciaries where it knew or should have known the fiduciaries were not qualified to loyally and prudently manage plan's assets and by failing to conduct an independent investigation into or monitor the merits of investing the Plan's assets in company stock, where facts showed fiduciaries embarked upon acquisitions or unregulated businesses, resulting in a substantial decline in the company's net income and an increase in total debt; a restructuring plan which ended up saddling the company with substantial debt; spending abuses by corporate executives; and a precipitous decline in the stock price).

¹⁸⁵ 29 U.S.C. §1103(a)(1). 403(a)

¹⁸⁶ *In re Worldcom, supra* (2005). However, in that case, the court found the complaint sufficient with respect to Merrill Lynch's administration of the Plan, but not with respect to its role as an investment advisor. Under the terms of the plan, Merrill Lynch was required to follow the directions as to investments given to it by the Investment Fiduciary, that is, Worldcom, and the plan participants. Still, Merrill Lynch retained the discretion and even the obligation as a directed trustee to abide by duties imposed by ERISA. On this point, ERISA provides that the directed trustee is subject to the direction of a named fiduciary who is not a trustee, in which case the directed trustee shall be subject to proper directions of such fiduciary which are made in accordance with the terms of the plan and which are not contrary to [ERISA]. 29 U.S.C. § 1103(a). Thus, as a directed trustee, Merrill Lynch was deprived of discretion to manage and control the Plan's assets generally, but retained the discretion, and indeed the obligation, to follow only "proper" directions of the Investment Advisor, directions which were made in accordance with the terms of the Worldcom Plan and which were not "contrary to" the ERISA statute. This meant that as a directed Trustee, Merrill Lynch was not required to exercise its independent judgment in deciding how and whether to invest employee funds as directed; it had only to make sure that [Worldcom's] directions were proper, in accordance with the terms of the plan, and not

C. The Fiduciary Duties Under ERISA

Section 1104(a)(1) of ERISA expressly imposes three general duties on pension plan fiduciaries: (1) “to discharge their duties with prudence; (2) to diversify investments to minimize the risk of large losses”; and (3) to act “solely in the interest of the participants” and for the “exclusive purpose” of providing benefits to those participants.¹⁸⁷ This list does not purport to be an exhaustive list of duties owed.

Instead, the common law of trusts is engrafted upon ERISA to define the general scope of fiduciary authority and responsibility.¹⁸⁸ The ordinary trust law understanding of fiduciary administration of a trust is to perform the duties imposed, or exercise the powers conferred, by trust documents.”¹⁸⁹ It also includes the activities that are “ordinary and natural means’ of achieving the

contrary to ERISA.” *Id.* at 761. A directed trustee’s conduct is still measured by the prudent person standard, meaning a directed trustee is not justified in complying with directions if the trustee knows or ought to know that the holder of the power is violating his duty to the beneficiaries as a fiduciary in giving directions. *Id.* at 762. Here, the facts did not show that the decline of Worldcom was generally out of step with other large companies and the directed trustee had no duty to inquire whether Worldcom was undertaking prudence reviews of plan’s investments, such as where the plan administrators request investment in company stock where public information calls into question short term viability as a going consensus

¹⁸⁷ 29 U.S. C. § 1104(a)(1). ERISA also expressly prohibits certain transactions where the potential for abuse is particularly acute. Section 1106 forbids a fiduciary from engaging in a transaction that the fiduciary “knows or should know” is a transaction with a party in interest. 29 U.S.C. § 1106(a). Furthermore, employer securities ordinarily may not comprise more than ten percent of the aggregate fair market value of plan assets. Finally, ERISA requires fiduciaries discharge their duties in accordance with the terms of the plan, except when such terms conflict with titles I and IV of ERISA.

¹⁸⁸ *Varity Corporation v. Howe*, 516 U.S. 489, 496 (1996), *citing* H.R. Rep. No. 93-533, pp. 3-5, 11-13 (1973); 2 Legislative History of the Employee Retirement Income Security Act of 1974 (Committee Print Compiled for the Senate Subcommittee on Labor of the Committee on Labor and Public Welfare by the Library of Congress, Ser. No. 93-406, pp. 2350-2352, 2358-2360 (1976); G. Bogert & G. Bogert, *Law of Trusts and Trustees* § 255, p. 343 (rev. 2d ed. 1992).

¹⁸⁹ *Worldcom*, 263 F. Supp. 2d 745 at 758 *citing Varity Corp.*, 516 U.S. at 502.

‘objective’ of the plan.”¹⁹⁰ Although Congress expected that the courts would interpret the common law standard with regard to the special nature and purpose of employee benefit plans.¹⁹¹ The common law of trusts, however, does not provide a complete answer to the question of the scope of a fiduciary’s duties. In some cases, trust law will only provide a starting point for analysis, after which a court must ask “whether or to what extent, the language of the statute, its structure, or its purposes require” a departure from the common law trust rules.¹⁹² In this endeavor the competing congressional purposes become evident: on the one hand, Congress’ desire to offer employees enhanced protection for their benefits and on the other, its desire not to create a system that is so complex that administrative and litigation costs unduly discourage employers from setting up pension plans.¹⁹³

1. The Duty to Act Prudently

Section 404(a) of ERISA holds fiduciaries to the “prudent man” standard, which includes the duty to act “for the exclusive purpose of providing benefits to participants and their beneficiaries... with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like

¹⁹⁰ *Id.* at 758, citing *Varity Corp.* 516 U.S. at 504.

¹⁹¹ *Varity Corporation*, 516 U.S. at 497, citing *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101, 110-111 (1989); see also *In re Enron Corporation Securities, Derivative & “ERISA” Litigation v. Enron Corporation*, 284 F. Supp. 2d 511, 546 (S.D. Tex. 2003), citing *Pegram v. Herdrich*, 530 U.S. 211, 224 (2000).

¹⁹² *Varity Corporation*, 516 U.S. at 497.

¹⁹³ *Id.* at 497.

capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims,¹⁹⁴ and in accordance with the documents and instruments governing the plan.”¹⁹⁵

To meet the “prudent man” standard,¹⁹⁶ fiduciaries must act with care, and “with single-minded devotion” to plan participants and beneficiaries.¹⁹⁷ In evaluating the conduct of a fiduciary to determine compliance with the prudent man standard, courts objectively assess whether the fiduciary, at the time of the transaction, utilized proper methods to investigate, evaluate and structure the investment; acted in a manner as would others familiar with such matters; and exercised independent judgment when making investment decisions. The test is

¹⁹⁴ *Id.* at § 1104(a)(1)(A)(B).

¹⁹⁵ *Worldcom*, 263 F. Supp.2d at 758.

¹⁹⁶ Under 29 U.S.C. §1104(a)(1)(B).

¹⁹⁷ 284 F.Supp. 2d at 547. *citing* Department of Labor regulations at 29 C.F.R. 2550.404a-1(b), explaining when requirements are satisfied including having given appropriate consideration to those facts and circumstances that given the scope of such fiduciary’s investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action, including the role the investment or investment course of action plays in that portion of the plan’s investment portfolio with respect to which the fiduciary has investment duties. “[A]ppropriate consideration” includes but is not limited to (1) a determination by the fiduciary that the particular investment or investment course of action is reasonably designed as part of the portfolio, to further the purpose of the plan, taking into consideration the risk of loss and the opportunity for gain (or other return) associated with the investment or investment course of action. Consideration of the composition of the portfolio with regard to diversification, the liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan; the projected return of the portfolio relative to the funding objectives of the plan. Thus, because every investment necessarily causes a plan to forego other opportunities, an investment will not be prudent if it would be expected to provide a plan with a lower rate of return than available alternative investments with commensurate degrees of risk or is riskier than alternative available investment with commensurate rates of return.

The Department of Labor regulations reflects the modern portfolio theory rather than the common law of trusts standards, which examined each investment with an eye toward its individual riskiness.

one of conduct, not the result of performance.¹⁹⁸ Thus, the appropriate inquiry is “whether the individual trustees at the time they engaged in the challenged transactions, employed appropriate methods to investigate the merits of the investment and to structure the investment.”¹⁹⁹ Prudence is measured by an objective standard.²⁰⁰ Because the “prudent man” standard focuses on whether the fiduciary utilized appropriate methods to investigate and evaluate the merits of a particular investment, the appropriate methods in a particular case depend on the “character” and “aim” of the particular plan and decisions at issue and the “circumstances prevailing” at the time a particular course of action must be investigated and undertaken.²⁰¹ While a fiduciary may have some duty to investigate the wisdom of an investment, a failure to investigate will not result in liability unless an adequate investigation would have revealed to a reasonable fiduciary that the investment at issue was improvident.²⁰²

a. Duty to Follow Directives

While the “prudent man” standard that requires the fiduciary to act “with single-minded devotion” to the plan participants and beneficiaries²⁰³ would seem to mean a duty to follow the directives of the plan documents, this is so only

¹⁹⁸ 284 F. Supp.2d at 548. *Laborers National Pension Fund v. Northern Trust Quantitative Advisors, Inc.*, 173 F.3d 313, 317 (5th Cir.), cert. denied 528 U.S. 967 (1999)

¹⁹⁹ *Id.*

²⁰⁰ *Fink v. Nat'l Sav. & Trust Co.*, 249 U.S. App. D.C., 772 F.2d 951, 955 (D.C. Cir. 1985).

²⁰¹ *Bussian*, 223 F.3d 299.

²⁰² *Kuper v. Iovenko*, 66 F.3d 1447, 1460 (6th Cir. 1995); *Barker v. Am. Mobil Power Corp.*, 64 F.3d 1397, 1403 (9th Cir. 1995)(ERISA fiduciary has duty to investigate suspicion he has with respect to plan funding and maintenance); *Dynergy*-----.

²⁰³ 284 F. Supp.2d at 546,

insofar as such documents and instruments are consistent with the provisions of ERISA.”²⁰⁴ This means that fiduciaries do not fulfill the duty of prudence merely by following the governing plan documents. Instead, they “must exercise their judgment and refuse to follow the plan direction if their analysis leads them to believe that the plan-directed investment would be imprudent and inconsistent with ERISA.”²⁰⁵

b. Duty to Monitor

Another duty falling generally under the duty to act prudently is the duty to monitor those appointed under a power to appoint and remove plan fiduciaries. A person with discretionary authority to appoint, maintain, and remove plan fiduciaries is himself deemed a fiduciary with respect to the exercise of that authority.²⁰⁶ However, the scope of the duty to monitor appointees is relatively narrow²⁰⁷ and is said to require only oversight of appointees to ensure that their

²⁰⁴ 29 U.S.C. §1104(a)(1)(D); *see also Xcel*, 312 F.Supp.2d 1165 (D.Minn. 2004).

²⁰⁵ *Id.* at *11, *citing Herman*, 126 F.3d at 1369; *In re Enron Corp.*, 284 F.Supp.2d 511, 549 (S.D.Tex. 2003). However, a “directed trustee” is not required to exercise independent judgment in deciding how and whether to invest employee funds as directed, but is required to make sure that the directions are proper, in accordance with the terms of the plan and not contrary to ERISA. *In re Worldcom, Inc. ERISA Litigation*, 263 F. Supp.2d 745, 762, *citing Herman v. Nationsbank Trust Co.*, 126 F.3d 1354, 1371 (11th Cir. 1997). A “directed trustee” is nonetheless, still a fiduciary, the prudent man standard only modified in this particular. *Id.* , *citing Maniace v. Commerce Bank, N.A.*, 40 F.3d 264 (8th Cir. 1994).

²⁰⁶ *Coyne v. Delany Co. v. Selman*, 98 F.3d 1457, 1465 (4th Cir. 1996); *In re Enron*, 284 F.Supp.2d at 562 (“the complaint alleged facts, which had the fiduciary cared to investigate, (as was their duty) regulatory filings would have revealed that Enron was in deep trouble.”).

²⁰⁷ *Coyne*, 198 F.3d 1466, n. 10; *In re Enron*, 284 F. Supp.2d at 554-55.

performance has been in compliance with the terms of the plan and statutory standards, and satisfies the needs of the plan.²⁰⁸

2. The Duty to Diversify

Under the common law of trusts, a fiduciary is duty-bound “to make such investments and only such investments as a prudent [person] would make of his own property having in view the preservation of the estate and the amount and regularity of the income to be derived....”²⁰⁹ A fiduciary is required to exercise due care, meaning he must investigate the safety of the investment and its potential for income by securing reliable information, and taking into consideration the advice of qualified others, as long as he exercises his own judgment in the final decision.²¹⁰ The specific provisions of ERISA are parallel to the common law of trusts as it specifically requires that a plan fiduciary

²⁰⁸ *Id.* at 553; *EDS*----- (On plaintiffs’ allegation that defendants failed to monitor appropriately the Administrator defendants, and the investment committee defendants, the court also rejected defendants’ motion to dismiss, finding that a duty to monitor appointees by fiduciaries with appointment power is imposed by ERISA. *Id.* at 670, citing *Leigh v. Engle*, 727 F.2d 113, 135 (7th Cir. 1984), holding that two fiduciaries responsible for selecting and retaining the plan administrators had a duty to monitor appropriately the administrators’ actions.” The two fiduciaries could not “abdicate their duties under ERISA merely through the device of giving their lieutenants [appointees] primary responsibility for the day to day management of the trust.” *Id.* at 666-67. Rather, the two fiduciaries “were obliged to act with an appropriate prudence and reasonableness in overseeing” the appointees’ conduct. *Id.* at 135. Indeed, the Department of Labor Interpretive Bulletin, further explains: “at reasonable intervals the performance of trustees and other fiduciaries should be reviewed by the appointing fiduciary in such manner as may be reasonably expected to ensure that their performance has been in compliance with the terms of the plan and statutory standards, and satisfies the needs of the plan.” 29 C.F.R. § 2509.75-8 at FR-17. Other courts, adopting this reasoning have imposed a duty to monitor appointees. The court, however, decline to define the scope of the duty to monitor on a motion to dismiss, finding only that plaintiffs had broadly alleged a cause of action on this theory sufficient to entitle it to discovery on the issue. *Id.* at 671.

²⁰⁹ *Restatement (Second) Trusts* § 227 (1959).

²¹⁰ *Id.*, cmts. (a)-(c), e.

diversify the plan's investment to minimize risk of loss. However, the duty to diversify under ERISA is limited in three ways: First, plan investments must be diversified unless it is clearly prudent not to diversify.²¹¹ The evaluation of diversification is not to be done solely on the basis of hindsight, nor on the basis of the results of investments.²¹² To prevail, plaintiff must show that the portfolio, on its face, was not diversified. The burden then shifts to defendant to demonstrate that it was "clearly prudent" not to diversify, the express statutory exception.²¹³ At the same time, the plan fiduciary must follow the documents and instruments governing the plan, which may direct the fund be funded solely with company stock, to the extent they are consistent with ERISA.²¹⁴ In case of a conflict, the fiduciary must act in accordance with provisions of ERISA which above all requires fiduciaries to act solely in the best interests of the beneficiaries. In determining whether a trustee has breached his duties in this regard, the court

²¹¹ 29 U.S.C. § 1104(a)(1)(C). ERISA's duty to diversify, however, is not measured by hard and fast rules or formulas. Instead, Congress recognized that the degree of investment concentration will depend upon the facts and circumstances of each case. Among the considerations are: the purposes of the plan; the amount of the plan assets; financial and industrial conditions; the type of investment, whether mortgages, bonds or shares of stock or otherwise; distribution as to industries; the dates of maturity. H.R. Conf. Rep. No. 1280, 93d Cong., 2d Sess. (1974), reprinted in 1974 U.S. Code Cong. & Admin. News 5038, 5085

²¹² *In re: Unysis Savings Plan Litigation*, 74 F.3d 420, 434 (3d Cir. 1996).

²¹³ *Id.* at 548-49. 29 U.S.C. § 1104 (a)(1)(C).

²¹⁴ *See Dynergy*, at 892 (where plan required the employer match to be made in the form of shares of the company stock, and precluded the committee defendant from serving as plan administrator or named fiduciary regarding investment of trust assets, the fiduciary will not be held to have breached a duty because its fiduciary duties could not be said to extend to either the acceptance or the investment of employee matching contributions)

must examine both the merits of the challenged transaction and the thoroughness of the fiduciary's investigation into the merits of the transaction.²¹⁵

Second, in the case of an ESOP, where ownership of company stock is a principal purpose of the plan, fiduciaries are generally not obligated to diversify unless the failure to diversify would not be in the interests of the plan participants.²¹⁶ This is an express statutory exemption from the requirement of diversification for ESOP's, which are typically funded solely in the form of company stock. Congress envisioned that an ESOP would function both as an "employee retirement benefit plan and a 'technique of corporate finance: that would encourage employee ownership.'" ²¹⁷ Thus, there is a presumption that continued investment in the company's stock is proper and a plan participant has the burden of showing that under all the circumstances continued investment was not prudent.²¹⁸ However, the mere showing of a decline in stock price is usually held not sufficient to demonstrate imprudence. Instead, to overcome the presumption, plaintiff must show a precipitous decline in

²¹⁵ *Id.* at 549-50; *In re: Unysis Savings Plan Litigation*, 74 F.3d at 434. (reliance upon advisor's recommendation to invest failed to satisfy fiduciary duty, where plan administrators did not inquire into the basis for the recommendation). The Department of Labor regulations provide that the requirements of diversification are satisfied if fiduciaries give "appropriate consideration to those facts and circumstances that, given the scope of such fiduciary's investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action involved, including the role the investment plays in that portion of the plan's investment portfolio. 29 C.F.R. § 2550.404a-1(b)(i).

²¹⁶ 29 U.S.C. § 1104(a)(2).

²¹⁷ *Martin v. Feilin*, 965 F.2d 660,664 (8th Cir. 1992), *cert denied*, 113 S.Ct. 979 (1993).

²¹⁸ *Moench v. Robertson*, 62 F.3d 553, 570 (3d Cir. 1995); *Kuper*, 66 F.3d at 1459 (6th Cir. 1995).

the employer's stock, along with evidence that the company is on the brink of collapse or undergoing serious mismanagement.²¹⁹

However, where a plan's documents require the employer match to be made in company stock, a fiduciary cannot be liable for not diversifying investments.²²⁰

Third, fiduciaries may be absolved of liability where a plan participant's exercise of individual control over the assets of an individual account resulted in a loss.²²¹ In order for this exemption to apply, however, the plan participant must have been given adequate information in order to make informed decisions.²²²

²¹⁹ *Moench v. Robertson*, 62 F.3d 553, 570 (3d Cir. 1995); *Kuper*, 66 F.3d 1447, 1460 (6th Cir. 1995). In *Lalonde v. Textron*, 270 F. Supp. 2d 272 (D.R.I. 2003), the court granted defendants' motion to dismiss claims alleging breach of fiduciary duty in the management of an ESOP plan, where the plan administrator continued to invest in the company stock despite fluctuation and eventual decline in the stock value (between 9 and 22%) where the evidence did not show the decline was anything unusual or specifically related to the company's viability. *But see Lalonde v. Textron*, 369 F.3d 1 (1st Cir. 2004), affirming in part and reversing in part. The court ruled that as to certain claims, the district court failed to take into account plaintiff's allegation that, during the relevant period, the employer artificially inflated its stock price by concealing the "disparate problem throughout the company's segments and their adverse effect on Textron. The court believed that because of the seeming conflicting purposes of an ESOP, further development of the record was in order.

²²⁰ *Dynergy*, at 896 (fiduciary not liable for failing to comply with plan documents and instruments governing the plan where it refused to direct the diversification of employer matching grants out of employer stock or into diversified investments).

²²¹ 29 U.S.C. § 1104(c)(1)(B). Notwithstanding the general fiduciary duties imposed by the common law and by the ERISA general provisions, ERISA provides specifically that a fiduciary is not liable for losses that result from the exercise of control by the plan participants. But Section 1104(c) does not provide an automatic exemption. Instead, the fiduciary invoking this section has the burden of showing that the plan falls within the language of the Section, including that it offer a broad range of investments and "that the plan provided information sufficient for the average participant to understand and assess: the control the plans permitted to a participant and the financial consequences he or she assumed by exercising that control; the rights that ERISA provided to participants and the obligations that the Act imposed upon fiduciaries; the plan's terms and operating procedures; the alternative funds the plans offered; the investments in which assets in each fund were placed; the financial condition and performance of the investments; and developments which materially affected the financial status of the investments." 29 U.S.C. §

1104(c) provides: “In 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.” The Department of Labor has promulgated regulations specifying the kinds of plans that are plans under ERISA Section 1104 (c), the circumstances in which a participant or beneficiary is considered to have exercised independent control over the assets in his account as contemplated by Section 1104 (c), and the consequences of a participant’s or beneficiary’s exercise of control.” 29 C.F.R. § 2550.404c-1(a). In particular, the regulations require that the plan inform the participants or beneficiaries that the plan is intended to constitute a plan described in Section 1104(c) of ERISA and that “fiduciaries...may be relieved of liability for any losses which are the direct and necessary result of investment instructions given by such participant or beneficiary.” *Id.* at §2550.404c-1(b)(2)(1)(i). And, the plan must also allow participants the opportunity to choose from a broad range of investment alternatives, give investment instruction with appropriate frequency, diversify investments, and obtain sufficient information to make informed investment decisions. Section 1104(c) requires the defendant establish that the plans provided information sufficient for the average participant to understand and assess; the control the plans permitted and participant to exercise and the financial consequence he or she assumed by exercising control; the rights that ERISA provided to participants and the obligations that the Act imposed on fiduciaries; the Plan’s terms and operating procedures; the alternative funds the plans offered; the investments in which assets in each fund were placed; the financial condition and performance of the investments; and developments which materially affected that financial status of the investments. *Unisys* at *447. In *Unisys*, the company failed to make this threshold showing; the evidence failed to show the breadth of actual plan investments or assess all of the investment alternatives available to participants. And, while participants’ ability to make initial contributions to the plan’s various investment funds was unfettered, transfer restrictions were problematic, one could conclude that these restrictions so significantly limited their ability to decide in which funds their respective assets were allocated, that the restrictions were antithetical to the concept of “independent control” that Congress enacted in Section 1104(c). Further, the company’s agreement with one investment fund not to honor employee requests for withdrawal in exchange for that investment’s consent to a reduction in the waiting period for asset transfers between non-competing funds and another fund, control within the meaning of 1104(c) was no longer available to the participants under the plan from that point forward. *Id.* *447-48. Moreover, notwithstanding a breach of duty, a fiduciary may not be held liable to plan participants or beneficiaries absent a showing of a causal connection between the failure to fulfill the duty and the harm caused. *Diduck v. Kaszycki & Sons Contractors, Inc.*, 974 F.2d 270, 279 (2d Cir. 1992). In the case of an allegation that an investment was imprudent, to establish the causal connection, a complaining plan participant must demonstrate that an adequate investigation would have revealed to a reasonable fiduciary that the investment at issue was improvident. *Fink v. National Savings & Trust Co.*, 772 F.2d 951, 962 (D.C. Cir. 1985); *see also* -----.

²²² *Westar*-----

3. Duty of Loyalty

Perhaps the most fundamental duty of ERISA plan fiduciaries is a duty of complete loyalty,²²³ to insure that they discharge their duty “solely in the interests of the participants and beneficiaries,” and to “exclude all selfish interest and all consideration of the interests of third persons.”²²⁴ This duty has its source in the common law of trusts,²²⁵ which as stated earlier only offers a starting point for analysis of ERISA.²²⁶

The duty of loyalty is compromised to an extent by the “two hat” rule, which exists in recognition that employer-fiduciary may wear “two hats,” acting both as a fiduciary to an ERISA plan and as an employer with an obligation to the company. Not every action of an ERISA fiduciary that affects a plan participant need to be undertaken in the participant’s best interests.²²⁷ As such, employers are permitted to act in accordance with their interests as employers, even when adverse to the interest of the beneficiaries, so long as they are not at the time acting as an ERISA fiduciary. Thus, purely business decisions by an ERISA

²²³ 29 U.S.C. § 1104(a)(1)(B).

²²⁴ 284 F. Supp.2d at 547.

²²⁵ *Pegram v. Herdrich*, 530 U.S. 211, quoting *Central States, Southeast & Southwest Areas Pension Fund v. Central Transport, Inc.*, 472 U.S. 559 (1985)(rather than explicitly enumerating all of the powers and duties of trustees and other fiduciaries, Congress invoked the common law of trusts to define the general scope of their authority and responsibilities).

²²⁶ *Hughes Aircraft Co. v. Jacobson*, 525 U.S. 432 (1999).

²²⁷ *In re Xcel Energy Inc. Securities Derivative & ERISA Litigation*, 312 F. Supp. at 1175.

employer are not governed by the duty of prudence or loyalty requirement.²²⁸ This means that a decision to amend or terminate a plan is a business decision, not the function of a fiduciary.²²⁹ Similarly, decisions characterized as settlor functions, “regarding the form or structure of the Plan, e.g., who is entitled to receive benefits and in what amounts, how benefits are calculated, allowing plan participants the ability to direct plan’s fiduciaries to purchase company stock, imposing age and other restrictions on the ability of the participants to direct the plan’s fiduciaries to transfer plan assets out of company stock, do not trigger fiduciary duties.”²³⁰

Thus, an employer-sponsor of a pension plan may fire an employee for reasons not related to the ERISA plan or may need to modify the terms of a plan to be less generous to the beneficiary.²³¹ When making fiduciary decisions, a fiduciary may wear only his fiduciary hat. The statute states that one is a

²²⁸ *Kuper v. Iovenko*, 66 F.3d 1447, 1456 (6th Cir. 1995)(decision to arrange trust to trust transfer was not a fiduciary decision), *citing Berlin v. Michigan Bell Tele. Co.*, 858 F.2d 1154,1163 (6th Cir. 1988).

²²⁹ *In re CMS Energy ERISA Litigation*, 312 F.Supp.2d 898, 911 (E.D. Mich. 2004) 2004 U.S. Dist. LEXIS 8713 at *19-20.

²³⁰ *Hughes Aircraft Co. v. Jacobson*, 525 U.S. 432 (1999); *see also Lockheed Corp. v. Spink*, 517 U.S. 882 (1996)(nothing in ERISA requires employers to establish pension plans, nor mandate what kind of benefits employers must provide if they chose to have such a plan); *In re Enron*, 284 F.Supp.2d at 655. (nothing in ERISA requires employers to establish employee benefit plans, nor mandate the creation of pension plans, nor dictate the benefits to be afforded once a plan is created, *citing Lockheed Corp. v. Spink*, 517 U.S. 882, 887 (1996); *Smith v. Contini*, 205 F.3d 597, 602 (3d Cir. 2000); *Pegram v. Herdrich*, 530 U.S.211, 226 (2000)(“specific payout detail of the [ERISA] plan was, of course a feature that the employer as plan sponsor was free to adopt without breach of any fiduciary duty under ERISA since an employer’s decisions about the content of a plan are not themselves fiduciary acts).

²³¹ To the extent an employer is not required to establish a plan to start with, once set up, when they undertake the actions of plan design or modification, “they do not act as fiduciaries, but are analogous to the settlers of a trust.” *Lockheed Corp. v. Spink*, 517 U.S. at 890.

fiduciary only “to the extent” that he acts in such a capacity in relation to a plan.²³² “ERISA does require, however, that a fiduciary with two hats wear only one at a time, and wear the fiduciary hat when making fiduciary decisions.”²³³

However, “a growing number of circuits have found the distinction between the employer and fiduciary ‘hats’ begins to blur when company circumstances are such that business details impact the administration of the ERISA plan.”²³⁴ Arguments that a decision to provide a company stock fund as an investment option, and to make contributions to employees’ retirement funds with company stock were not decisions made in a fiduciary capacity, but were business decisions concerning plan design have been rejected on a motion to dismiss.²³⁵ In any event, when wearing its ERISA hat, the fiduciary must have sole regard for the interests of the beneficiaries.²³⁶

²³² *Id.* at 550, citing *Pegram v. Herdrich*, 530 U.S. at 225-26. Thus, the act of amending a plan does not constitute a fiduciary act and no duty to the beneficiary of the plan is raised.

²³³ *Hughes Aircraft Co. v. Jacobson*, 525 U.S. 432 (1999).

²³⁴ *Hill v. BellSouth*, 313 F.Supp. 2d 1361 N.D. Ga. 2004) citing *Varity Corp. v. Howe*, 516 U.S. 489 (1996)(finding fiduciary duty existed as to dissemination of information). In *Varity Corp.*, the Court held that an employer acted as a fiduciary when it “intentionally connected its statements about [a new division’s] financial health to statements it made about the future of benefits, so that its intended communication about the security of benefits was rendered materially misleading.” The Court left intact the distinction between ordinary business decisions made by an employer which might have an adverse collateral effect on a plan and actions specifically directed toward the plan or its beneficiaries).

²³⁵ *In re CMS Energy ERISA Litigation*, 2004 U.S. Dist. LEXIS 8713 at *32-33; *In re Sprint Corp ERISA Litigation*, 388 F. Supp. 2d 1207 (D.Kan. 2004)(refusing to dismiss complaint where it alleged a breach of duty of prudence by allowing fund to invest so heavily in company stock).

²³⁶ *In re Enron Corp. Sec., Deriv. & ERISA Litigation*, 284 F. Supp. 2d at 511,540 (S.D. Tex. 2003).

a. The Duty to Disclose

ERISA requires a plan administrator to provide a summary plan description to each plan participant within ninety days of becoming a participant.²³⁷ A summary plan description must be “calculated to be understood by the average plan participant” and be “sufficiently accurate and comprehensive to reasonably apprise such participants and beneficiaries of their rights and obligations under the plan.”²³⁸ After initial disclosure, ERISA requires the plan administrator to supply an updated summary plan description to each participant every five years if the plan contains amendments, or every ten years if not. A plan administrator is also required to provide a summary description of material modifications to the plan or other plan related information within seven months after the end of the plan year in which the modification or change was adopted.²³⁹ But the fiduciary’s duty to disclose is not so limited to such formal kinds of information. Instead the duty is informed by the common law. The duty to disclose under ERISA has been described as an “area of developing and controversial law.”²⁴⁰ It needs not be stated, that a fiduciary may not materially

²³⁷ 29 U.S.C. § 1024(b)(1)(A).

²³⁸ 29 U.S.C. § 1022 (a)(1); 1022(b); *see also* 29 C.F.R. § 2520.102-2(a)(requiring plan administrators to exercise “considered judgment and discretion by taking into account such factors as the level of comprehension and education of typical participants in the plan.”

²³⁹ 29 U.S.C. § 1024(a)(1)-1024 (b)(3).

²⁴⁰ *In re Enron Corp. Sec., Deriv. & ERISA Litigation*, 284 F. Supp. 2d at 555.

mislead those to whom fiduciary duties are owed.²⁴¹ “[W]hen a plan administrator speaks, it must speak truthfully.”²⁴² “Courts have generally agreed that where an ERISA fiduciary makes statements about future benefits that misrepresent present facts, these misrepresentations are material if they would induce a reasonable person to rely on them.”²⁴³ The duty to disclose has been stated as “a constant thread in the relationship between beneficiary and trustee; which 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.”²⁴⁴ Under the common law, a fiduciary’s duty to disclose was generally triggered by a

²⁴¹ *In re: Unisys Savings Plan Litigation*, 74 F.3d at 440; *In re Unisys Corp. Retiree Medical Benefit “ERISA Litigation,”* 57 F. 3d 1255, 1261 (3d Cir. 1995)[other cases cited on page 440041?]

²⁴² *Fischer v. Philadelphia Elec. Co.*, 994 F.2d 130, 135 (3d Cir.), *cert denied* 126 L. Ed. 2d 586 (1993); *In re Dynergy, Inc. ERISA Litigation*, 309 F. Supp.2d 861 (S.D.Tex. 2004); *Varity Varity Corp. v. Howe*, 516 U.S. 489, 493 (1996); *Peoria Union Stock Yards Co. Retirement Plan v. Penn. Mut. Life Ins. Co.*, 698 F.2d 320, 326 (7th Cir. 1983); *Xcel*----- at 1176; *Martinez v. Schlumberger, Ltd.*, 338 F.3d at 425 (“When an ERISA plan administrator speaks in its fiduciary capacity concerning a material aspect of the plan, it must speak truthfully”); *McCall v. Burlington Northern/Santa Fe*, 237 F.3d at 510-11; *Mullins v. Pfizer, Inc.*, 23 F.3d 663, 668 (2d Cir. 1994)(“when a plan administrator speaks, it must speak truthfully”).

²⁴³ *Id.* at 556, *citing Ballone v. Eastman Kodak Co.*, 109 F.3d 117, 122-23 (2d Cir. 1997); *Mullins v. Pfizer*, 23 F.3d at 669; *Kurz v. Philadelphia Electric Co.*, 994 F.2d 136, 140 (3d Cir. 1993), *cert. denied sub. nom Philadelphia Electric Co. v. Fischer*, 510 U.S. 1020 (1993); *James v. Pirelli Armstrong Tire Corp.*, 305 F.3d 439, 439 (6th Cir. 2002)(“[A] misrepresentation is material if there is a substantial likelihood that it would mislead a reasonable employee in making an adequately informed decision in pursuing... benefits to which she may be entitled.”), *cert. denied* 123 S.Ct. 2077 (2003).

²⁴⁴ *Restatement (Second) of Trusts*, §173, cmt.d; *see also Bixler v. Central Pennsylvania Teamsters Health and Welfare Fund*, 12 F.3d 1292 (3d Cir. 1994); *Adams v. Freedom Forge Corp.*, 204 F.3d 475, 480 (3d Cir. 2000); *Watson v. Deaconess Waltham Hosp.*, 298 F.3d 102, 114 (1st Cir. 2002); *Griggs v. E.I.DuPont DeNemours & Co.*, 237 F.3d 371, 380-81 (4th Cir. 2001); *Bowerman v. Wal-Mart Stores, Inc.*, 226 F.3d 575, 590 (7th Cir. 2000); *Bins v. Exxon Co. U.S.A.*, 220 F.3d 1042, 1048-49 (9th Cir. 2000)(en banc); *Krohn v. Huron Mem’l Hosp.*, 173 F.3d 542, 547-48 (6th Cir. 1999) [CONTINUED LEXIS P. 15]

specific request from a beneficiary.²⁴⁵ However, given that this duty is founded upon the recognition of the disparity of training and knowledge between the lay beneficiary and the trained fiduciary,²⁴⁶ even in the absence of a request for information, the fiduciary may be under a duty to provide material information to his beneficiary.²⁴⁷ This does not mean that the fiduciary is obligated to disclose everything it knows about an investment, but only that which is material of which it has knowledge that is sufficient to apprise the average plan participant of the risks associated with a particular investment.

Courts have taken varying positions on the question whether a plan fiduciary's general duty of loyalty expands the duty to disclose -- to include matters other than those specified under the disclosure rules. Some courts refuse to read an additional disclosure obligation into the fiduciary duty provisions because ERISA deliberately defined fiduciary and disclosure obligation appearing in separate sections of the statute,²⁴⁸ these courts holding that an employer has no affirmative duty to communicate any information about future plans as to plan design to its employees, either before or after it gave serious consideration to

²⁴⁵ Restatement (Second) Trusts §173.

²⁴⁶ *In re Unisys Savings Plan Litigation*, 74 F.3d at 441 (3d Cir. 1996).

²⁴⁷ *Id.* 441.

²⁴⁸ *See Bd. of Trs. of the CWA/ITU Negotiated Pension Plan v. Weanstein*, 107 F.3d 139, 147 (2d Cir. 1997)(finding Congress intentionally structured disclosure obligations to limit categories of documents that administrators must disclose such that disclosure duties are not extended by general fiduciary duties); *Porto v. Armco, Inc.*, 825 F.2d 1274, 1276 (8th Cir. 1987)(“an administrator who complies with the statutory standard for disclosure cannot be said to have breached the fiduciary duty by not providing earlier disclosure”); *Faircloth v. Lundy Packing Co.*, 91 F.3d 648, 657 (4th Cir. 1996)(finding precedent does not recognize general fiduciary obligation under ERISA to provide information related to plan on request).

those programs.²⁴⁹ Other courts have held that the fiduciary duty section of ERISA codifies and makes applicable to the ERISA fiduciary the law of trusts.²⁵⁰ These courts have ruled that trust principles impose a duty of disclosure upon an ERISA fiduciary when there are “material facts affecting the interest of the beneficiary which [the fiduciary] knows the beneficiary does not know, but needs to know for his protection.”²⁵¹ This means that in some circumstances a fiduciary may have an expanded duty to disclose even in the absence of a specific request for information from the fiduciary, where the participant has “no reason to suspect that it should make inquiry into what may appear to be a routine matter.”²⁵² By incorporating the principles from the law of trusts, these courts have broadened considerably the disclosure duties of fiduciaries. The broadening should be of concern since the courts have not identified any clear limiting lines.

²⁴⁹ *Martinez v. Schlumberger Technology Corp.*, 338 F.3d 407 (5th Cir. 2003)(discussing the cases that have ruled on the question).

²⁵⁰ Courts have relied on the legislative history that “the principles of fiduciary conduct are adopted from existing trust law, but with modification appropriate for employee benefit plans.” H.R. Rep. 93-533 at 12-13 (1973), reprinted in 1974 U.S.C.C.A.N. 4639, 4650-51.

²⁵¹ RESTATEMENT (SECOND) TRUSTS, §173, cmt. d (1959).

²⁵² *Id.* at 556, quoting *Glaziers and Glassworkers Union Local No. 225 Annuity Fund v. Newbridge Securities, Inc.*, 93 F.3d 1171, 1181 (3d Cir.1996); *Griggs v. E.I. Dupont De Nemours & Co.*, 237 F.3d 371 (4th Cir. 2001)(fiduciary may have affirmative duty to provide material facts affecting the interest of the beneficiary which he knows the beneficiary needs to know for his protection); *Bins v. Exxon Co. U.S.A.*, 189 F.3d 929 (1999)(“once a fiduciary has material information relevant to a plan participant or beneficiary, it must provide that information whether or not it is asked a question.), on rehearing en banc, 220 F.3d 1042, 1048-49 (9th Cir. 2000); *Schmidt v. Sheet Metal Workers’ Nat. Pension Fund*, 128 F.3d 541, 546-47 (7th Cir. 1997)(“plan fiduciary may violate its duties...either by affirmatively misleading plan participants about the operations of a plan, or by remaining silent in circumstances where silence could be misleading); see also *Eddy v. Colonial Life Ins. Co.*, 919 F.2d 747, 750 (D.C. Cir. 1990).

The Supreme Court spoke on this issue in *Varity*, where it stated that the “fiduciary duty primarily functioned ‘to constrain the exercise of discretionary powers which are controlled by no other duty imposed by the trust instrument or the legal regime. If the fiduciary duty applied to nothing more than activities already controlled by other specific legal duties, it would serve no purpose.”²⁵³ Yet, the court chose not to “reach the question whether ERISA fiduciaries had a duty to disclose truthful information on their own initiative, or in response to employee inquiries.”²⁵⁴ One of the strongest assertions of an affirmative duty to disclose is found in the Seventh Circuit opinion in *Anweiler v. Am.Elec. Power Svc. Corp.*,²⁵⁵ where the court stated “fiduciaries must also communicate material facts affecting the interests of beneficiaries. This duty exists when a beneficiary asks for information, and even when he or she does not.”²⁵⁶ The Third Circuit also has weighed in on the issue, in *Adams v. Freedom Forge Corp.*²⁵⁷ ruling that

²⁵³ *Varity*, 516 U.S. at 504.

²⁵⁴ *Id.* at S.Ct. 1075 (The court refused to dismiss a complaint which alleged a failure to disclose negative information about the company’s financial condition, noting the unsettled nature of the question, that the issue was more amenable to resolution on a motion for summary judgment after discovery). See also *In re Xcel Energy, Inc. Securities Derivative & ERISA Litigation*, 312 F. Supp.2d 1165, 1176 (D. Minn. 2004). the court described the duty of disclosure under ERISA as “an area of developing and controversial law. *Id.* at *1176, citing *Watson v. Deaconess Waltham Hosp.*, 298 F.3d 102, 114 (1st Cir. 2002); *Griggs v. E.I.DuPont DeNemours & Co.*, 237 F.3d 371, 380-81 (4th Cir. 2001); *Bowerman v. Wal-Mart-Stores, Inc.*, 226 F.3d 574, 590 (7th Cir. 2000); *Bins v. Exxon Co. U.S.A.*, 220 F.3d 1042, 1048-49 (9th Cir. 2000)(en banc) [other cases **lexis p.15???**]

²⁵⁵ 3 F.3d 986, 991 (7th Cir. 1993).

²⁵⁶ *Id.* at 991.

²⁵⁷ 204 F.3d 475, 480 (3d Cir. 2000).

a plan fiduciary had “an affirmative duty to inform when the [fiduciary] knows that silence might be harmful.”²⁵⁸

Some courts have limited the duty of affirmative disclosure to circumstances where the information would have an “extreme impact” on plan beneficiaries.²⁵⁹ In *In re Unisys Savings Plan Litigation*,²⁶⁰ the court found that the plan administrator had a duty to inform the plan participants of the precarious financial position of a company in which it had invested more than 30% of the plan funds, although the court specifically did not hold that the plan administrator had any duty in the first place, under Section 1104(a) of ERISA, to communicate anything at all to plan participants as to the risks accompanying the investments, nor give investment advice or its opinion on the financial condition of the investment option.²⁶¹ The court held that the plan administrator had a duty to disclose and that duty was not limited only to public information, but might include non-public information.²⁶² But what did the Third Circuit mean by the last statement?²⁶³

²⁵⁸ 312 F.3d at 1177, citing *Adams v. Freedom Forge Corp.*, 204 F.3d 475, 480 (3d Cir. 2000), quoting *In re Unisys Corp. Retiree Med. Benefits “ERISA” Litig.*, 57 F.3d 1255, 1262 (3d Cir. 1995), cert. denied, 517 U.S. 1103 (1996).

²⁵⁹ *Ehlmann v. KaiserFound. Health Plan of Tex.*, 198 F.3d at 552, 556 (5th Cir. 2002).

²⁶⁰ 74 F.3d 420 (3d Cir. 1996).

²⁶¹ *Id.* at 443.

²⁶² *Id.* at 443. See also *Dynergy*, ----- Where plaintiffs alleged among other things that the defendant, Benefits Plan Committee, breached a fiduciary duty of disclosure where it failed to disclose accounting improprieties and other financial problems at the company. The court found that a fiduciary may have a duty to disclose facts affecting the interest of the beneficiary which he knows the beneficiary does not know, and which the beneficiary needs to

VI. Irreconcilable Decisions from the Courts on an Irreconcilable Conflict

Where a fiduciary is privy to material non-public information about the company's health, do the general duties of prudence and loyalty require that fiduciary to cause the company to cease making contributions to pension plans in the form of company stock or to advise plan participants to sell company stock? Would such disclosure amount to prohibited insider trading? Is the ERISA fiduciary an insider under the securities laws? In *Dirks*,²⁶⁴ the Supreme Court explained that persons who are not traditional insiders of corporations, i.e., directors, officers, and controlling shareholders, may be regarded as insider for purposes of insider trading prohibitions.²⁶⁵ These other persons might include accountants, lawyers and advisers who become privy to corporate information on a confidential basis. Would this definition also include an ERISA fiduciary. If the fiduciary is the chief executive officer, a member of the board of directors or other high officer, such as a director of benefits, then the answer is obvious.

If fiduciaries were to follow the duty of disclose literally, they would disclose to plan participants all forms of material non-public information on which the plan participant could decide to divest itself of company stock in its fund. The plan participant would not want to make a public disclosure of this

know for his protection _____ at 889 However, a plaintiff must allege that the defendant had actual knowledge of the material information they allegedly should have disclosed. *Id.*

²⁶³ *Id.* at 889.

²⁶⁴ See text accompanying notes to _____, *supra*.

²⁶⁵ *Dirks v. SEC*, U.S. at _____.

information, so as to avoid the losses from a precipitous in the stock price once the information becomes public or is otherwise disclosed. On the one hand the fiduciary is obligated to communicate the information to the plan participant. On the other, the fiduciary is constrained by the securities laws not to trade or cause a trade without public disclosure. District courts have taken conflicting views on the issue, some courts finding no general duty to communicate the information to plan participants, others finding such as duty as limited by prohibitions on insider trading, and others finding a duty to communicate all information material to an informed investment decision. What is a fiduciary to do?

A. No Breach of Duty to Act Prudently or to Disclose

In *Hull v. Policy Management Systems Corporations*:²⁶⁶ the plan was an employee stock ownership plan whereby employees contributed a percentage of their salary to their individual accounts and employee decided how these employee-contributed funds were invested; the employer matched some of the employee contributions in company stock; these matching funds did not, however, vest immediately and the employee lacked control over the funds until they vested

²⁶⁷

A committee of three individuals appointed by the board made the investment decisions as to the nonvested employer-matching funds. The plan empowered the Board of directors to appoint and remove members of the

²⁶⁶ 2001 U.S. Dist. Lexis 22343 (D. S.C. 2001).

²⁶⁷ *Id.* at *4-5.

committee, but provided that the “Board shall have no other responsibilities with respect to the plan.”²⁶⁸

Plaintiffs alleged a breach of fiduciary duty by the plan fiduciaries by providing misinformation and omitting to provide information relating to the corporation’s value²⁶⁹ while the corporation continued to contribute company stock, which price dropped sharply after certain negative information was released to the general public.²⁷⁰ **[EXPLAIN THIS BREACH MORE CLEARLY]**²⁷¹

The court refused to read in the language creating the board’s authority over the plan, a requirement that the corporation keep the Plan Committee “informed of what [could] only be characterized as ‘inside information’ for use in the making of its investment decisions.”²⁷² The court found no general fiduciary

²⁶⁸ *Id.* at *18.

²⁶⁹ *Id.* at *4-5.

²⁷⁰ *Id.* at *4-5.

²⁷¹ As to the claim against the corporate defendants, the complaint was dismissed. The grounds included that they were not fiduciaries under ERISA, on the basis that they had no investment authority over the plan assets. Thus, the first question for the court was whether the complained of actions were taken in a fiduciary role and the court found that they were not. *Id.* at *13. The court found that the authority to make investment decisions as to employer-matching contributions was not vested with either the corporate employer or the Board, but with the Plan Committee. The terms of the plan empowered only the Plan Committee to make investment decisions. *Id.* at *17-18. The board’s authority was limited to causing the Company to make contributions to the Plan, to appoint and remove the members of the Committee, and to terminate the Plan in whole or in part. The court found no general duty to supervise the activities of the Plan Committee as plaintiff had alleged. *Id.* at *18. Moreover, the court failed to find any allegations that any duty to supervise had been breached. *Id.* at *21.

²⁷² *Id.* at 22.

duty to disclose owed by the employer to the Plan and dismissed the claims accordingly.²⁷³

In essence, the court found, plaintiff sought to hold the Plan Committee defendants liable under a standard which would “put the Committee in the untenable position of choosing one of three unacceptable (and in some instances illegal) courses of action: (1) obtain ‘inside’ information and then make stock purchase and retention decisions based on this ‘inside’ information; (2) make the disclosures of ‘inside’ information, overstepping its role and in any case, likely causing the stock price to drop; or (3) breach its fiduciary duty by not obtaining and acting on ‘inside’ information.”²⁷⁴ The court did not decide whether plaintiff’s assertion that at least the decision to refrain from additional purchases would not violate securities laws, although in the court’s view, plaintiff’s theory

²⁷³ *Id.* at *17. While the court found that the Plan documents demonstrated that the corporate defendants owed certain limited fiduciary duties (to appoint and remove plan committee members; supply full and timely information of all matters relating to the Compensation and length of service of all Participants, their Retirement, death or other cause of Termination of Employment), and the plaintiff included numerous allegations of wrongdoing by the corporate defendants, the court found no connection between the two. If the allegations of providing misinformation and failing to provide accurate information, ultimately proved true, the Plan’s remedy would be the same as for the plaintiffs class action suit in the related securities action. This result would not be unreasonable as the duties of disclosure owed to the Plan by the corporate defendants were not based on the duties owed by an ERISA fiduciary to a Plan and its participants, but the general duties of disclosure owed by a corporation and its officers to the corporation’s shareholders. *Id.* at *23. The court finally dismissed claims against the Plan Committee, finding the plaintiff essentially alleged that the Plan Committee breached its fiduciary duties by failing to discover the truth about the company stock’s value. The plaintiff did not allege that the Committee defendants had any actual knowledge of any misinformation or that they participated in the dissemination of information which they knew or should have known was misleading, or that the Plan Committee failed to act independently or yielded to any pressure by the corporate defendants to make any particular investment decision. *Id.* at *25.

²⁷⁴ *Id.* at *26.

would nonetheless violate the spirit of those laws, and at the least, impose a higher standard on ERISA fiduciaries as to Plan purchases of employer stock than would be applied to other stock purchases.²⁷⁵ The court dismissed the complaint in all respects.

In *In re McKesson HBOC, Inc. ERISA Litigation*²⁷⁶, the plan was a 401(k) and Employee Stock Ownership Plan (“ESOP”). Participating employees contributed deferred compensation and the employer made various contributions to the plan, including matching contributions, in the form of company stock or cash, at the company’s election, but any cash contributions were to be converted to company stock as soon as practicable.²⁷⁷ An Administrative/Investment Committee managed the plan.

Plaintiffs alleged *inter alia* that the plan fiduciaries breached their duty to the plan participants by: 1) establishing and maintaining an investment policy in which all company contributions were invested in company stock and by continuing to hold a substantial portion of Plan assets in company stock even after the announcement of accounting irregularities and improprieties; 2) failing to

²⁷⁵ *Id.* at *26-27.

²⁷⁶ cite

²⁷⁷ 2002 U.S. Dist. Lexis 19473 (N.D. Cal. 2002). Plaintiff sued McKesson Corporation (“McKesson”) which as a result of a merger became McKesson HBOC, Inc., with HBOC becoming a subsidiary. Prior to the merger McKesson and HBOC as separate companies, each had its own ERISA employee pension benefit plans. The McKesson Corporation Profit-Sharing Investment Plan (“McKesson Plan”) was a Prior to the merger, HBOC also sponsored its own 401(k) plan which also provided for employee contributions and various contributions by HBOC on the employee’s behalf. Unlike the McKesson Plan, however, the HBOC participants were to be invested by selecting from among seven available investment funds, one of which was an HBOC company stock fund.

monitor the performance of the Administrative/Investment Committee of the HBOC plan; 3) failing to communicate truthful information to the Administrative/Investment Committee; and 4) failing to provide a mechanism in which participants could be provided with truthful information.²⁷⁸

The court granted defendants' motion to dismiss the complaint²⁷⁹ agreeing with defendants that there was no discretion regarding how the company contributions were to be invested, and hence there was no fiduciary duty under ERISA to invest in any manner inconsistent with the plan; that while there was generally a duty of diversification, ERISA contains a statutory exemption to the diversification requirement for ESOP's.²⁸⁰ There was a presumption that the fiduciary's decision to follow the plan was reasonable and that presumption must be rebutted by a showing that a prudent fiduciary acting under similar circumstances would have made a different investment decision and that the

²⁷⁸ *Id.* at *8, *41. *Id.* at *9. After the two companies merged, McKesson publicly announced that the company had engaged in improper and illegal accounting practices, had materially misrepresented the financial condition of the company and the financial results would be restated downward. As a result, the Company's stock price dropped sharply in value with a consequent rapid decline in the value of the assets held in the McKesson Plan, exceeding \$800 million. *Id.* at *5

²⁷⁹ *Id.* at *4.

²⁸⁰ Plaintiff responded that notwithstanding this plan requirement, a fiduciary may be liable for a decision to continue to invest in company stock where a prudent fiduciary acting under similar circumstances would have made a different investment decision. *Id.* at *14, citing *Kuper v. Iovenko*, 66 F.3d 1447, 1459 (6th Cir. 1995); *Moench v. Robertson*, 62 F.3d 553, 571-72 (3d Cir. 1995). The court found that the precedent cited by plaintiff were to some extent distinguishable. In those cases, the plans required the company contributions to be invested primarily, but not entirely, in company stock, thus providing the fiduciaries with some discretion regarding investment options. In contrast, the McKesson Plan required all company contributions to be in the form of company stock or at the company's election, cash to be converted to company stock as soon as practicable. *Id.*

fiduciary abused his or her discretion by following the plan and investing in employer securities.²⁸¹

The complaint, where it asserted breach of fiduciary duty by the failure to divest the plan of the company stock also was insufficient. The defendants argued and the court accepted, that they could not have sold company stock without disclosing the financial improprieties without violating federal securities laws on insider trading, while at the same time, disclosing the information publicly prior to selling the stock would itself have resulted in the same precipitous decline in stock value.²⁸² The court stated that “not even a fiduciary acting in its fiduciary capacity is permitted to engage in insider trading”;²⁸³ “fiduciaries are not obligated to violate the securities laws in order to satisfy their fiduciary duties.”²⁸⁴ This court conceived of the issue as one of causation as opposed to substantive misconduct, and ruled that even if the defendants breached a fiduciary duty by failing to divest the plan of McKesson stock after the merger, plaintiffs had not alleged facts to establish that any damages were caused by such breach.

²⁸¹ *Id.* at *13, *citing* 29 U.S.C. § 1104(a)(2). Plaintiff also had the burden of showing a causal link, i.e., that an adequate investigation would have revealed to a reasonable fiduciary that the investment at issue was improvident. In this case, the court found that the complaint did not sufficiently allege facts showing that following the plan was an abuse of discretion. All that the complaint alleged was that the fiduciary breached their duty by allowing the plan to become overweighted in company stock prior to and in anticipation of the merger.*Id.* at *16. 2002 U.S. Dist. Lexis 19473, at 15-16.

²⁸² *Id.* at *19.

²⁸³ *Id.* at *21.

²⁸⁴ *Id.* at *21, *citing* Restatement (Second) Trusts §166, cmt. a (the Trustee is not under a duty to the beneficiary to do an act which is criminal or tortuous).

This case summed up says to divest would have required the fiduciaries to disclose not just to plan participants, but publicly, the accounting irregularities, otherwise be liable for a violation of the insider trading prohibitions, but that the carrying out of their fiduciary obligations did not require the fiduciary to violate law or commit a wrong on a third party, even though the beneficiary may be injured by the fiduciary's failure to act.²⁸⁵ In other words, the fiduciary could remain silent, leaving the beneficiary in the dark to continue at his peril.

However, unlike the *Hull* case, this court treated the decision to divest differently from the decision to continue to invest in company stock, granting plaintiffs' leave to amend to go beyond barebones allegations in the complaint to allege a breach in that regard to plead more specifically that the fiduciaries breached their duties and abused their discretion in not deviating from the McKesson Plan, by continuing to follow the plan and make contributions in the

²⁸⁵ *Id.* at *21. Still, plaintiffs argued that the fiduciaries had other options other than violating the insider trading rules that could have averted the loss to the plan, including selling the stock back to the company in a private transaction; seeking an independent assessment from a financial or legal advisor or resigning in favor of an independent fiduciary, or seeking judicial guidance if the only apparent option for preserving the trust was to deviate from the terms of the trust itself; or seeking insurance against the loss. The court rejected each of these alternative proposed courses of action as unpersuasive, accepting the arguments of the defendants that retaining independent counsel or an outside fiduciary after learning of the accounting problems would not have avoided that loss, since an independent fiduciary would have been constrained by the same securities laws that applied to McKesson. Repurchasing McKesson stock at the inflated pre-disclosure trading levels would have shifted the loss to McKesson's other public shareholders, and it was not certain that the company would have agreed to such a transaction. *Id.* at *22. Nor would insurance have protected the plaintiffs, since the fiduciaries would have been obligated to disclose the accounting irregularities or be liable for insurance fraud. The court found no lawful action that could have been taken that would have avoided the subsequent loss occurring after public disclosure of the accounting problems. *Id.* at *23.

form of company stock.²⁸⁶ Would there nonetheless be communicative content to a decision by the company to cease making matching contributions in stock, but

²⁸⁶ *Id.* at *25-26. The court also upheld plaintiff's theory that there was a breach of discretion for the plan not to make contributions in the form of cash as opposed to stock, although plaintiffs needed to plead more facts. *Id.* at *27. The court further ruled on the question of who was the appropriate ERISA fiduciary defendants, holding that the Board Compensation Committee was, in that the Plan designated the company as the named fiduciary. The Plan also provided that the Compensation Committee was responsible for investment policy of the Plan, which was responsible for the selection of the Trustees and investment advisors and managers and for the overall investment policy of the plan. *Id.* at *30. Because the Master Trust required the Compensation Committee to implement the investment policy as determined by the Board of Directors, the Master Trust being one of the documents or instruments governing the Plan within the meaning of the statute, the Board of Directors would also be deemed fiduciaries with respect to the plan. *Id.* at *33-34. However, with respect to the decision to contribute stock as opposed to cash, only the company was a fiduciary since the plan provided that the company had the sole discretion in that decision. *Id.* at *33-34. The court also found the plan's trustee, Chase Manhattan Bank, was a directed trustee, with no discretion to determine whether employer contributions would be in cash or stock, but the allegations of breach of fiduciary duty was insufficient. The complaint alleged in only conclusory fashion that Chase knew the investments directions were improper, in violation of the plan and in violation of ERISA. The court dismissed certain claims of the complaint against HBOC, finding that the Administrative Committee was the plan fiduciary, but not the Board, although the Board had the authority to appoint the Trustee and the Administrative Committee and the duty to provide channels and mechanisms through which the Administrative Committee would communicate with participants and beneficiaries, but had no discretion in selecting investment options and therefore would not be liable for breach of fiduciary duty claims related to selecting investment options. The only possible claim to which the Board could be liable were claims for failure to monitor the Administrative Committee, failure to communicate information to the Trustees or Administrative Committee needed for their proper performance of their duties; or failure to provide a mechanism for information to be communicated to the participants. The complaint, however, contained no facts to support any allegations on failure to monitor. *Id.* at *51. Moreover, since the plan documents specified that the investment decision making rested solely within the individual HBOC plan participants, it was not necessarily the case that the Plan fiduciaries would be liable for breaches of fiduciary duty merely because the participants elected to invest in HBOC stock and that stock proved to be an imprudent investment. *Id.* at *51. In addition, no facts were alleged to establish that the company and board failed to communicate such information to the Trustee and the Administrative Committee to enable them to perform their duties nor that the board failed to provide channels or a mechanism through which the Administrative Committee and the Trustee could communicate with participants and beneficiaries or what harm resulted from the alleged failure to set up such channels and mechanisms for communication. *Id.* at *52. Accordingly, the claim for relief was dismissed with leave to amend. Similarly, plaintiffs' claim that defendants breached their fiduciary duty by failing to inform the McKesson plan fiduciaries that HBOC would be an imprudent investment was dismissed absent showing that the HBOC fiduciary had a duty pre-merger to make that disclosure. *Id.* at *55

in cash? Would the beneficiary and other non-employee shareholders need to know more?

Several other decisions from the district courts are in accord with *Hull* and *McKesson*.²⁸⁷

B. Duty to Disclose Consistent With Insider Trading Laws

In re Enron Corporation Securities, Derivative & “ERISA” Litigation, Pamela Tittle, et. al., v. Enron Corp., et. al. took an entirely different position from *Hull & McKesson*.²⁸⁸ There, the plans were the Enron Corporation Savings Plan (“Savings Plan”), the Enron Corporation Employee Stock Ownership Plan (“ESOP”) and the Enron Corporation Cash Balance Plan (“Cash Balance Plan”). The employees made contributions from their earnings, and the company made matching contributions in company stock.

The plaintiffs alleged defendants breached their fiduciary and co-fiduciary duties of prudence, care and loyalty under ERISA by: 1) allowing the Savings Plan participants the ability to direct the Plan’s fiduciaries to purchase Enron stock for their individual accounts from monies the participants contributed as

²⁸⁷ *Edgar v. Avaya*, 2006 U.S. Dist. LEXIS 23151(D.N.J. April 24, 2006)(divesting plans of company stock prior to disclosure of adverse information would be in violation of federal securities laws; “[n]ot even a fiduciary acting in its fiduciary capacity is permitted to engage in insider trading.”)

²⁸⁸ 284 F.Supp.2d 511 (S.D. Texas 2003). There were five classes of defendants: 1) individual directors and officers of the corporation; 2) committees, trustees, and individuals that administered the three pension plans; 3) Enron’s accountant Arthur Andersen LLP and some of its individual partners and employees; 4) Enron’s outside law firm and some of its individual partners; and 5) five investment banks. The complaint pleaded causes of action under ERISA, RICO, state common law negligence and civil conspiracy. *Id.* at 531.

deductions from their salaries; 2) inducing the participants to direct the fiduciaries to purchase Enron stock for their individual accounts in exchange for funds they contributed to the plan; 3) causing and allowing the Savings Plan to purchase or accept Enron's matching contributions in the form of Enron's stock; 4) imposing and maintaining age restrictions and other restrictions on the participants' ability to direct the Savings Plan fiduciaries to transfer both Savings Plan and ESOP assets out of Enron stock; and 5) inducing the Savings Plan and ESOP participants to direct or allow the fiduciaries of both plans to maintain investments in Enron stock when they knew of the company's precarious financial position.²⁸⁹

²⁸⁹ 29 U.S.C. § 1104(a)(1)(A)-(D), n.9 and 1105. *Id.* at 533.; Defendant Arthur Andersen, the company's outside auditor was charged with breaching its fiduciary duties by concealing from the Plan fiduciaries and Plan participants the actual financial condition of Enron and the imprudence of investing in Enron stock. *Id.* at 533-34. Plaintiffs also alleged breach of fiduciary duty based on the lockdown (freeze, blackout) of the two plans, without adequate notice to participants, while the plans switched to a new record keeper and trustee, during which time, the price of Enron stock fell from \$33.84 to \$10.00 per share. Plaintiffs complained that during the lockdown, plan participants were unable to move their investments from one plan investment fund to another despite exigent circumstances that made the blackout imprudent. *Id.* at 535-36. Plaintiffs also alleged a breach of fiduciary duty by the failure of defendants to appoint and monitor other plan fiduciaries and failure to disclose to the investing fiduciaries material information about Enron's true financial condition; that defendants knew or should have known that the plan fiduciaries appointed were not qualified to manage plan assets loyally and prudently; failure to monitor adequately the investing fiduciaries investment of these assets; failure to monitor adequately the plan's other fiduciaries' implementation of the terms of the plan; failed to disclose to the investing fiduciaries material facts concerning Enron's financial condition that they knew or should have known were material to loyal, prudent investment decisions concerning the use of Enron stock in the plans and/or with respect to the implementation of the terms of the plans; failure to remove fiduciaries who defendants knew or should have known were not qualified to manage plan assets loyally and prudently; knowingly participating in the investing fiduciaries' acts; breach by accepting the benefits of those breaches, both personally and on behalf of Enron; and by knowingly undertaking to hide acts and omissions of the fiduciaries that defendants knew constituted fiduciary breaches; and by failing to remedy those known breaches. *Id.* at 537.

The court first found the defendants could be liable for failing to diversify. It noted the nature of an ESOP plan, that it is one which is funded primarily with the employer's stock. However, it pointed out that a fiduciary of an ESOP is not relieved of his traditional duties of loyalty, prudence, and care under §404 of ERISA,²⁹⁰ even though the fiduciary is not bound by the requirement of diversification of plan assets under §404(a)(2).²⁹¹ Instead, ERISA only provides a presumption that a fiduciary of an ESOP acted consistently with ERISA in investing plan assets in the employer's securities unless a showing is made that circumstances existed that made such an investment defeat or impair the original purpose of the trust.²⁹² The court pointed out that an ERISA fiduciary must diversify the plan's investments to minimize risk of loss unless under the circumstances, it is clearly prudent not to diversify.²⁹³

The court went on to say defendants could be liable for not exercising independent judgment despite plan directives. An ERISA fiduciary has the duty to follow the documents and instruments governing the plan, but only to the extent that they are consistent with ERISA.²⁹⁴ In case of conflict, the provisions of the ERISA policies as set forth in the statute and regulations prevail over those

²⁹⁰ 29 U.S.C. § 1104(a).

²⁹¹ 29 U.S.C. § 1104(a)(2).

²⁹² 284 F. Supp.2d at 534.

²⁹³ 284 F. Supp.2d at 548, *citing* 29 U.S.C. § 1104(a)(1)(C).

²⁹⁴ 284 F. Supp.2d at 549.

of the Fund guidelines.²⁹⁵ In any case, such a determination is not properly made on a motion to dismiss, but only after discovery develops a factual record.²⁹⁶

The court also ruled that defendants might be liable for not acting prudently, the court noting that a fiduciary must meet the prudent man standard.²⁹⁷ The court found that law of trusts provides a starting point for the analysis whether a breach of duty has occurred, noting it may not provide a complete analysis, since ERISA may permit conduct that the common law trusts may not, recognizing that an ERISA fiduciary may wear many hats: as the employer and as plan fiduciary.²⁹⁸ In meeting this prudent man standard, the trustee is also under a duty to the beneficiary to give him upon his request at reasonable times complete and accurate information as to the nature and amount of that property, and to permit him or a person duly authorized by him to inspect -- the subject matter of the trust and the accounts and vouchers and other documents related to the trust.

In addition, the trustee is under a duty to communicate to the beneficiary material facts affecting the interest of the beneficiary which he knows the beneficiary does not know and which the beneficiary needs to know for his

²⁹⁵ *Id.* at 549.

²⁹⁶ *Id.*

²⁹⁷ Explained Supra

²⁹⁸ *Id.* at 546.

protection in dealing with a third person with respect to his interest.²⁹⁹ The court found that there “is an affirmative duty beyond a full and accurate response triggered by a participant’s specific question, to disclose material information to plan participants and beneficiaries it is a breach of duty for employers to knowingly make material misleading statements about the stability of a benefits plan.”³⁰⁰ “A 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.”³⁰¹

The court noted that the under the common law of trusts, which Congress indicated should apply as a threshold step to define duties of plan fiduciaries under ERISA, generally the trustee’s duty to disclose information was triggered

²⁹⁹ *Id.* at 555, citing *Bins v. Exxon Co. U.S.A.*, 189 F.3d 929 (1999)(“We believe that once an ERISA fiduciary has material information relevant to a plan participant or beneficiary, it must provide that information whether or not it is asked a question.”); *Sheet Metal Worker’s Nat. Pension Fund*, 128 F.3d 541, 546-47 (7th Cir. 1997). Courts have recognized a duty to provide information after request for information from plan participant/beneficiary. *Watson v. Deaconess Waltham Hosp.*, 298 F.3d 102, 114 (1st Cir. 2002); *Griggs v. E.I. Dupont de Nemours & Co.*, 237 F.3d 371, 380-81 (4th Cir. 2001); *Bowerman v. Wal-Mart-Stores, Inc.*, 226 F.3d 574, 590 (7th Cir. 2000); *Krohn v. Huron Memorial Hosp.*, 173 F.3d 542, 547-48 (6th Cir. 1999); *Eddy v. Colonial Life Ins. Co.*, 919 F.2d 747-50 (D.C. Cir. 1990).

³⁰⁰ 284 F. Supp. 2d at 558, citing *Adams v. Freedom Forge Corp.*, 204 F.3d 475, 480 (3d Cir. 2000), in turn citing *In re Unisys Corp. Retirem. Med. Ben. “ERISA Litiga”*, 57 F.3d 1255 (3d Cir. 1995), *cert. denied*, 517 U.S. 1103 (1996).

³⁰¹ 284 F.Supp.2d at 558. The court reviewed those cases involving the duty to disclose potential changes to an ERISA plan, focusing on the 5th Circuit’s ruling rejecting the test requiring “serious consideration”, in favor of a “fact-specific approach, where the overarching question in such analysis is whether there is a substantial likelihood that reasonable person in plaintiff’s position would have considered the information an employer-administrator allegedly misrepresented important in making a decision to retire. *Id.* at 560.

by a specific request from a plan participant or beneficiary.³⁰² And, the trustee is under a duty to the beneficiary to give him upon his request at reasonable times complete and accurate information as to the nature and amount of the trust property, and to permit him or a person duly authorized by him to inspect the subject matter of the trust and the accounts and vouchers and other documents related to the trust.”³⁰³ The trustee has a duty to disclose material facts affecting the interest of the beneficiary which he knows the beneficiary does not know and which the beneficiary needs to know for his protection in dealing with a third person with respect to his interest...”³⁰⁴ As such, plaintiffs had stated a claim generally for breach of fiduciary duty to disclose based on material information in counts regarding the defendants’ alleged fraudulent accounting, concealment of its deceitful business practices and of the company’s precarious, swiftly deteriorating financial condition and defendants alleged representations knowingly intended to induce the plan participant’s continued participation in the pension plan’s purchase and holding of Enron stock, which was known and should have been known to the plan fiduciaries.³⁰⁵

³⁰² *Id.* at 554, citing Restatement (Second) of Trusts § 173.

³⁰³ Restatement (Second) Trusts §173.

³⁰⁴ *Id.*

³⁰⁵ *Id.* at 563-64. Plaintiffs alleged that the Chief Executive Officer, Lay, the -----, Olson, the compensation committee, and the company breached their fiduciary duty by failing to disclose information about Enron’s dangerous financial condition that they knew or should have known to plan participants, the Administrative Committee, or plan counsel, while these defendants were individually selling large amounts of their own Enron holdings. *Id.* Specifically, plaintiffs alleged that there were dangerous accounting irregularities which the company either participated in or knew about but did nothing to address. *Id.*

Defendants countered that if they met their duty of loyalty by selectively disclosing only to the plan participants non-public information about material accounting irregularities and financial improprieties, so that the participants could make an informed decision not to purchase additional shares or to sell their currently held shares of Enron stock before the market and the public found out and the price plunged, they would be violating insider trading prohibitions under the federal securities laws.³⁰⁶ The court recognized that Rule 10b-5 requires that a corporate insider, because he owes a fiduciary duty to shareholders, either disclose material non-public information publicly or abstain from trading his own shares for personal gain.³⁰⁷ The court stated, “if a plan fiduciary were to tell plan participants of Enron’s actual financial condition so they could sell at a high price based on this nonpublic information, he would also be violating insider trading laws and he, the plan participants as ‘tippees,’ and the Administrative Committee might be found liable for securities law violations.”³⁰⁸ The court discussed the two cases cited by Defendants: *Hull v. Policy Management Systems Corp.*,³⁰⁹ and *In re McKesson HBOC, Inc. ERISA Litigation*.³¹⁰ Both courts dismissed plaintiff’s claims of breach of fiduciary duty by the plan fiduciary’s failure to

³⁰⁶ 284 F. Supp. 2d at 563.

³⁰⁷ *Id.* at 564.

³⁰⁸ *Id.*

³⁰⁹ 2001 U.S. Dist. Lexis 22343 (D.S.C. Feb. 9, 2001).

³¹⁰ 2002 U.S. Dist. Lexis 19473 (N.D. Cal. Sept. 30, 2002).

disclose adverse information to the plan participants on the ground that such disclosure would have been a violation of securities laws. The Enron court while not commenting further on the cogency of the *Hull* decision, did attempt to distinguish *McKesson* on the basis that the ruling there applied to ESOP plans, which by their nature are generally excepted from the duty to diversify and on its face not applicable to 401(k) plans as was at issue in *Enron*. But this is not a valid distinction, first, because one of the plans in *Enron* was an ESOP and second because even with ESOP's a fiduciary may be required to diversify unless he demonstrates that it was clearly prudent not to diversify.³¹¹ The court merely dismissed *McKesson* as misguided, finding the defendant's argument there as essentially an argument that the fiduciary should both breach his duty under ERISA and in violation of the securities laws, become part of the alleged fraudulent scheme to conceal Enron's financial condition to the detriment of current and prospective Enron shareholders, which include his plan's participants. Instead, the court believed that "the statutes should be interpreted to require that persons follow laws, not undermine them; they should be construed not to cancel out the disclosure obligations under both statutes or to mandate concealment, which would only serve to make the harm more widespread; the statutes should be construed to require, as they do, disclosure by Enron officials and plan fiduciaries of Enron's concealed, material financial status to the investing public

³¹¹ *Id.* at 548-49. See discussion, *supra*.

generally, including plan participants, whether ‘impractical’ or not, because continued silence and deceit would only encourage the alleged fraud and increase the extent of injury.”³¹²

The court found, that “a fiduciary’s duty of loyalty should also not be construed to require him to enable and encourage plan participants to violate the law, i.e., to sell their stock at artificially high prices to make a profit or avoid loss before disclosure of Enron’s financial condition was made public.”³¹³ “Nor would selective disclosure of that information by the fiduciary to plan participants protect any lawful financial interests of the plan participants,” since “[l]ike any other investor, plan participants have no lawful right, before anyone else is informed of Enron’s negative financial picture, to profit from fraudulently inflated stock prices or to avoid financial loss by selling early before public disclosure.”³¹⁴ Any damage suffered to plan participants as a result of a drop in price before they could make a profit or avoid a loss would not be the fault of the plan fiduciary but of the underlying alleged fraudulent scheme, and the corporate officials who participated in the scheme would be liable to plan participants.”³¹⁵ The court concluded, “[a] trustee has no duty to violate the law to serve its beneficiaries.”³¹⁶ An ERISA fiduciary is not an insurer of the value of plan assets, even where that

³¹² *Id.* at 565.

³¹³ *Id.* at 565.

³¹⁴ *Id.* at 565.

³¹⁵ *Id.* at 565.

³¹⁶ *Id.* at 565, *citing* Restatement (Second) Trusts §166, cmt.a.

price is the result of fraud or manipulation; but only has a duty to satisfy the prudent man rule, which provides immunity from liability if the fiduciary performs the necessary investigations and provides accurate information in accordance with it.³¹⁷ The court placed reliance upon the Department of Labor's interpretation of ERISA and its interface with the securities laws, which rejected the *McKesson* court's interpretation. The Department of Labor, in an *amicus curiae* brief suggested practical ways to resolve the alleged tension between ERISA and the federal securities statutes: 1) disclosure of the information to other shareholders and the public at large or forcing Enron to do so; 2) eliminating Enron stock as a participant option and as the employer match under the Savings Plan; 3) alerting the regulatory agencies, such as the SEC and the Department of Labor to the misstatements. But this is no solution to the harm that results from public disclosure of misconduct, which causes the stock price to plunge.³¹⁸

³¹⁷ *Id.* at 565-66.

³¹⁸ *Id.* at 567. The court went on to consider the personal liability of corporate employees, noting that courts were divided about if and under what circumstances the officers and employees of a corporation that is a named fiduciary in plan instruments may be personally liable for a breach of their fiduciary duty. Some courts have held that individual employees must have an individual discretionary role in the plan administration to be liable as a fiduciary under ERISA. See *Confer v. Custom Engineering Co.*, 952 F.2d 34, 37 (3d Cir. 1991); *Torree v. Federated Mutual Ins. Co.*, 1993 U.S. Dist. LEXIS 18605 (D.Kan. Dec. 3, 1993). Officers and employees are not liable under ERISA, solely by reason of holding office. Other courts, stressing the functional definition of a fiduciary under ERISA, have held that individuals within the corporations who actually exercised the fiduciary discretionary control of authority in their official capacity may also be personally liable, depending on the facts of the particular case. See *Kayes v. Pacific Lumber Co.*, 51F.3d 1449, 1459-61 (9th Cir. 1995); *Stewart v. Thorpe Holding Co. Profit Sharing Plan*, 207 F.3d 1143, 1156 (9th Cir. 2000) (where committee or entity is named as the plan fiduciary, the corporate officers or trustees who carry out the fiduciary functions are themselves fiduciaries and cannot be shielded from liability by the company), *cert. denied* 531 U.S. 1074 (2002); *Landry v. Air Line Pilots Ass'n Inter. AFL-CIO*, 901 F.2d 404, 418 (5th Cir. 1990) (members of the board of directors

But is the employee-shareholder “any other investor”? Perhaps not, since whether she funds her retirement plan with Enron stock or cash or stock of another company is not up to the employee. The employee wholly lacks the discretion, autonomy of a voluntary market participant, but perhaps has the most to lose by a decision made by another.

In re Worldcom, Inc. ERISA Litigation followed the reasoning of *Enron*.³¹⁹ There, the plans were a 401(k) Salary Savings Plan and an employee pension benefit plan.³²⁰

The plan provided a number of different funds in which participants could choose to invest their account balances, including a money market fund, a bond

of an employer that maintains an employee benefit plan will be viewed as fiduciaries only to the extent they have responsibility for functions listed under ERISA, such as selection and retention of plan fiduciaries, over which they necessarily would exercise “discretionary authority or discretionary control respecting management of such plan) [[[other cases at 569]; *Bannistor v. Ullman*, 287 F.3d 394, 403-06 (5th Cir. 2002)(corporate officers liable as fiduciaries since they exercised control over plan assets, approved a new health plan, and had check-signing authority for their employer corporation. Finally, the court considered whether the fiduciaries were relieved of liability to the extent that plan participants had control over plan assets under Section 404(c) of ERISA. The court found that the predicates for this exemption from liability were not established on this motion to dismiss, namely whether the fiduciaries provide participants with “complete and accurate information” about investment alternatives, a range of investments, procedures to permit transfers and to deal with conflicts of interests, as well as notice that the plan qualifies under 404(c). Furthermore, under 404(c), a plan participant lacks independent control where he “is subjected to improper influence by a plan fiduciary or plan sponsor with respect to the transaction or where a “plan fiduciary has concealed material nonpublic facts regarding the investment from the participant or beneficiary...” Plaintiffs alleged that among other things, Enron concealed material non-public facts about Enron’s financial condition from them. *Id.* at 577.

³¹⁹ 263 F. Supp.2d 745 (S.D.N.Y. 2003).

³²⁰ 29 U.S.C. § 1002(2)(A). The plan was an eligible individual account plan as defined in ERISA, 29 U.S.C. § 1107(d)(3) and a “qualified cash or deferred arrangement” as defined in I.R.C. § 401(k).

fund, various equity funds, and one or more funds invested in Worldcom stock.³²¹

Under the plan, participants had discretion to allocate their investments among the alternatives offered, and to reduce or eliminate their investments in Worldcom stock at any time.³²²

Worldcom was the sponsor of the Plan and Worldcom was designated as the plan administrator and as the investment fiduciary. The plan provided that the Investment Fiduciary's duties to include the power and discretion to: establish and change the investment alternatives among which participants may direct the investment of their accounts; and review the status of the investment policy and the selection and performance of the investment alternatives offered under the Plan.³²³

Plaintiffs alleged breach of fiduciary duty to act with prudence: 1) when the defendants continued to offer Worldcom stock as an investment alternative under the plan; 2) when they failed to investigate and monitor the plan's investments, including its investment in Worldcom stock, that had they done so, they would have discovered that Worldcom was an infirm investment and they would have been obligated to reassess the merits of allowing participants to

³²¹ The Plan is a "defined contribution" or "individual account" plan as defined by ERISA, 29 U.S.C. § 1002(34). The purpose of the plan was to "encourage eligible employees to save on a regular basis, by salary deferral, and to provide [employees] an opportunity to become shareholders of the Company and thereby furnish the incentives inherent in employee stock ownership." 263 F.Supp. 2d at 753.

³²² *Id.* at 753.

³²³ *Id.* at 763-64. *Id.* at 753-54. In addition, Worldcom was a named fiduciary of the Plan as defined by ERISA. 29 U.S.C. § 1102(a).

continue to invest in Worldcom stock and would have divested the plan of its Worldcom holdings.³²⁴

The court rejected Defendants' asserted argument that they had no discretion as to whether an investment in Worldcom stock should be offered to employees since the plan description advised Worldcom employees that one of their investment options was to invest in Worldcom Stock and that to the extent that plan participants exercised independent control over the assets in his account, a fiduciary could not be liable for any loss that resulted from the participant's exercise of control. The court ruled that ERISA does not shield fiduciaries from liability in these circumstances if the investment decisions were "not independent" if a plan fiduciary has concealed material non-public facts regarding the investment from the participants unless the disclosure would violate the law.³²⁵

The court ruled, "[t]o the extent, therefore, that any plan fiduciary had responsibility to decide or present it [sic] views on the wisdom of the investment options, it would have been a breach of that duty not to alert Worldcom of the need to eliminate, or at least, to consider eliminating Worldcom stock as one of the investment alternatives."³²⁶ Even in the context of an ESOP, which is designed to give employees the opportunity solely to invest in the employer's

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³²⁵ *Id.* at 764, *citing* 29 C.F.R. § 2550:404c-(c) (2).

³²⁶ *Id.* at 764.

stock, a fiduciary may be liable for continuing to offer such an investment, where circumstances arose which were not known or anticipated by the settlor of the trust that make continued investment in the company's stock imprudent.³²⁷

Plaintiffs also alleged that the chief executive officer breached his fiduciary duty to “monitor the plan’s other fiduciary and by the failure to disclose to the Investment Fiduciary, Worldcom, and other investing fiduciaries material facts he knew or should have known about the financial condition of Worldcom. Defendant’s theory was that the duty to disclose arises under the federal securities laws and not under ERISA; that by allowing plaintiffs to state an ERISA claim for failure to disclose information that, if material, would have required the chief executive officer to disclose, impermissibly extends the reach of ERISA and imposes on corporations a duty of continuous disclosure not contemplated by the well-developed regime of securities regulation.³²⁸ Defendants argued that plaintiffs’ allegations if accepted would impose a continuous duty of disclosure on ERISA fiduciaries that overwhelms the federal securities law disclosure requirements and compels fiduciaries to violate the prohibitions against insider trading. Defendant argued that if an ERISA fiduciary who is also an insider discovers material information affecting the value of the investment in the plan

³²⁷ *Id.* at 764, citing *Moench v. Robertson*, 62 F. 3d 553, 571, 572 (3d Cir. 1995)(corporate insider’s knowledge of impending collapse of the corporation’s stock price, the “precipitous decline” in the price of the stock, and the fiduciary’s own “conflicted status” might constitute such a change in circumstances).

³²⁸ *Id.* at 765.

sponsor's stock, the fiduciary has one of two choices: disclose the material information to plan participants before making it publicly known, thereby violating the insider trading laws by suggesting that they divest stock based upon material non-public information; or publicly disclosing the information, thereby exposing the plan participants to harm when the market reacted to the adverse information.³²⁹ The court rejected defendants' argument finding that when the chief executive officer wore his ERISA "hat" he was required to act with all the care, diligence and prudence required of ERISA fiduciaries, which meant that he had a duty to disclose to the investment fiduciary and the other investing fiduciaries material information he had regarding the prudence of investing in Worldcom stock. The court rejected the suggested tension between the federal securities laws and ERISA, that would cause dismissal of the claim, although the reasoning is not too convincing. The court explained that ERISA fiduciaries cannot transmit false information to plan participants when a prudent fiduciary would understand that the information was false. Nor, the court stated, was there anything in the plaintiffs' claim requiring ERISA fiduciaries to convey non-public material information to plan participants. Instead, what was required, was that any information that is conveyed to participants be conveyed in compliance with the standard of care that applies to ERISA fiduciaries.³³⁰ The complaint alleged that Worldcom filed periodic SEC filings about the company's financial condition

³²⁹ *Id.* at 767.

³³⁰ *Id.* at 767.

and was under a duty to correct any prior material misrepresentation when it became aware of the falsity.³³¹ “In any event, the existence of duties under one federal statute does not, absent express congressional intent to the contrary, preclude the imposition of overlapping duties under another federal statutory regime.”³³²

But this ruling still does not respond to the Scylla and Charybdis position the insider who is an ERISA fiduciary is put in: violate the insider trading by disclosing material non-public information to plan participants who then trade the company’s shares to persons without the same information or violate the fiduciary duty of loyalty by not disclosing material non-public information to plan participants, who in the absence of that information continue to invest in and hold the company’s shares which is overvalued in the absence of public disclosure of the information. The court seems to suggest that the insider/plan fiduciary can rightfully adhere to both duties of disclosure. They are not excused from non-disclosure, since the securities laws require it if trading occurs; yet they are not excused from liability to plan participants whose share value drops upon public announcement of the information, since ERISA requires disclosure.

Some courts like in *Enton* have drawn a false distinction between the types of plans at issue in order to side step the larger issue of the propriety of disclosure

³³¹ *Id.* at 767.

³³² *Id.* at 767, citing *United States v. Sforza*, 326 F.2d 107, 111 (2d Cir. 2003).

to plan participants. In *Rankin v. Rots*,³³³ plaintiffs, plan participants brought a claim under ERISA alleging breach of fiduciary duty against certain plan fiduciaries, including the company, the board of directors and members of the board finance committee and members of the employee benefits investment committee appointed by the finance committee, and the director of employee benefits. Plaintiffs alleged, *inter alia* that the fiduciaries breached their fiduciary duty by: 1) continuing to invest in company stock when there existed a substantial risk; 2) failing to provide complete, accurate, and material information about the company's true financial condition; 3) failing to disclose material adverse information which severely threatened plan assets; 4) failing to give plan participants accurate, complete, non-misleading and adequate information about the composition of the Plan's portfolios; 5) failing to monitor or evaluate the performance of those appointed to fiduciary capacities; and 6) by promoting company stock as a prudent plan investment and encouraging Plan participants to invest in company stock.³³⁴ The defendants moved to dismiss on, among other grounds, that to the extent they had any fiduciary duties with respect to the disclosure of information, they could not as a matter of law breached them

³³³ 278 F. Supp.2d 853 (E.D. Mich. 2003).

³³⁴ These were the allegations against the chairman and CEO of the company and largely repeated against other fiduciaries, including the allegation against the outside directors, that they failed to take steps to eliminate or reduce the amount of company stock in the plan; maintained restrictions on the trading of company stock held in the plans at sometime when such restrictions had the effect of creating and maintaining an unsound level of concentration of plan assets; allowing and compelling continued investment in the company stock fund, when a reasonable fiduciary would have known that the investment was not prudent; failing to disclose material adverse information which severely threatened plan assets. 278 F.Supp. 2d at 863-64.

because to have disclosed non-public information about the company would have violated securities laws. In ruling on the motion the court reviewed the decisions of three other courts on the same defense: *Hull v. Policy Management Sys. Corp.*,³³⁵ which assumed the same defense argument was correct, but did not decide the motion to dismiss based on the argument; *In re McKesson HBOC ERISA Litigation*,³³⁶ accepting the argument, in a slightly different context and dismissed plaintiffs' claims accordingly; and *In re Worldcom, Inc.*,³³⁷ flatly rejecting the argument. The court thought the better view was that in *Worldcom*. The court essentially quoted large sections from the *Worldcom* decision, without any explanation why it was the better view.

In *Hill v. BellSouth*,³³⁸ the court endeavored to narrow the duty of disclose to cases presenting special circumstances. The court, however, was not successful, since the circumstances there are those occurring in every case. The court otherwise did not resolve the insider trading dilemma. There, plaintiffs, a class consisting of participants and beneficiaries in a plan governed by ERISA, sued defendants, the company sponsoring the plan and various officers and directors alleging breach of fiduciary duty under ERISA. The Company was the plan's sponsor. Under the terms of the plan, the Defendant Savings Plan

³³⁵ 2001 U.S. Dist. Lexis 22343 (D.S.C. Feb. 9, 2001). See discussion of *Hull*, *supra* at text accompanying notes ----to -----.

³³⁶ 2002 U.S. Dist. Lexis 19473 (N.D. Ca. Sept. 30, 2002). See discussion of *McKesson*, *supra* at text accompanying notes ----to -----.

³³⁷ 263 F.Supp.2d 745 (S.D.N.Y. 2003).

³³⁸ 313 F.Supp. 2d 1361, 2004 U.S. Dist. Lexis 6045 (N.D. Ga. March 30, 2004).

Committee was to serve as Plan Administrator and the Plan was administered through that Committee. Defendant, board of directors, appointed, monitored and removed members of the Savings Plan Committee. The Board of Directors Finance/Strategic Planning Committee, among other responsibilities, oversaw qualified benefit plans. Other defendants included the chief financial officer and executive vice-president, principal accounting officer and vice-president-finance, who signed documents filed with the Securities and Exchange Commission. The company and the Savings Plan Committee were named fiduciaries of the plan.³³⁹ Under the plan, participants contributed a portion of their salaries to the plan and could direct their contributions to be invested in any of the plan's investment options, including BellSouth Stock Fund. The Stock Fund invested in shares of company's stock. Participants' contributions were of two types: basic and supplemental. The Company matched participants' basic contributions, but not supplemental. Matching contributions were made in company stock to an Employee Stock Ownership Plan.³⁴⁰ In January 2001, accounting errors led the company to record doubtful consumer accounts as realized revenue. The company reported these inaccurate revenue statements both to the SEC and to the public through a series of SEC filings and press releases. Later, the company

³³⁹ *Id.* at *5.

³⁴⁰ *Id.* at *5. Initially, these matching contributions could not be transferred to other plan funds, but the plan was modified to allow participants to make such transfers and reallocations. *Id.* at *5.

issued a press release revealing the overstatement to be \$163 million, or about \$.09 per share. The release was followed by an SEC filing.

Plaintiffs alleged that the inclusion of the Stock Fund as a plan option, coupled with communications from Defendants discussing the benefits of Company stock ownership but omitting any discussion of risks, led participants to invest their contributions in Company stock. The failure to properly consider the accounting irregularities and riskiness of certain investments, before investing in company stock amounted to a failure of the plan committee to prudently manage the plan's assets.³⁴¹ Plaintiffs further argued that defendants failed to prudently manage plan assets, to provide complete and accurate information to plan participants and beneficiaries, and to avoid conflicts of interest. Finally, plaintiffs alleged that the company, the board of directors and Finance Committee's failure to monitor the Savings Plan committee's investment in company stock for its prudence, as well as their failure to disclose to that Committee accurate information about Company finances and accounting practices was also a breach of fiduciary duty.³⁴²

Defendants moved to dismiss on the ground, *inter alia* that the investment in the company stock was prudent, especially in light of a presumption that

³⁴¹ *Id.* at *7. Plaintiffs also allege that incentive awards, tied to the value of the company's stock, created a conflict of interest in defendant officers of the company, as they would be unlikely to reveal to plan participants information that might discourage their purchase of company stock in order to bolster stock value.

³⁴² *Id.* at *7.

investment in employer securities is presumptively prudent for Individual Plan Accounts; that the losses from the specific investments complained of did not render company stock an imprudent investment; that its press releases were not fiduciary in nature and could not form the basis of an argument that the Company misled plan participants. Defendants also argued that they had no affirmative duty to disclose information not specified by ERISA; indeed to do so, revealing “inside information” to Plaintiffs might be a violation of Rule 10b-5 which prevents insider trading.³⁴³ Defendants argued from this that there was no proximate cause between defendant’s failure to disclose because assuming that information was wrongly withheld, upon its release, the market would have immediately adjusted and Plaintiffs could not have sold stock at the pre-disclosure price.³⁴⁴

In denying the motion to dismiss, the court began with a discussion of what the fiduciary duty is under ERISA. Some courts have adopted a presumption of prudence for fiduciaries of ESOPs, holding that in the context of investing in the employer’s own stock. That presumption may be overcome by a showing that under the circumstances, the fiduciary could not have reasonably believed that the plan’s drafters would have intended that the fiduciary continue to

³⁴³ *Id.* at 1366. Defendants also argued that they were not liable for lack of diversification because of a statutory exemption; that the existence of a financial interest in the performance of company stock is insufficient to state a cause of action for breach of fiduciary; Defendants further argued that the director and officer defendants did not act in a fiduciary capacity.

³⁴⁴ *Id.* 1366.

comply with the ESOP's direction to invest in employer stock.³⁴⁵ In this case, the court found that plaintiff had sufficiently pleaded facts in which a reasonably prudent person would have found the unexpected nature of the loss, from certain investments, to the company as well as the accounting discrepancies, sufficient to signal that the company was no longer a prudent investment.³⁴⁶

Pointing *In re Enron*,³⁴⁷ for this statement, the court found a willingness among courts "to find an affirmative fiduciary duty to disclose information beyond the traditional duties to disclose specified in the statute or the common law obligation to respond to specific requests from plan participants or beneficiaries."³⁴⁸ However, this new affirmative duty to disclose has only been imposed in "special circumstances with a potentially 'extreme impact' on a plan as a whole, where plan participants generally could be materially and negatively affected."³⁴⁹ But no general disclosure duty has been recognized; some special circumstances are required. In this case, the court accepted plaintiff's allegations as true and the defendant admitted that certain investments were risky; that the company was losing money, in an area in which no other peer company had invested to the same extent; and that revenues had been inflated by improper

³⁴⁵ *Id.* at *12, citing *Moench v. Robertson*, 62 F. 3d 553, 571 (3d Cir. 1995); *Kuper v. Iovenko*, 66 F.3d 1447,1459 (6th Cir. 1995).

³⁴⁶ *Id.* at 1368. The court did express reservations about plaintiffs ability to muster sufficient facts in support of its claim that the Latin American investments rendered Company stock an imprudent investment, but on a motion to dismiss, where the court is required to accept the allegations as true, it could not find that plaintiffs could not prove any set of facts to prove it claim.

³⁴⁷ 284 F. Supp.2d at 555.

³⁴⁸ 313 F.Supp.2d 1361, 1369 citing *In re Enron*, 284 F.Supp. 2d at 559.

³⁴⁹ *Id.* at 1370, citing *In re Enron*, 284 F.Supp. 2d at 559.

accounting, all the while defendants kept encouraging employee investment in the company stock, which then already represented 40% of the plan's assets.³⁵⁰ The motion to dismiss was denied.³⁵¹ The court did not address what recourses were available to the fiduciaries to protect the trust under the circumstances, i.e., whether the fiduciaries were obligated to make discrete disclosures to the plan and run afoul of insider trading laws or make a public disclosure, which would as the defendants have asserted, caused an adjustment in the stock price, leaving plaintiffs unable to sell their shares at the pre-disclosure price.

In *In re Westar Energy, Inc., ERISA Litigation*,³⁵² plan participants sued the corporate sponsor along with individual fiduciaries³⁵³ alleging, *inter alia* violations of the duty of prudence and loyalty.³⁵⁴ The pension plan at issue was a 401(k) plan, under which the company matched employees' contribution up to a

³⁵⁰ *Id.* at 1369.

³⁵¹ The court went on to deny the motion to dismiss on the conflict of interest claim based upon plaintiff's allegations that defendant's compensation was tied to stock performance and defendants knew of overstatement revenues. At the very least, the court found, plaintiffs have pleaded facts, accepted as true, that show the fiduciaries had insider knowledge, knowledge which affected the price of stock that they held and in some cases, sold, and acted in a way that benefited them personally, yet did not protect the trust. *Id.* at 1370. The court also denied the motion to dismiss the claim alleging failure to monitor, finding that plaintiffs' allegations based upon the assumption that the decision to invest in company stock was imprudent; plaintiffs' theory was that the failure to monitor consisted in allowing imprudent investment in Company stock. The allegations did state such a claim. *Id.* at 1371.

³⁵² 2005 U.S. Dist. LEXIS 28585 (D. Kan. September 29, 2005).

³⁵³ The defendants included the corporation sponsor; the Investment and Benefits Committee, the administrator of the Plan; David D. Wittig, former the chief executive officer; and nine individual members of the Committee.

³⁵⁴ The gist of the complaint was that the defendants breached their fiduciary duties through engaging in, allowing, failing to monitor, failing to disclose, misleading communications (through representations and omissions) and through failing to appropriately respond to the risky, abusive, aggressive, illegal and wrongful conduct of themselves and others. *Id.* at *5.

maximum of 50% of the first six percent of the participant's contributions.³⁵⁵ Among the investment alternatives was the Westar Energy Common Stock Fund. The company could match contributions with either common stock or cash. For most of the life of the plan, the company matched contributions with company stock. In fact, until just before the suit was instituted, company matching contributions were effectively locked into Westar stock, for matching contributions were not permitted to be transferred into other investment accounts.³⁵⁶ The plan was administered by the Investment and Benefits Committee with the responsibility of taking "all actions required of the Company in the administration of the Plan." "The Committee was comprised of three to five members, who were appointed and removed by the company's chief executive officer. One of the members was responsible for the routine administration of the Plan, and the other members and the Committee as a whole were responsible for matters relating to the investment of the Plan's assets, including the semi-annual or greater review of the investment performance, the condition of the Plan's assets, the selection of a trustee or any other investment managers, review of the performance of the trustee and any other investment managers and the recommendation of changes in investment managers. The Committee was also responsible for the assumption of any responsibilities

³⁵⁵ The plan was designated as a stock bonus plan within the meaning of §401(a) of the Internal Revenue Code, and an employee stock ownership plan within the meaning of §4975(e)(7) of the Internal Revenue Code.

³⁵⁶ *Id.* at *8. This restriction did not apply to participants age 55 and over. *Id.* at *8, n. 13.

delegated to an individual member of the Committee in the event that the “Committee deems it necessary and prudent to do so.”³⁵⁷

The specific conduct of which the plaintiffs complained was that the company embarked on acquisitions of unregulated businesses in the home security field, acquiring three companies at price exceeding \$600 million, which resulted in a substantial decline in the company’s income and a substantial increase in debt obligations; undertook a restructuring scheme which saddled the company with a capital structure of 93% debt, all the while making public statements that the restructuring would be beneficial for the company, and knowing the events and occurrences showed otherwise;³⁵⁸ and permitted a variety of executive compensation schemes and self-dealing transactions calculated to drain corporate resources.³⁵⁹ The plaintiffs maintained that the defendants misrepresented or failed to disclose certain facts regarding the proposed

³⁵⁷ *Id.* at *9. According to Plan documents, the Committee reviewed the investment options available to Plan participants; the Plan participants were specifically told the “number and type of Investment Funds may be adjusted from time to time by the Investment and Benefits Committee as it deemed advisable. *Id.* The court declined to address the applicability of ERISA 404(c), which precludes liability on the part of a fiduciary where the participant exercised “independent control” over their accounts, provided they had sufficient information to make informed decisions with regard to investment alternatives, because the company did not address the issue in its reply brief and because the complaint made numerous allegations that the defendants failed to provide adequate information to participants for informed decision making and because this is an affirmative defense, placing the burden of proof on the defendants. Thus, the issue was not properly determined on a motion to dismiss.

³⁵⁸ These events and occurrences included the criticism by the Kansas Corporation Commission and other experts, the rejection of a rate increase, and an actual decrease in rates. *Id.* at *30.

³⁵⁹ Plaintiffs sought to hold the named fiduciary, corporate sponsor, liable for breach of a duty of prudence and loyalty where it continued the allocation and designation of discretion to the Committee despite knowledge that the Committee was not capable to managing the funds honestly and prudently. As such, the corporation was not entitled to the safe harbor protection under ERISA. *See* 29 U.S.C. § 405(c).

restructuring, company compensation policy and accounting misrepresentations.³⁶⁰

Defendants asserted among other things³⁶¹ that to make the disclosures plaintiffs identified, would have required them to violate securities laws on insider trading and that ERISA cannot be construed to “invalidate, impair, supersede any law of the United States.” Defendants relied largely on *In re McKesson HBOC, Inc. ERISA Litigation*³⁶² and *Hull*.³⁶³ The court first attempted to distinguish the case from the facts in *Hull*, pointing out that unlike in *Hull*, the plaintiffs made no allegation that the defendant investment committee had actual knowledge of misrepresentations or misinformation communicated to plan participants. But here, plaintiffs alleged that defendants knew or should have known that representations in SEC filings contained misrepresentations. The complaint also alleged facts, which if proven, would circumstantially show that at least some of the Committee Defendants knew or should have known of the misrepresentations, since some were officers involved in the underlying transactions. But this was not a fair reading of *Hull*. The plaintiffs, as here, alleged deliberate conduct by

³⁶⁰ *Id.* at *43. The Plaintiffs alleged the company failed to disclose the Asset Allocation agreement in connection with the restructuring, which provided for the imposition of \$1.6 billion of debt on the utility business, debt which had been used to acquire the non-utility businesses and assets.

³⁶¹ Defendants also asserted that plaintiffs had failed to establish a causal nexus between their alleged misconduct and the plaintiffs’ injuries. The court dismissed the assertion, finding -----
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³⁶² There the court dismissed a claim for failure to state a claim upon which relief could be granted, finding that there was no feasible option available to the defendants that would not have violated federal securities laws, including those on insider trading.

³⁶³ cite

fiduciaries in providing misinformation and failing to provide information of which they had actual knowledge.

Essentially, the *Westar* could interpreted defendant's argument as one involving the theory of "inevitable loss", that any actions they might have taken would not have prevented the loss of stock value. At the same time, it rejected that theory. It simply chose to follow *Enron*, that plan fiduciaries must follow both laws, meaning that there must be disclosure before trading, "whether impractical or not, because continuing silence and deceit would only encourage the alleged fraud and increase the extent of injury."³⁶⁴

C. Skirting the Issue

Some courts, rather than dealing with the issue head on or taking a position that would be clearly disingenuous, have acted to skirt the issue altogether. In *In re Williams Companies ERISA Litigation*,³⁶⁵ plaintiffs pension fund participants and beneficiaries sued the company, sponsor of the pension

³⁶⁴ 2005 U.S. Dist. Lexis 28585, at *53-54. In what seems a departure from the lack-step rulings of many cases, in *Wright v. Oregon Metallurgical Corp.*, 360 F.3d 1090 (9th Cir. 2004), the Ninth Circuit adopted a more normal view on required disclosure declined to adopt the *Moench* standard for imposing liability for breach of the duty of prudence on the ground that it tended to encourage corporate officers to utilize inside information for the exclusive benefit of the corporation and its employees, which might potentially violate federal securities laws. *Id.* at 1098, n.4. In *Wright*, the plaintiffs sought to hold plan fiduciaries liable for failing to investigate investment alternatives or to amend the plan to permit participants to sell a higher percentage of employer securities than then permitted was a breach of the duty of prudence, exclusive purpose and prohibited transactions under ERISA. There, the plan was an employee stock bonus plan and an employee stock ownership plan, the terms of which mandated that a defined minimum percentage of each plan participant's portfolio had to be invested in the employer stock. The plan originally allowed participants to sell up to 40% of the employer stock in their individual accounts each year so long as the participant remained an employee. *Id.* at 1093-94.

³⁶⁵ 271 F. Supp.2d 1328 (N.D. Okla. 2003).

plans, along with the board of directors and the Benefits and Investment Committee for breach of fiduciary duty under ERISA. Plaintiffs alleged that the fiduciaries breached their duties by failing to disclose that the company was operating below company sponsored expectations; that it was impossible for the company to meet its financial goals without substantially revising estimates to include massive cap-ex spending reductions, information which suggested that investment in the company stock was imprudent. The plan at issue was an eligible individual account plan,³⁶⁶ under which each participant in the plan has an individual account and his or her plan benefit was based solely on the value of that account, i.e., contribution to the account plus any earnings and less any losses or allocated expenses.³⁶⁷ The plan was also an employee pension benefit plan,³⁶⁸ which had both an employee and employer contribution feature, permitting but not requiring employees to invest a portion of their salary in a variety of options, including company stock. Eligible individual account plans are expressly exempted from ERISA's diversification requirements, which would otherwise limit the holding of company stock.³⁶⁹ The plan declared that it was a qualified employee stock ownership plan designed to invest primarily in qualifying employer securities and explicitly included the company's common stock as an

³⁶⁶ 29 U.S.C. § 1002(34).

³⁶⁷ *Id.*

³⁶⁸ 29 U.S.C. § 1002(2)(A).

³⁶⁹ 29 U.S.C. § 1104(a)(2).

investment option.³⁷⁰ Employee participants had responsibility for deciding how their contributions would be invested.³⁷¹ The plan promoted employee ownership through the company's voluntary match, which was invested solely in the company's common stock,³⁷² and provided that participants could diversify out of their match and BESOP accounts when their employment was terminated or upon reaching a designated age--initially 55, then lowered to 50.³⁷³

The defendants moved to dismiss on the grounds, among other things, that they had no duty to disclose material non-public financial information and, in any event, any such disclosure would have constituted a violation of federal securities laws; that they had no duty to eliminate company stock as an investment option and, even if they did, Section 404(c) of ERISA insulates them from liability, that section exempting the plan from the diversification requirement; and they had no duty to avoid any alleged conflict of interest. The court rejected all three arguments, although it did not give separate reasons for each defense, finding that “parsing of the alleged actions by the Committee defendants [would not be] useful

³⁷⁰ 271 F. Supp.2d at 1328.

³⁷¹ *Id.* at 1332.

³⁷² *Id.* at 1333.

³⁷³ *Id.* at 1334. The court found that the Benefits Committee given the power under the plan to appoint members of the Administrative Committee or Investment Committee and to delete or establish an Investment Fund was a fiduciary for purposes of ERISA liability as well as the Investment Committee, charged with recommending investment managers who would actually invest the contributions of each fund and for monitoring the performance of the investment funds and investment managers and for implementing any investment objectives or guidelines established by the Benefits Committee, but not the company, nor the board merely by virtue of their power to appoint members of the Benefits Committee, where they otherwise did not control investment decisions or communicate Plan information. *Id.* at 1338, 1339, 1342.

at this stage of the litigation.”³⁷⁴ The court found that the fundamental question was “whether the allegations in the Complaint, accepted as true, make out a claim for a breach of fiduciary duty,” and ruled that they did.³⁷⁵ The court specifically found that under the plan, the Investment Committee had the discretion to recommend investment options to the Benefits Committee and the Benefits Committee had the discretion to delete or establish an Investment Fund. In that the plan did not require that company stock be offered as an investment option, any plan fiduciary had a duty to decide or present its views on the wisdom of investment options and it would have been a breach of that duty to fail to address the need to eliminate, or at least to consider eliminating, company stock as one of the investment alternatives.³⁷⁶ In the court’s view, the duty to disclose, duty to eliminate inappropriate investment options, and the duty to avoid a conflict of interest were in effect different aspects of a single fiduciary duty.³⁷⁷ Indeed, the court found that had the Investment Committee recommended removing company stock from the list of available investment options, based upon its alleged knowledge that company stock was wrongfully inflated, the damage alleged would not have occurred.³⁷⁸ The court otherwise did not address the insider trading prohibition asserted by the defendants, leaving it unclear whether the

³⁷⁴ *Id.* at 1343.

³⁷⁵ *Id.* at 1343.

³⁷⁶ *Id.* at 1343. The cited *In re Worldcom, Inc., ERISA Lit.*, 263 F. Supp. 2d 745 (S.D.N.Y. 2003).

³⁷⁷ *Id.* at 1343.

³⁷⁸ *Id.* at 1342.

fiduciary, after having considered the prudence of company stock as an investment, would have had to disclose publicly the basis of this conclusion so that plan participants could divest.

In *In re CMS Energy ERISA Litigation*,³⁷⁹ plaintiffs, plan participants sued the employers and certain directors and officers of the companies, alleging, *inter alia*, breach of fiduciary duty under ERISA in failing to prudently and loyally manage plan assets; failing to provide complete and accurate information to participants and beneficiaries; failing to monitor the plan's fiduciaries; and causing the plan to engage in a prohibited transaction by acquiring CMS stock for the plan for more than adequate consideration.³⁸⁰ The retirement plan was established and sponsored by CMS Energy Corporation, Consumers Energy Company and CMS Marketing Services and Trading Company. The plan had two components, both allowing for investment in CMS stock. One part was a 401(k) Savings Plan allowing for employees' direction of contributions into an investment of their choosing, from ten investment options, including Fund CS, which consisted primarily of CMS stock.³⁸¹ The other plan was an Employee Stock Ownership Plan, where matching contributions up to 3% of an employee's

³⁷⁹ 312 F. Supp.2d 898 (E.D. Mich. 2004).

³⁸⁰ *Id.* at 903.

³⁸¹ *Id.* at 902. Prior to January 1, 2001, participating employees could contribute up to 16% of their pay to the plan; thereafter, they were permitted to contribute up to 25% of their pay. *Id.* at 902. Under the 401(k) plan, participants decided how to allocate their account assets among the investment options offered to them. According to the plan terms, the matching contributions made by participants' employers, as well as incentive contributions, were made primarily in the form of CMS stock and allocated to Fund CE, which consisted of CMS Energy Corporation common stock and temporary investments. *Id.* at 902.

salary were directed into the participating employee's ESOP account. Also, incentive contributions were sometimes contributed to employees' ESOP accounts.³⁸²

Plaintiffs alleged that CMS engaged in "round trip" electricity trades, where purchases and sales of electricity happened simultaneously, with the same parties and at the same price, that these trades, while having no effect on net earnings of CMS, indicated an increased buying and selling volume, by including \$4.4 billion of revenues and expenses, but which had no economic substance, and violated generally accepted accounting practices, rendering the financial statements materially false. Plaintiff alleged that the CMS stock dropped after CMS stopped making round trip trades and an investigation of the practice became public.³⁸³

³⁸² *Id.* at 902

³⁸³ *Id.* at 902-03. The first question for the court on defendants' motion to dismiss was who was a plan fiduciary within the meaning of ERISA. The individual defendants argued that they were not specifically mentioned in the plan and could not therefore be deemed a fiduciary simply by virtue of their positions as officers and directors of CMS. Also, the absent any discretionary authority or control exercised by them, their status as directors and officers did not make them fiduciaries. The court first looked to the terms of the plan itself, which provided that the "Employer shall be responsible for the general administration of the plan and for carrying out the provisions thereof. They may establish rules and regulations to carry out the provisions of the Plan, ... The Board of Directors of Consumers shall appoint such persons, who may be Members under the Plan, as it determines at any time to act as Plan Administrators in all dealings under the plan. The Employers are hereby designated as the Named Fiduciaries and Plan sponsors for the plan." *Id.* at 906-07. The court concluded that ERISA did not require an individual to be named in a plan to be fiduciary, which meant that individual directors and officers of the named plan fiduciary, the Employers, could be held to be fiduciaries. Here, the broad language in the plan arguably implied that any investment policy would be made by the Employers, where the plan did not otherwise delegate investment policy or decisionmaking power to any other managers, although the Board of Consumers could choose a plan administrator and the Employers could choose an investment manager, but instead reserved the broadest administrative and management responsibility to the Employers. The court was not inclined to dismiss the complaint against the individual defendants

Defendants argued, *inter alia*, that they did not breach their duties to prudently and loyally manage plan assets, where the assets were invested exactly as required by explicit plan terms. However, the court pointed out, where as here, the plan contributions made by the employers were made in a fund that consisted *primarily*, not exclusively, of company stock, that left the plan administrator, inside directors and employer named fiduciaries with significant discretion to manage the plan assets. This meant the fiduciaries had a duty to exercise judgment in investing in company stock. In any event, the court ruled, even if the plan contained absolute requirements, defendants were still obligated under ERISA³⁸⁴ to ignore the plan, to the extent such term required them to act imprudently.³⁸⁵ Ordinarily, a fiduciary is entitled to a presumption that she acted consistently with ERISA when she invests assets in employer stock in accordance

absent specific findings on what responsibilities were actually assumed by them. *Id.* at 908-09. Defendants argued that was no ERISA fiduciary duty to advise plan participants concerning whether investment in company stock was a sound decision or any duty to refuse the selection of a fund by an employee because ????????? The defendants argued that the conduct at issue involving business decisions, which might lead to a securities claim do not automatically constitute a breach of fiduciary duty under ERISA. *Id.* 911. The defendant cite to *Hamilton v. Carell*-, 243 F.3d 992, 998 (6th Cir. 2001) for the proposition that corporate business decisions do not generally implicate fiduciary duties, and only actions taken in administering or managing plan assets, rather than establishment of a plan, are subject to fiduciary standards, citing *Akers*, 71 F.3d at 230. Plaintiffs countered with the argument that alleged failures here, i.e., to offer CMS stock to plan participants, match with CMS stock, and withhold critical information about CMS stock from participants, during the period of sham trading and securities fraud were not “business decisions” protected by the “two hats” rule, but were discretionary acts squarely within the defendants’ fiduciary responsibilities. The court did not straightforwardly respond to defendants’ argument, but rejected them, pointing out that “ERISA did not require that the fiduciary with two hats wear only one at a time and wear the fiduciary hat when making fiduciary decision.” *Id.* at 911. The court noted further, while defendants may be fiduciaries regarding certain actions, but not others, the plaintiffs had pleaded sufficient facts to put defendants on notice of the claims against them. But on notice of what? What conduct specifically was actionable?

³⁸⁴ 29 U.S.C. § 1104(1)(1)(D).

³⁸⁵ 312 F. Supp. 2d at 913.

with Plan documents. But that presumption can be overcome by a showing that a prudent fiduciary would have made a different investment decision.³⁸⁶

The decision seemed to lump Defendants' remaining arguments into one: that with the ESOP's, Congress sought to encourage employee investment in the company, such that such investments were not improper; that they could not be liable because the plan gave participants a variety of investment fund choices for the Savings Plan; and that they could not have obtained inside information about CMS' financial dealings and lawfully used such information to benefit plan participants, that such use would have constituted "tipping" as proscribed by the Securities laws.³⁸⁷ The court noted the exemption from the diversification requirement under ERISA as to ESOP's, but noted that only a portion of the plan here fell within the exemption, and even as to that portion, a fiduciary is still obligated to diversify if not diversifying would be imprudent.³⁸⁸ As to the argument that defendants could not be liable for following the directions of the

³⁸⁶ *Id.* at *39, citing *Kuper v. Iovenko*, 66 F. 3d at 1459. The court accepted defendants argument that there could be no breach of fiduciary duty for failure to amend the plan, but ruled that advising plan participants about the wisdom of company stock as an investment was not a de facto plan amendment. Instead, plaintiffs' claims were that the plan administrator exercised authority and control over plan assets by advising the committees with regard to performance of the plan's investment and investment managers, selecting plan investment options and ensuring that plan assets were prudently managed and protected. Furthermore, the plan reserved broad management and administrative powers for the Employers, who chose and directed the trustee under the plan and made incentive and matching contributions to the plan in the form of company stock and/or under the terms of both plans, cash or temporary investments. Such discretion created the potential for fiduciary liability. *Id.* at 914, citing *Kuper*, 66 F.3d at 1459.

³⁸⁷ *Id.* at 914. The defendants relied on *Hull v. Policy Management Sys. Corp.*, 2001 U.S. Dist. LEXIS 22343, *26 (D.S.C. Feb. 9, 2001) which held that a fiduciary does not breach an ERISA fiduciary duty by failing to disclose to plan participants material non-public information, which would violate the insider trading laws.

³⁸⁸ *Id.* at 914-15.

plan, the court pointed out that plaintiffs' claim was not that defendants failed to give investment advice, but that they failed to take action through other measures short of amending the plan in order to protect plan assets.³⁸⁹

On the insider trading issue, the court found the case relied on by defendants, *Hull*, as not on point. Instead, the court relied on an opinion by a court in its jurisdiction, *Rankin v. Rots*,³⁹⁰ which quoted extensively from the *Worldcom*,³⁹¹ case that “[t]hose who are ERISA fiduciaries...cannot in violation of their fiduciary obligations disseminate false information to plan participants, including false information contained in SEC filings.... [I]n any event, the existence of duties under one federal statute does not, absent express congressional intent to the contrary, preclude the imposition of overlapping duties under another federal statutory regime.”³⁹² The court adopted the thinking of the court in *Rankin*, finding that the securities law does not bar any portion of plaintiffs' claims. Again this court does not explain why.³⁹³

³⁸⁹ *Id.* at 915.

³⁹⁰ 278 F. Supp. 2d 853 (E.D. Mich. 2003).

³⁹¹ *Quayle v. MCI Worldcom*, 2001 U.S. Dist. LEXIS 17450.

³⁹² 312 F.Supp. 2d at 915, quoting *Worldcom*, 2001 U.S. Dist. LEXIS 17450, 2003 WL 21385870, at *14-15.

³⁹³ *Id.* at 915. Defendants argument addressed plaintiffs' allegation that defendants breached fiduciary duties by conveying misleading information about the soundness of CMS stock and the prudence of investing in that security, through the “SEC and other filings...in the Summary Plan Description, and by directing participants to review the reports in order to educate themselves regarding the risks and benefits of investing in CMS stock in the plan.” Defendants argued that plaintiffs do not allege fact sufficient to state a cause of action because under the “two hats” rule communication of business information through SEC filings does not implicate a fiduciary duty, because in making such a communication, defendants were specifically satisfying a securities law requirement. In a related cause, the plaintiffs alleged that defendants breached their fiduciary duty to plan participants by failing to disclose information about CMS stock. Defendants argued

In *In re Electronics Data Systems Corp. "ERISA" Litigation*,³⁹⁴ plan participants brought suit under ERISA, naming the company and certain officers, including the former chief executive officer, the benefit administration committee, and the investment committee, as defendants alleging breach of fiduciary duty by not disclosing the great risks associated with some of the company's "mega-deals", i.e., multi-year information technology outsourcing contracts negotiated for over \$250 million each.³⁹⁵ The risks affected plaintiffs interest in the EDS

that they did not have a duty to disclose inside information they might have learned about CMS which might have impacted CMS stock values, particularly where the plan itself precludes the named fiduciaries' representatives from making recommendations as to the investment options given by the plan. Moreover, defendants argued, plan participants had the same right and access to public corporate financial information as any other shareholders of CMS stock; that any claim regarding the non-disclosure by the company of the roundtrip trading was properly litigated in the pending securities class action. While the court agreed that defendants did not have a duty to provide investment advice, the plaintiffs' allegations were broader, that they concerned the fiduciaries surrounding disclosure; that the defendants could not mislead or fail to disclose information that they knew or should have known would be needed by participants to prevent losses. *Id.* 915-16. The court also rejected the defendants' argument that it had no duty to monitor. Plaintiffs alleged that "the Employer Named Fiduciaries and Insider Director Defendants breached their fiduciary duties by failing to adequately monitor the Plan Committee, the Plan Administrators and other persons, if any, to whom management of Plan Assets were delegated; that the defendants knew or should have known that the other fiduciaries were imprudently allowing the plan to continue offering company stock as an investment option and investing plan assets in company stock when it no longer was prudent to do so, yet failed to take action to protect the participants for the consequences of other fiduciaries' failure." *Id.* at 916-17. The court rejected defendants' argument noting that the administrative and management responsibilities reserved to the Employers were very broad, that plaintiffs had sufficiently alleged a breach of the duty to monitor. *Id.* at 916-17. The court went on to reject the defendants' motion to dismiss the claim alleging a breach of duty by a co-fiduciary, since the court rejected the motion to dismiss on primary liability which is a requirement for establishing co-fiduciary liability. *Id.* at 917. The court granted the motion to dismiss the claim that the plan purchased CMS stock for more than adequate consideration, where the defendants knew the price of the stock was artificially inflated by fraud. ERISA defines adequate consideration as "the price of the security prevailing on a national securities exchange." 29 U.S.C. § 1002(18) and this definition precludes any consideration of an alternative definition under certain circumstances, where defendants are aware of fraud affecting the selling price, as plaintiffs argued.

³⁹⁴ 305 F. Supp. 2d 658 (E.D. Tex. 2004).

³⁹⁵ *Id.* at 661. While the company boasted of the value of these "mega-deals" on the company's revenues, it was not disclosed that the deals were subject to substantial risks from benchmarking

401(k) retirement plan. The plan was an eligible individual account plan under ERISA which allowed EDS employees to contribute up to 20 percent of their income into one or more various investment options. One of the offered investment options was the EDS Stock Fund, which invested up to 99% of its assets in EDS stock. Also, whenever, EDS made matching contributions on employee investments, those matching contributions were invested in the EDS Stock Fund.³⁹⁶ The harm for which plaintiffs sought recovery included the loss in value by over 50% of EDS stock upon announcement by the company that it would not reach its expected earnings per share by some 70%. Upon the announcement, the EDS stock price plummeted by over 50%, wiping out some \$8 billion in market value, including significant plan value for shares held by plan participants and beneficiaries in the EDS stock fund.³⁹⁷

Plaintiffs alleged that Defendants breached their fiduciary duties under ERISA by continuing to invest plan funds in EDS stock despite knowledge that the stock was an inherently risky investment; by failing to prudently manage plan investments; by continuing to invest plan assets in high risk EDS stock; by misleading plaintiffs by false and misleading Summary Plan Descriptions to plan

and milestone contract provisions, which if triggered, negatively affected EDS. Also the “mega-deals” contracts included early termination provisions that allowed clients to leverage renegotiated terms magnified problems associated with increased costs or pricing reductions. And, some of EDS’s exceptionally large government contracts required large up-front capital investments that reduced EDS’ liquidity. Finally, EDS’ exposure to high risk industries, e.g., airlines industry, allegedly made the company’s investment in the mega deals a risk. *Id.* at 662.

³⁹⁶ *Id.* at 662. Plaintiffs alleged that the EDS Stock Fund represented over 20.8 % of total plan assets on December 31, 2000.

³⁹⁷ *Id.* at 662-63.

participants; by failing to disclose inherent risks in EDS information technology contracts and in its association with the airlines industry.³⁹⁸

Among other things, defendants also argued that they could not be held liable because of an “ESOP presumption” that bars plaintiffs claims. That presumption holds that it is presumed prudent to invest an ESOP in employer stock.³⁹⁹ That is, “an ESOP Trustee is entitled to a presumption that it acted consistently with ERISA in investing plan assets in the employer’s securities unless a showing was made that circumstances have arisen that would make such an investment defeat or impair the original purpose of the trust.”⁴⁰⁰ The court explained, although, courts generally refuse to consider presumptions at the pleading stage, defendants relied heavily on a district court opinion holding that plaintiffs must affirmatively plead facts sufficient to overcome the ESOP presumption.⁴⁰¹ The court refused to rely on that case, and ruled that generally courts should not apply evidentiary standards at the motion to dismiss stage of the

³⁹⁸ *Id.* at 663.

³⁹⁹ *Id.* at 668, citing *Moench v. Robertson*, 62 F.3d 553, 568-72 (3d Cir. 1995).

⁴⁰⁰ *Id.* at 668, citing *Enron*, 284 F. Supp.2d at 534 n.3.

⁴⁰¹ *Id.* at 668, citing *Lalonde v. Textron, Inc.*, 270 F. Supp. 2d 272, 280 (D.R.I. 2003), *rev’d in part, aff’d in part* 369 F. 3d 1 (1st Cir. 2004). In *Lalonde*, the defendant Textron had established an ESOP plan for the plaintiff employees’ benefit. Under the plan, the trustee automatically invested 50% of employee contributions and 100% of employer matching contributions into Textron stock. *Id.* at 276. Plaintiffs alleged that the trustee violated its fiduciary duties by investing in Textron stock when volatile conditions caused the stock to lose 43% of its value over one year. The court noted that ESOP fiduciaries are in a “unique station of having to facilitate the ESOP goal of employee ownership, while at the same time being bound by ERISA’s rigorous fiduciary obligations.” *Id.* at 278. Thus, the court adopted the “reasoning of the Third and Sixth Circuits that an ESOP fiduciary is entitled to a presumption that its decision to remain invested in employer securities was reasonable.” But, without citation or explanation, the *Lalonde* court declared that plaintiffs must plead facts sufficient to overcome the evidentiary presumption or have the case dismissed on a 12(b)(6) motion. *Id.* On appeal-----

pleadings, because doing so conflicts with the concept of notice pleading under Rule 8(a) of the Federal Rules of Civil Procedure.⁴⁰²

On defendant's motion to dismiss on the ground that plaintiffs' allegations that defendants failed to provide complete and accurate information to plan participants and beneficiaries, the court again ruled against the motion. Plaintiffs alleged that the duty of loyalty owed by fiduciaries required that they speak truthfully to participants, not to mislead them regarding the plan or plan assets, and to disclose information that participants need in order to exercise their rights and interests under the plan. In other words, plaintiffs alleged that defendants, as fiduciaries, offered their beneficiaries an investment which they knew to be unsound and concealed any information that would have allowed the beneficiaries to discover that the investment was unsound. The court rejected defendants' assertion that that count of the complaint was a fraud claim which was required to be pleaded with particularity under Rule 9(b) of the Federal Rules of Civil Procedure, the court finding that the heightened pleading requirements do not apply in a breach of fiduciary duty claim.

Defendants also argued that they had no duty to communicate with plan beneficiaries because the plan allocated the duty to communicate to BAC.

⁴⁰² The theory behind Rule 8 is that all that is required is a short, plain statement of the claim that only needs to give the defendant fair notice of what the plaintiff's claim is and the grounds upon which it rests, and that a plaintiff need not plead a prima facie case before discovery. To require plaintiffs to plead more would conflict with Rule 8(a) and lead to windy complaints, covering matters which may prove to be irrelevant upon discovery. *Id.* at 669.

Against the defendants' arguments, the court considered plaintiffs allegations that defendants were de facto fiduciaries who "were all responsible for the selection and monitoring of the plan's investment options; the plan did not effectively allocate fiduciary duties; and the plan required all fiduciaries to "furnish *all information* needed for the proper performance of such Fiduciary duties." Taken the allegations as true, the court could not find that plaintiffs could not prove any set facts consistent with the allegations that would establish a duty to communicate with plan beneficiaries.⁴⁰³

Defendants further argued that even if they had a duty to communicate with plan beneficiaries, they could not perform that duty without violating the insider trading laws. Defendants claimed that they acquired information about EDS' allegedly poor financial situation in their corporate capacity, and that the information was not publicly available; that if they were to reveal the non-public information to the plan beneficiaries they would violate federal insider trading laws. The court agreed that ERISA does not require Defendants to violate federal insider trading laws by imposing a so-called "duty to tip," it ruled that at the same time Defendants could not use the securities law to shield themselves from their fiduciary duty to protect plan beneficiaries. The court adopted the analysis of the *Enron*, case on this issue: "as a matter of public policy, the statutes should be interpreted to require that persons *follow* the laws, not undermine them. They

⁴⁰³ *Id.* at 672.

should be construed not to cancel out the disclosure obligations under both statutes or to mandate concealment which would only serve to make the harm more widespread; the statutes should be construed to require, as they do, disclosure by Enron officials and plan fiduciaries of Enron's concealed, material financial status to the investigating public generally, including plan participants, whether 'impractical' or not because continued silence and deceit would only encourage the alleged fraud and increase the extent of injury."⁴⁰⁴

In *Xcel Energy, Inc. Securities & "ERISA" Litigation*,⁴⁰⁵ plaintiffs, plan participants, alleged that certain ERISA fiduciaries, including the chairman of the board, president, CEO, directors and members of the finance committee, and the chief financial officer and chief accounting officer, breached their duty by the failure to disclose certain information and failed to act prudently in managing plan assets. The plans at issue were a 401(k) plans and an ESOP, both defined contribution plans providing for individual accounts and eligible individual

⁴⁰⁴ *Enron*, 284 F. Supp. 2d 565. Finally, in a related cause of action, plaintiffs alleged a breach of the duty of loyalty to plan beneficiaries, when with knowledge of the questionable value of EDS stock as an investment, the plan fiduciaries continued to offer it, because it had a conflict of interest as corporate officers with an incentive to conceal unknown information about EDS' stock value, and failed to hire independent advisors, and by failing to take any other steps necessary to eliminate the inherent conflict of interest. The court rejected defendants' motion to dismiss on the ground that that count of the complaint cannot state a claim because ERISA permits fiduciaries to be paid under incentive-based compensation schemes, even though the complaint does not mention the former CEO's incentive-based compensation. 305 F.Supp.2d 658, 674 (E.D. Tex. 2004).

⁴⁰⁵ 312 F.Supp. 2d 1165 (D.Minn. 2004).

account plans.⁴⁰⁶ The 401(k) plan identified three plan fiduciaries: the company, an appointed committee and the plan trustee. The ESOP plan identified two fiduciaries: the company and the trustee. The plans identified the company as plan administrators.⁴⁰⁷

Plaintiffs alleged that defendants knew of the significant risks posed to Xcel stock value as a result as a result of certain cross-default provisions and round trip trading (buying energy and selling it back at the same price, thereby inflating sales revenue), yet failed to advise plan participants of these risks or otherwise take action such as diversification to protect plan assets. When the cross-default provisions became public, the stock price of Xcel dropped. Plaintiffs alleged that defendants knew or should have known of various risks to plan participants who were investing in Xcel stock through the plans; that as plan fiduciaries, defendants were obligated to invest plan funds prudently and with only the interests of plan participants in mind, diversify plan investment, monitor

⁴⁰⁶ As defined contribution plans, the plans provided an individual account for each plan participant based on that participant's contributions and company matching contributions. 29 U.S.C. § 1002(34) and 1107 (d)(3). Each of the plans included an ESOP component and a non-ESOP component. An ESOP was designed to invest primarily in qualifying employer securities. 29 U.S.C. 1107 (d)(6). The non-ESOP components allowed participants to contribute a portion of their pay to various investment funds, including an Xcel stock fund, on a pre-tax basis to provide for retirement. Participants chose the fund or funds in which their contributions were to be invested. Each plan called for the company to make matching contributions. Company contributions to the ESOP's were made in Xcel stock or cash to be invested in Xcel stock. Contributions to the non-ESOP component were either made in cash or company stock, if the employee had chosen that particular investment. *Id.* at *1173.

⁴⁰⁷ *Id.* at *1173.

individuals assigned fiduciary duties, investigate matters posing significant risk to the plans, and disclose material information to plan participants.⁴⁰⁸

Defendants moved to dismiss on the ground among other things that the complaint failed to state a claim upon which relief could be granted. First, defendants argued that they were not plan fiduciaries liable under ERISA. While the complaint did not specify which particular duty was breached by a particular defendant, the court thought in light of the theory of notice pleading under Rule 8 of the Federal Rules of Civil Procedure, dismissed at this stage of the litigation was not warranted. It was sufficient that plaintiffs alleged that defendants were either named fiduciaries or functional fiduciaries.⁴⁰⁹

Defendants also argued that they were entitled to a presumption of prudence since the plan was an ESOP, such that plaintiff was required to plead a rebuttal to the presumption. But the court rule that presumptions are evidentiary standards that should not be applied to motions to dismiss.⁴¹⁰ In any event, to overcome the presumption, plaintiff was only required to plead that continued investment in company stock constituted an abuse of discretion in light of the circumstances.^{411 412}

⁴⁰⁸ *Id.* at 1165.

⁴⁰⁹ *Id.* at 1178-79.

⁴¹⁰ *Id.* at *1180, *citing Swierkierwicz*, 534 U.S. at 510-14.

⁴¹¹ *Id.* at *1180, *citing In re McKesson*, 2002 U.S. Dist. LEXIS 19473. The individual defendants also argued that they were not acting as fiduciaries, that the company was the designated fiduciary, that individuals on committees with fiduciary responsibility such as the finance committee were not acting in an individual capacity and that the finance committee was responsible only for oversight. Taking the allegations in the complaint as true, the court thought it premature to

However, the court agreed with defendants that plan elements, and design that ESOP funds be invested in company stock, that participants be restricted from trading in the ESOP until the age of 55 and that company stock be offered as an option in the non-ESOP portion of the plan are plan design decisions that are not subject to ERISA's fiduciary standards.⁴¹³ But plaintiffs did not argue that the plan design violated ERISA, but that defendant had an affirmative duty to disclose after they became aware of material adverse information about the true value of the stock. Defendants also argued that to have revealed the adverse information to plaintiff's apart from the market or to have selectively acted upon that information to the plan's benefit could have constituted insider trading.

On this argument, the court joined those courts holding ERISA plan fiduciaries cannot use the securities laws to shield themselves from potential liability for alleged breaches of their statutory duties.⁴¹⁴

determine defendants fiduciary status at the motion to dismiss stage of the proceedings because such a determination is a mix question of law and fact and because "fiduciary status under ERISA is to be construed liberally, consistent with ERISA's policies and objectives." *Id.* at *1181.

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⁴¹³ *Id.* at *1181.

⁴¹⁴ *Id.* at 1181-82, citing *In re Elec. Data Sys.*, 305 F. Supp.2d 658, 2004 U.S. Dist. LEXIS 2631; *In re Enron*, 284 F.Supp.2d 511, 565. The court quoted from *Enron* that the "statute should be interpreted to require that persons follow laws, not undermine them. They should be construed not to cancel out the disclosure obligation under both statutes or to mandate concealment, which would only serve to make the harem more widespread, the statutes should be construed to require, as they do, disclosure by [company] officials and plan fiduciaries of [the company's] concealed, material financial status to the investing public generally, including plan participants, whether 'impractical' or not...." *Id.* at *1182, quoting *In re Enron*, 284 F. Supp.2d at 565-66.

VII. Resolution of the Conflict

The conflict is this. Some courts rule that a plan fiduciary has no duty to disclose to plan participants facts of financial misconduct or other transactions which might influence the decision of the plan participant to dispose of company stock, if to do so would violate the securities laws. Other courts impose liability upon plan fiduciaries for failing to make the same disclosure to plan participants, but also impose a duty upon the fiduciary not to violate insider trading laws.

How can these cases be harmonized? How can the affirmative duties imposed by ERISA on a plan fiduciary be reconciled with the prohibition on insider trading under the securities laws? Should the plan fiduciary who is a corporate insider be required or permitted to make discrete disclosures to plan participants of information having a negative impact on the value of company stock as an investment, allowing divestment of that stock? Here are some relevant considerations.

The prohibition on insider trading is not absolute. Instead, it binds only those who have a duty--either to those with whom the possessor of the information is trading or the corporation whose shares are being traded or to the source of the information. Thus, one who obtains information through independent research, fortuitously, and even by theft is free to trade to the disadvantage of the other party. With this is the reflection of the idea that the securities laws cannot and should not strive to equalize all risks in the market;

there are some informational disadvantages that are unavoidable. But how is the plight of the employee-shareholder similar to the fortuitous possessor of information? It seems that there are not. Instead, they seem in no different position than the insider in *O'Hagan*, who obtained and traded on information in breach of a duty owed to the source of the information. Here, the plan participant would be trading on information received from one, a plan fiduciary/insider in breach of a duty owed to the source. But, is the case different if the corporation discloses the information to the plan fiduciary without restrictions on what could be done with the information? Using it by the tippee, then would not be actionable, because the disclosure would not have been wrongful. Would the corporation have a duty to make public disclosures? Regulation FD may yet require it.

Chiarella held that not all instances of unfairness amount to fraud. While giving the plan participants the advantage of the bad news to enable divestment, passing on the projected losses to the purchasers, it cannot be argued that this unfairness does not amount to fraud if what the insider in *O'Hagan* did was fraudulent.

The rulings from the courts supposedly requiring disclosure to both participants and to the public are not satisfying; they leave millions of innocent employee-investors subject to harm and may impose onerous disclosure duties on corporations, that far exceed that now required by the Securities Acts. ERISA

and the Securities Acts serve discrete aims: ERISA to encourage and safeguard employee retirement plans, through stringent fiduciary duties requiring prudent management; the Securities Acts to encourage periodic disclosure to ensure informed investment decisions.

It seems helpful to consider the extent to which the plan participants had actual control over the investment of plan assets. If they do not, then requiring a plan fiduciary to disclose material non-public information will help avoid injury to one who is as innocent as the person on the other side of the trade. It is important to consider the extent to which the persons on the other side of the trade assume a degree of risk in investing in stocks to start with, and whether research could have produced the non-public information, or at least some red flags. The securities laws should not aid those who knowingly engage in a crooked game.

Under the *Dirks* analysis, it is arguable that a disclosure to the plan participants would be actionable where the ERISA fiduciary does not personally benefit by the disclosure, but is only acting to protect plan beneficiaries. Yet, the broad definition given to personal benefit by the Supreme Court including a reputational advantage which might translate into a pecuniary benefit in the future would suffice. Does the ERISA fiduciary obtain such an advantage from protecting the assets of the plan.? The court did not find such a benefit in *Dirks*, who alerted clients to the massive fraud taking place in the corporation whose shares were traded.

Do the interests in protecting pension plan benefits outweigh the possible harm to shareholders dealing without equal information in an anonymous market? The Court has made clear that only uses of material non-public information which is a breach of some fiduciary duty is actionable under Section 10(b). As said above, the fortuitous acquirer or one who is given permission by the source of the information may use it without regard to injury to the person trading on the other side. So also information obtained through research and intuition may be used without the requirement of disclosure, yet the same harm results to the person on the other side of the trade without that information.

Congress could require that no plan fiduciary be an insider of the corporation. But this would only mean less information than is currently available. The possible losses to pensioners might be reduced by stricter limits on the extent that pension plans can be funded with company stock. While not permitting the corporate insider to make non-public disclosures to facilitate trades by the employee-shareholders, courts could read the ERISA fiduciary duty to require him or her to advise the employees that further investment in the company would not be wise, but without stating why, if that would reveal non-public corporate information, and to urge the company to match contributions in other than company stock. This decision, not to fund pension plans with company stock would not be a trade and therefore not prohibited by insider trading laws.

But it would go a long way to reducing potentially devastating losses to the pensioners.

According to Department of Labor regulations, 29 C.F.R. § 2550.404a-1(b), these requirements are satisfied if the fiduciary has given appropriate consideration to those facts and circumstances that, given the scope of such fiduciary's investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action. Appropriate consideration includes but is not limited to a determination that the particular investment or course of action is reasonably designed, as part of the portfolio to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain, and a consideration of the composition of the portfolio with regard to diversification, the liquidity and current return of the portfolio relative to

anticipated cash flow requirements of the plan; and the projected return of the portfolio relative to the funding objectives of the plan.