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ERISA FIDUCIARY LIABILITY AND INDEMNIFICATION

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The material in this outline is not intended to provide legal advice as to any of the subjects mentioned but is presented for general information only. Readers should consult knowledgeable legal counsel as to any legal questions they may have.

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I. ERISA FIDUCIARY LITIGATION

Traditionally, most fiduciary claims have been brought by participants in and beneficiaries of a company's employee benefit plan for denied or unpaid benefits. However, new developments in the law and resourceful plaintiffs' lawyers have created meaningful exposures for plan fiduciaries and other corporate insiders. The primary exposures for companies and their directors, officers, and fiduciaries arising under the Employee Retirement Income Security Act of 1974 ("ERISA") are discussed below.

A. Stock Drop Litigation

1. Introduction

Over the last several years, there has been an explosion in the frequency and severity of ERISA litigation filed following a sudden and large downturn in a company's stock price. Such a stock drop frequently results in securities class action lawsuits filed on behalf of the company's public shareholders who purchased shares at an allegedly inflated market price. These lawsuits typically allege that the company and its directors and officers failed to disclose adverse information sooner, thereby resulting in the artificial inflation of the market price for the company's securities during an alleged class period. The shareholders allege that they are entitled to recover the difference between what they actually paid for the securities and what the market price would have been if full and accurate information had been timely disclosed.

A favorite new type of class action lawsuit now being filed with regularity by plaintiff law firms is brought under ERISA. Primarily beginning with the Enron debacle, these class actions are brought on behalf of participants and beneficiaries of a company's retirement plans to the extent the plans own securities of the company. The complaints in these class actions contain the same factual allegations as set forth in the securities class action lawsuits (i.e., the defendants misrepresented or failed to disclose certain material information about the company or its financial performance or condition). Instead of alleging those misrepresentations or omissions constitute a violation of the securities laws, however, the new lawsuits allege the defendants breached their fiduciary duties under ERISA.

2. Overview of the Primary Claims and Defenses

The typical ERISA stock drop lawsuit is filed by and on behalf of a putative class of participants in and beneficiaries of a company's 401(k) plan against the company, its directors and officers, the plan, members of the plan's investment and benefits committee, and other individuals who at least arguably functioned as fiduciaries with respect to the plan. Plaintiffs generally allege that those supposed fiduciaries breached their fiduciary duties under ERISA by allowing the plan or its participants to purchase company stock as an investment option when they knew or should have known that the stock was (1) artificially inflated based on misrepresentations or material omissions, or (2) inherently imprudent based on various risk factors whether disclosed to plan participants or not. In order to set forth a colorable claim, plaintiffs need not allege that company stock was the only plan option available to plan participants or that plan participants were forced to invest in or maintain their investments in company stock. Rather, the plans at issue will typically give participants the freedom to invest in

several diversified fund options, only one of which will have a high or exclusive concentration of company stock.

The typical categories of claims in these ERISA class actions include:

- Claims against officers and directors for deceiving plan participants and beneficiaries by disclosing false and misleading information and failing to disclose material information about the company and its financial condition and performance, either in statements to the general public, to shareholders or to employees;
- Claims against plan fiduciaries (many of whom are also officers) for failing to disclose adverse information to plan participants and beneficiaries, failing to disclose such information to other plan fiduciaries who had responsibility for investing plan assets, failing to correct misleading statements made by other officers and plan fiduciaries, and failing to adequately monitor wrongdoing by other plan fiduciaries; and
- Claims against plan fiduciaries for retaining or investing in company stock in plan accounts, permitting participants to invest in company stock by continuing to include the stock as an authorized investment option in self-directed plans, failing to adequately diversify plan assets, and failing to investigate the suitability of plan investments.

These ERISA class action lawsuits are sufficiently new that a meaningful body of case law is not yet developed addressing the propriety of the underlying legal theories. On their surface, however, these lawsuits raise several concerns from a defense perspective. First, the definition of eligible class members in the ERISA class action is broader than the definition of class members in the securities class action. Whereas the securities class is limited to purchasers of securities during the designated class period, the ERISA class action is on behalf of all plan participants or beneficiaries who held or invested in the company's securities through their retirement plan during the class period. In other words, persons who simply held company securities in their retirement account, and who made no direct investment decision regarding those securities, constitute a significant portion of the ERISA class, but would be excluded from the securities class. Although participants and beneficiaries who purchased company securities during the class period could be class members in both the ERISA and securities class actions, the ERISA class action will include a potentially large number of additional plaintiffs in its class. Moreover, because recovery in either the securities or ERISA action may be only a fraction of each class member's claimed damages, settlement of one lawsuit may provide an offset of any potential recovery in the other lawsuit, but will rarely serve as a complete bar to this somewhat duplicative liability.

Second, securities claims under §10(b) of the Securities Exchange Act of 1934 require plaintiffs to prove the defendants acted with scienter (i.e., with intent to deceive or reckless behavior), whereas claims for breach of fiduciary duty under ERISA are generally subject to a

lower threshold similar to negligence. Plaintiffs' pleading burden is also generally more relaxed than that imposed in the securities context, which has accounted for most cases surviving the motion to dismiss phase of the litigation. Given plaintiffs' lax pleading burden, even the weakest ERISA cases will frequently proceed to expensive and time-consuming discovery.¹

Defendants in the ERISA class action do have several intriguing and potentially persuasive defenses unique to these type of cases that have not yet been fully explored by courts:

- Who is an ERISA Fiduciary? The ERISA class actions seek to expand the definition of an ERISA fiduciary to include corporate directors and officers not otherwise responsible for the management of plan assets. Traditionally, courts have recognized a person as a fiduciary under ERISA only to the extent the person exercises discretionary authority or control in connection with managing or administering an ERISA plan, providing investment advice for the plan, or investing plan assets. In addition, such a fiduciary is generally treated as a fiduciary only to the extent of the plan functions over which the person exercises authority or control. In other words, a plan trustee is not automatically liable as a fiduciary for decisions involving plan administration, absent an express designation of such authority or the exercise of discretion or control over those functions. Under pre-existing authority, a director or officer who does not have express discretionary authority or control with respect to plan investments and does not in fact exercise such authority or control should probably not be treated as an ERISA fiduciary or subject to ERISA fiduciary duties. However, even when directors and officers do not themselves serve in a fiduciary capacity, plaintiffs will often seek to hold them liable to the extent they appointed others to serve in a fiduciary capacity. According to plaintiffs, the duty to appoint fiduciaries confers with it a duty to monitor such fiduciaries. To date, courts have been generally supportive of the plaintiffs' inclusion of such defendants in that capacity.
- Does ERISA Apply to Matters Regulated by the Securities Laws? For more than 70 years, the federal securities laws have regulated matters relating to the purchase and sale of securities, with the goal of assuring that all affected parties have the benefit of accurate and complete information in order to make an informed investment decision. ERISA, on the other hand, traditionally has been viewed as establishing only four general standards of conduct for

¹ Although no automatic stay of discovery specifically applies to the ERISA action, the ERISA case is normally coordinated with the companion securities case for pre-trial purposes. Accordingly, most courts in this coordinated proceeding will limit plaintiffs' access to certain ERISA-specific discovery while their motion to dismiss is pending.

fiduciaries: (1) the duty of loyalty to act for the exclusive benefit of the plan and its participants; (2) the duty of prudence to act reasonably with respect to plan matters; (3) the duty to diversify plan assets; and (4) the duty to follow the terms of plan documents consistent with the other three duties. If the ERISA plaintiffs are successful in imposing upon fiduciaries the duty to disclose complete and accurate information about the company's securities, to correct a company's financial statements or forecasts, or to preclude participants from investing in company securities under certain circumstances, new and unprecedented duties for ERISA fiduciaries would be created. Although defendants have argued such a result is inconsistent with the long-standing securities regulation scheme, courts are divided as to whether such duties should be imposed.

- Are Directors and Officers Acting in a Corporate or ERISA Fiduciary Capacity? Traditionally, courts have recognized that a company and its directors and officers can take actions in the ordinary course of business which may adversely affect ERISA plans without creating liability exposure (e.g., terminate or amend plans). Moreover, when directors and officers who have no fiduciary responsibility for the investment of plan assets make disclosures of allegedly false or misleading information to employees, shareholders or the public, such conduct arguably is not taken in their capacity as an ERISA fiduciary, but is arguably in their corporate capacity. Plaintiffs have argued in response that defendants' incorporation of SEC filings in plan documents makes the SEC filing, and the representations contained therein, a fiduciary communication. Courts have been split as to whether such communications are in a corporate or fiduciary capacity, but courts are more apt to recognize that a fiduciary duty was created when plan participants are encouraged to review the company's SEC filings.
- What are Directors and Officers Expected to do if they Discover Adverse Material Nonpublic Information? If upon learning of nonpublic adverse information directors and officers quickly disclose the information and sell the company stock held in the plans, the company's stock price would undoubtedly drop significantly given the large number of company shares usually held in plan accounts. Such a dramatic collapse in the stock price would likely constitute an overreaction to the adverse information and thus unnecessarily penalize plan participants and other shareholders. In addition, if the directors and officers "quietly" begin divesting company stock held in plan accounts without publicly disclosing the adverse information, they would be trading while in possession of material nonpublic information and thus

would likely violate the insider trading laws. Stated differently, the underlying premise of the ERISA class actions place directors and officers in an impossible dilemma that could result in excessive and unnecessary losses to plan participants and beneficiaries. Notwithstanding these defense arguments, courts to date have routinely required such disclosure of nonpublic information by ERISA fiduciaries and have ignored the practical and securities laws implications from such disclosure.

- Do Fiduciaries Have Duties Regarding Directions by Participants to Invest in Company Stock? Pursuant to Section 403(a)(1) of ERISA, a trustee who is designated by the plan as the “directed trustee” is relieved of fiduciary duties regarding plan assets as long as the trustee is following “proper direction” from the participants. Courts have disagreed whether a directed trustee has an obligation to override a participant’s investment decision if the trustee knows the direction is imprudent. Some courts have ruled either the directed trustee is not a fiduciary or directed trustees are entitled to a presumption that the investment direction is reasonable. Other courts impose some type of fiduciary obligation on the directed trustee.
- Are Plan Investments Entitled to a Presumption of Prudence? Based on the notion that a 401(k) plan is an eligible individual account plan (“EIAP”) under Section 404(a)(2) of ERISA, defendants have argued, with mixed results, that the plan is exempt from ERISA’s requirement that the plan’s assets be prudently diversified. This defense has its origin in Congress’ encouragement of employee participation in company ownership through ESOPs and other profit-sharing plans. In deference to that congressional purpose, a few courts have held that a fiduciary cannot be liable for failing to diversify plan assets or for offering company stock to employees as a plan investment option. More often, however, courts have held that a fiduciary’s decisions with respect to an EIAP are subject to a presumption of prudence. Generally, courts have held that the presumption will not be overcome absent an impending collapse of the company or extreme circumstances where the validity of the company was at issue. Along these lines, defendants have argued, with some success, that mere fluctuation in a company’s stock price or allegations of mismanagement or fraud, which may give rise to securities or derivative liability, cannot form the basis for an imprudent investment claim under ERISA.
- Can Plaintiffs’ Claims Be Brought as a Class Action for Monetary Damages? Typically at the class certification stage of the litigation, defendants have argued that plaintiffs’ claims are really

brought on behalf of individual participants or, at most, a subset of the plan, as opposed to on behalf of the plan as a whole. The defense has its roots in Section 502(a)(2) of ERISA, which allows actions for monetary damages to be brought solely on behalf of the plan as a whole. Individual claims by plan participants and beneficiaries may be brought under ERISA Section 502(a)(3), but that Section limits claimants' recovery to injunctive and equitable relief. Plaintiffs have argued that their claims, although brought by a subset of plan participants who invested in company stock, seek to benefit the plan as a whole by restoring assets to the plan. This issue was recently resolved in plaintiffs' favor by the U.S. Supreme Court in *LaRue v. DeWolff* (discussed below).

In summary, these ERISA class actions present difficult issues for courts to analyze. Only a handful of these cases have been decided on summary judgment and none of the cases has been tried to a verdict. It will likely be a number of years before a sufficient body of case law definitively addresses these various issues.

3. Recent Litigation Developments

While relatively few ERISA stock drop cases have been decided on their merits, and while the law surrounding these cases is still undeveloped, some recent developments should give some measure of hope to defendants unwilling to surrender to early and usually unsupportable settlement demands.

a. DiFelice v. U.S. Airways, Inc.

Following a six-day bench trial, the Federal District Court for the Eastern District of Virginia ruled in *DiFelice v. U.S. Airways, Inc.*, Case No. 1:04cv889 (E.D. Va. June 26, 2006), that US Airways and the trustee of its 401(k) plan did not breach their ERISA fiduciary duties by continuing to allow the stock of its parent company, US Airways Group, Inc. ("USAG"), to remain an investment option in the Plan while both US Airways and USAG were in grave financial condition and eventually subjected to bankruptcy protection. The Fourth Circuit Court of Appeals affirmed the trial court decision in *DiFelice v. U.S. Airways, Inc.*, 497 F.3d 410 (4th Cir. 2007).

The case was filed on behalf of participants in US Airways' 401(k) Savings Plan against US Airways and the Plan's directed trustee. Plaintiffs alleged that defendants breached their fiduciary duties by (i) failing to provide complete and accurate information to Plan participants regarding investments in USAG stock, and (ii) including USAG stock as an investment option in the Plan in light of USAG's dire financial condition. The court denied defendants' Motion to Dismiss based on the liberal pleadings test. However, after full discovery, the court granted the defendants' Motion for Summary Judgment with respect to the claim alleging improper disclosures. The remaining claim relating to USAG stock being an imprudent investment option proceeded to trial.

The trial court ultimately rejected plaintiffs' argument that the defendants should be liable simply because the USAG stock was a too risky investment. Rather, the appropriate measure of review, according to the trial court, was based on a "portfolio management theory," in which an investment should not be judged by its individual risk and return characteristics, but by its contribution to the risk and return of a portfolio of investments. Moreover, the trial court recognized that the risks facing US Airways and USAG were publicly disclosed and reflected in the company's stock price. According to the court, because investors who assume greater risk are compensated for that risk with the possibility of greater returns, the price of USAG shares gave participants the opportunity to realize a potential return far in excess of other Plan options. Therefore, the inclusion of a high-risk, high-yield investment option amongst other investment options was not imprudent so long as defendants provided Plan participants with sufficient investment options and information necessary to construct a diversified portfolio. Although the Court of Appeals agreed with the trial court that it was not imprudent for Plan fiduciaries to offer USAG stock as an investment option, the Court of Appeals veered from the trial court's rationale and held that the prudence of each investment option had to be evaluated independently, as opposed to as part of a portfolio of investments.

Meaningful to both the trial court's and Court of Appeal's decisions was that the company stock fund was among twelve investment options, the Plan placed no conditions on investment of matching contributions by the company (unlike many other plans), and the fiduciaries warned participants of the high risks of the stock fund. The Court of Appeals also believed it was important that the fiduciaries monitored the performance of the stock fund by holding regular meetings, considering whether to continue to hold the stock in the Plan, seeking the advice of outside counsel, and retaining an independent fiduciary when the Company was considering reorganization.

The Court of Appeal's ruling is important to defendants, both in terms of being the first ERISA "stock drop" case to be tried and the context in which it was decided. Despite being on the brink of bankruptcy, US Airways continued to offer USAG stock as a plan investment option. USAG stock was not removed as an investment option until one day after US Airways filed bankruptcy, by which time the stock was worthless. In addition, unlike some cases in which employer stock is "hard-wired" into the plan, the Plan's named fiduciary had the discretion to select or remove USAG stock as a plan option. Notwithstanding those somewhat troubling facts, the Court found the defendants to have acted consistent with their ERISA duties.

b. Nelson v. Hodowal

On January 2, 2008, the Seventh Circuit Court of Appeals affirmed a defense verdict in the second "stock drop" case to be tried to conclusion. *Nelson v. Hodowal*, 512 F.3d 347 (7th Cir. 2008).

The lawsuit arose out of a merger between AES Corporation and IPALCO Holdings, Inc., whereby all IPALCO shares in one of its subsidiaries' 401(k) plans were replaced by shares of AES. Following the merger, AES stock lost more than 90% of its value. Litigation was filed by and on behalf of participants in IPALCO's 401(k) plan who alleged that the plan's fiduciaries (1) should have removed all IPALCO and AES stock as a plan investment, (2) failed to disclose their sales of nearly all of their own IPALCO and AES stock, and (3) should not have allowed

matching contributions, made in IPALCO stock, to be converted to AES stock upon the merger. Although the trial court denied defendants' Motion to Dismiss and partially denied defendants' Motion for Summary Judgment, after a six-day trial, the court found in favor of defendants on all claims. On appeal, plaintiffs challenged only one aspect of the trial court's ruling—namely, whether defendants breached their fiduciary duties by promoting AES while at the same time divesting their own holdings in AES stock.

In holding that defendants did not breach any fiduciary duty, the Court of Appeals adopted the trial court's findings that the defendants believed what they told to participants and that defendants sold their stock because they believed they were going to lose their jobs as a result of the merger. The Court further noted that the defendants had disclosed their stock sales through public securities filings and those sales did not have any affect on AES' stock price. As a result, the Court of Appeals concluded that the sales could not have been material to investors or plan participants. Finally, the Court held that the defendants satisfied their disclosure duties by retaining an independent plan fiduciary to provide investment advice to plan participants.

The Court of Appeal's decision, while favorable to defendants, may not have widespread impact given the narrow issue before the Court. Unlike in most ERISA stock drop cases, there was no evidence before the Court to suggest that the plan fiduciaries had insider knowledge of any unfavorable developments or wrongdoing. Moreover, because only one narrow issue was argued on appeal by plaintiffs, the Court did not address whether the plan fiduciaries acted prudently with respect to their oversight of the fund or decision to offer IMPALCO or AES stock in the fund.

c. Edgar v. Avaya, Inc.

The United States Court of Appeals for the Third Circuit affirmed dismissal of an ERISA stock drop case in *Edgar v. Avaya, Inc.*, 503 F.3d 340 (3d Cir. 2007). The plaintiffs in that case alleged that plan fiduciaries breached their duties of prudence and disclosure by offering Avaya common stock as an investment option in Avaya's 401(k) plans. Plaintiffs alleged that the price of Avaya's stock was artificially inflated by inaccurate earnings forecasts. According to plaintiffs, although the plan fiduciaries were aware of those inaccuracies, they failed to sell the Avaya stock or remove it as an investment option. Plaintiffs further alleged that the fiduciaries were liable for failing to disclose material adverse facts that eventually led to a 25% decline in the stock's value.

The Court of Appeals held that, because the plans required that Avaya's stock be offered as one of several investment options, the fiduciaries' decision to continue to offer Company stock as a plan alternative was subject to a presumption of prudence. While the Company was undergoing corporate developments that had a negative affect on the value of the Company's stock, the Court held that those developments did not constitute the type of "dire situation" that would require defendants to disobey the term of the plans. Accordingly, the Court held that plaintiffs could not satisfy their burden of demonstrating any "abuse of discretion."

The Court also rejected plaintiffs' duty of disclose claim. According to the Court, the fiduciaries did not have a duty to give investment advice or opine as to the stock's condition. The Court noted that the fiduciaries could have been in violation of insider trading laws if they

divested stock before news of the adverse developments was shared with the market and that, even if the fiduciaries had disclosed the adverse developments sooner, the resulting stock drop would have been the same.

d. In re Schering-Plough Corp.

The New Jersey District Court in *In re Schering-Plough Corp. ERISA Litigation*, No. 03-1204 (D.N.J. Aug. 15, 2007), recently issued a decision expanding when financial representations in SEC filings could give rise to a fiduciary claim under ERISA.

In general, courts have recognized that statements made in communications required *only* by federal securities laws, such as SEC filings, do not constitute fiduciary communications for purposes of ERISA liability. However, when financial statements are incorporated by reference into plan documents or when plan participants are encouraged to review the company's SEC filings, those statements may be deemed to have been made in a fiduciary capacity. See, e.g., *In re Dynegy, Inc. ERISA Litig.*, 309 F.Supp.2d 861, 879 (S.D.Tex. 2004) ("Plaintiff's allegations that defendants distributed material that expressly 'encouraged' Plan participants to 'carefully review' Dynegy's SEC filings, which they do not dispute materially misrepresented the Company's financial status, sufficiently alleges that . . . defendants breached the fiduciary duty to speak truthfully to Plan participants."). The SPD in *Schering-Plough* merely advised participants that they could obtain copies of prospectuses and financial reports upon request, but did not expressly incorporate the SEC filings or encourage reliance by participants. The court nevertheless held that the SPD impliedly incorporated the filings.

e. AEP, Guidant, Conexant

Three recent court of appeals decisions from the Sixth Circuit (*AEP*), Seventh Circuit (*Guidant*), and the Third Circuit (*Conexant*) have uniformly held that a plan participant who divests his or her stock after litigation is filed still has standing and, subject to other conditions, is an appropriate class representative. These appellate decisions on standing are contrary to many previous district court decisions and widen the pool of available plaintiffs.

4. Settlement Statistics

While the courts decide the legal viability of these ERISA stock drop claims and the appropriate measure of damages, the financial exposure to companies and their directors and officers remains very real. As with securities class actions, companies and their directors and officers often prefer to settle rather than risk a potentially debilitating judgment. Although often smaller than the settlement in the related securities litigation, settlements in these ERISA actions have been substantial. Not including the value of any non-monetary relief, the cash component of the largest ERISA settlements to date are reported as follows:

- AOL/Time Warner \$100 million
- Royal Dutch/Shell \$90 million
- Enron \$85 million
- Global Crossing \$79 million
- Lucent \$69 million

- Williams Companies \$55 million
- WorldCom \$51 million
- Household Int'l. \$46.5 million
- Dynegy \$30.75 million
- AT&T \$29 million
- CMS Energy \$28 million
- HealthSouth \$25 million
- Morrison Knudson \$21 million
- McKesson HBOC \$18.2 million

Directors and officers subjected to the uncertainty of whether ERISA class action lawsuits are viable face real financial risk and should take appropriate steps to minimize their exposure and to assure they are adequately protected financially in the event they do incur significant liability in these claims. Like other D&O exposures, ERISA fiduciaries can take various steps to reduce their exposure to these ERISA claims. In addition, fiduciaries should seek to maximize their two potential sources of financial protection in the event they incur liability in an ERISA class action: insurance and indemnification. Suggested loss prevention and financial protection strategies are summarized below.

5. Loss Prevention

The following summarizes a number of proactive loss prevention concepts that can reduce the likelihood that an ERISA stock drop claim will be filed and that can enhance the defendants' ability to successfully defend such a claim if filed.

- a. Maximize Protection from Plan Terms. Plan documents should be reviewed annually to assure compliance with the most recent case law and regulatory developments. Most importantly, if the plan allows participant-directed investments, the plan should have an express provision which relieves fiduciaries of fiduciary responsibility for losses incurred as a result of a participant's investment instruction. Such a provision is authorized by §404(c) of ERISA. However, Department of Labor regulations impose numerous conditions that must be satisfied in order for a fiduciary to escape liability based on such a provision. Those regulations generally require that the plan provide (i) diversified investment options; (ii) opportunities to transfer assets in the plan account; (iii) sufficient information to allow participants to make sound investment decisions; and (iv) notice to participants of the Section 404(c) provision. Although these requirements may appear reasonably easy to satisfy, recent ERISA claims demonstrate that fiduciaries frequently have difficulty proving all of these requirements were met. For example, in the Enron ERISA litigation, the court found that Enron's plan failed to satisfy any of these four requirements.

Plaintiffs frequently raise two issues when arguing that the §404(c) protection does not apply to fiduciaries. First, plaintiffs allege that plan fiduciaries either misrepresented or failed to provide to plan participants material information about the true value of the company's stock. Because this is largely a fact issue, plaintiffs usually are able to defeat the defendants' motion to dismiss based on §404(c). Second, some plans restrict the sale of the employer's matching stock contribution until the participant reaches a certain age. Such a restriction likely eliminates the protection under §404(c), and therefore should be eliminated if possible.

In any event, the plan should clearly and expressly provide diversified investment options for plan participants, and participants should receive notice that the plan documents relieve fiduciaries of their responsibilities with respect to participant-directed investments pursuant to §404(c).

- b. Offer Company Stock Pursuant to Plan Design. Even if §404(c) applies, the selection by plan fiduciaries of investment options for a participant-directed plan is a fiduciary act subject to ERISA fiduciary duties. Therefore, there is a fiduciary duty to monitor the prudence of continuing to offer company stock as an investment option in the plan. However, if the option to invest in company stock is expressly required by the plan documents, the plan fiduciaries arguably have no discretion over the decision to include company stock as an investment option and therefore arguably have no fiduciary duty with regard to whether company stock should remain an investment option for plan participants. Although this defense has received mixed results from the courts, such a plan provision is potentially quite beneficial to plan fiduciaries and therefore should be included in the plan documents if the company intends to permit plan accounts to own company stock.
- c. Don't Blindly Follow Plan Provisions. Even if the plan requires company stock as investment option or otherwise expressly requires certain action, fiduciaries are not necessarily protected by following those plan requirements. As a general matter, fiduciaries are required to administer the plans as written and are not permitted to vary from plan design. However, if a plan provision or its enforcement is inconsistent with the provisions of ERISA, some courts have recently required the fiduciaries to ignore that provision of the plan and substitute their judgment for the decision of the plan sponsor. This duty to override the plan's terms most frequently arises where the plaintiff proves that the fiduciary could not have reasonably believed that continued adherence to the

plan's terms was in keeping with the plan sponsor's expectations of how a prudent fiduciary would behave.

In light of this recent authority, fiduciaries should question whether, under the circumstances, a particular plan provision seems reasonable and should seek a legal opinion from qualified counsel regarding their fiduciary duty if there is concern about the provision. Assuming the fiduciaries disclose all relevant facts to qualified counsel and the legal advice appears on its face to be reasonable, fiduciaries should be able to avoid personal liability by acting in reliance upon the legal advice.

- d. Independent Fiduciaries. One of the most problematic allegations in ERISA stock drop claims is that the plan fiduciaries had an inherent conflict of interest by serving as both a plan fiduciary and as an officer or director of the sponsor company. Because of this dual capacity, plaintiffs argue that the plan fiduciaries took actions primarily for the benefit of the company rather than plan participants, and that plan fiduciaries knew but failed to disclose material non-public information which injured plan participants.

To avoid or at least minimize the effect of those allegations, companies should consider appointing independent fiduciaries to manage and monitor the plan's investment in company stock. These independent fiduciaries should have no actual or perceived relationship with the company or its directors and officers, and should have exclusive control over all investment-related decisions for the plan. Because liability exposure for plan administration is much less than liability exposure for plan investments, independent fiduciaries could be appointed solely with respect to plan investments, thereby allowing the plan sponsor and its officers to control various non-investment administrative tasks.

Alternatively, company officials who typically do not have access to the company's non-public information could be designated investment fiduciaries, although such a practice invites arguments that the fiduciary in fact knew or should have discovered the non-public information by reason of his position with the company.

- e. Avoid Inadvertent Fiduciary Status. The test for determining whether an individual or entity is a fiduciary under ERISA requires a "functional" analysis. A person who is not named as a fiduciary in the plan documents can still be liable as a fiduciary under ERISA if the person's actions were the functional equivalent of a fiduciary's actions. As a result, anyone who performs services or communicates on behalf of a plan is potentially liable for breach of ERISA fiduciary duties.

Frequently, ERISA stock drop claims name as defendants not only the plan's named fiduciaries, but also other directors, officers and human resources personnel of the plan sponsor, as well as investment and administrative committee members. To avoid individuals being inadvertently subjected to ERISA fiduciary duties, the company and the plan should tightly control the number of people who become involved in plan matters, and the responsibilities for each such person should be well defined and understood. In addition, the plan sponsor should not be a named fiduciary or, if named, the board of directors should expressly delegate the company's fiduciary responsibility to an individual or group of individuals. Otherwise, the directors may be liable for improperly discharging the company's ERISA fiduciary duties.

- f. Prompt and Accurate Communications. The federal securities laws require a company to disclose material information to investors only at certain designated times, such as when an SEC filing is due or when the company is purchasing or selling its own securities. In contrast, ERISA may require plan fiduciaries (including company officers) to disclose material information regarding the company on a more current basis if the information could reasonably be viewed as important to plan participants in making plan investment decisions. These conflicting disclosure obligations under the securities laws and ERISA place company officers who are plan fiduciaries in a classic catch-22. If they disclose the non-public information to plan participants, they are likely violating the insider trading rules under the securities laws. If they do not disclose the information to plan participants, they may violate their ERISA fiduciary duties.

Some courts have concluded that plan fiduciaries can remove themselves from this catch-22 by (i) disclosing the non-public information to all investors and plan participants as soon as possible, (ii) eliminating company stock from the plan, or (iii) notifying the regulators of the specific dilemma. In addition, if the plan utilizes only independent fiduciaries and not company officers with respect to plan investments, those independent fiduciaries will likely not learn of the non-public information and therefore not be placed in this difficult catch-22.

In any event, all communications by plan fiduciaries to participants should be prompt, accurate, clear and consistent with disclosures to other company constituents. Clever "spin" or other vague or confusing communications should not be tolerated. Instead, the communications should be easy to understand and convey the whole truth. Even unsophisticated participants should be able to

readily understand the disclosed information. Bad news should not be understated and good news should not be overstated.

- g. Encourage Diversification of Investments. Consistent with sound investment concepts, company management and plan fiduciaries should encourage participants to diversify their investments and not include within their investment portfolio an unreasonably large percentage of company stock. An excessive concentration of an employee's investment portfolio in company stock cannot only create unnecessary investment risk and engender ERISA claims, but may motivate employees to act inappropriately in order to artificially maintain or increase the company's stock price.
- h. Eliminate Company Stock in Plan. There are clearly benefits to employees owning stock in the company, thereby aligning their interests with outside investors. However, as demonstrated by the recent wave of ERISA claims, such a practice creates inherent and potentially large litigation risks. As a result, some companies are eliminating company stock as an authorized investment option and as the employer's matching contribution under plans. This is unquestionably the safest strategy from a risk management perspective.

B. Other ERISA Class Action Litigation

In addition to the "stock drop" litigation, two other types of ERISA class action lawsuits have created potential avenues of substantial exposure for companies and their insiders. Each is briefly discussed below.

1. Excessive Fee Cases

Beginning in September 2007, new class action lawsuits have been filed against nearly 20 companies and their fiduciaries arising out of their alleged mismanagement of fees charged by plan service providers.

Plaintiffs contend that fees and expenses paid by the plans, and borne by plan participants, were unreasonable and excessive, were not disclosed to Plan participants, and were not incurred solely for the benefit of the plans and their participants. In particular, plaintiffs allege that plan fiduciaries breached their fiduciary duties under ERISA §§502(a)(2) and 502(a)(3) by causing or allowing the plans to be charged excessive fees, either through excessive "hard-dollar" payments or "revenue-sharing" relationships between plan service providers and mutual funds held by the plans. Plaintiffs contend that, under those "revenue-sharing" relationships, service providers are compensated on an asset-based method that does not accurately reflect the actual value of the services rendered.

In most of the cases, plaintiffs have survived a motion to dismiss and the cases are proceeding slowly through discovery. At least one district court has plaintiff's claims on the ground that fiduciaries did not have a duty to disclose their fee and revenue-sharing relationships

with plan service providers and mutual fund managers. The court in that case further held that such decisions were protected under ERISA §404(c)'s safe harbor. The district court's decision is on appeal to the Seventh Circuit and is being watched closely by fiduciaries in other cases.

While it is too early to predict plaintiffs' ability to set forth a cognizable claim or estimate defendants' potential exposure, if the defendants can establish procedural prudence, through active monitoring of expenses and fee arrangements and, ideally, detailed record-keeping, they should be able to avoid liability. Even if plaintiffs are initially successful, they primarily seek to recover for the plan the excessive fees and expenses paid to service providers. Accordingly, these cases do not currently appear to present the same level of exposure as some of the other ERISA class action litigation discussed above.

2. Cash Balance Conversion Cases

Beginning in the mid-1990's, an increasing number of companies transitioned from a traditional pension plan, which pays benefits based on an employee's final average compensation, to a cash balance plan, under which an employee is paid benefits based on a work credit and interest credit. Due to the cash balance plan's interest component, workers who are near to retirement at the time of the conversion necessarily receive less than they would have received under the traditional benefits formula. Not surprisingly, those workers have filed class action lawsuits against their employers and plan administrators alleging, among other things, violations of ERISA's anti-discrimination provisions.

A significant decision was recently issued by the Seventh Circuit Court of Appeals in *Cooper v. IBM Personal Pension Plan*, No. 05-3599 (7th Cir. August 7, 2006). The litigation was filed by and on behalf of a putative class of participants in the IBM Personal Pension Plan who alleged that IBM's amendments to the Plan violated ERISA. Writing for a unanimous panel, Judge Easterbrook recognized that "[a]ll terms of IBM's plan are age-neutral" because every employee receives the same "pay credit" and the same "interest credit" per annum. According to the court, the basis for plaintiffs' claim and the district court's decision was that younger employees receive interest credits for more years than older employees, thereby increasing their benefits at the time of retirement. However, Judge Easterbrook concluded that the district court erred in construing the phrase "benefit accrual." Relying on the plain language and legislative history of §204(b)(1)(H), as well as similar language in the anti-discrimination provisions applicable to defined contribution plans, Judge Easterbrook noted that the phrase "benefit accrual" could only be construed as referring to the amounts an employer puts into the Plan "either in absolute terms or as a rate of change." According to the court, the fact that a younger employee, with more time left before retirement, would be generally entitled to larger retirement payments than an older employee is merely a function of the time value of money and "treat[ing] the time value of money as age discrimination is not sensible."

The district court's decision in *Cooper* had an immediate and chilling effect on many employers' decisions to maintain or implement cash balance or similar hybrid plans. Indeed, following the district court's decision, IBM eliminated its cash-balance plan for new workers and confined them to pure defined contribution plans. The Seventh Circuit's decision, coupled with Congress' enactment of the Pension Protection Act of 2006, which validates cash balance plans

and other hybrid plans, and defense-oriented decisions from the Third and Sixth Circuits have should have the opposite effect on companies as they evaluate their plan options.

However, from a litigation perspective, the Pension Protection Act only provides prospective relief. Accordingly, it is anticipated that litigation concerning cash balance plans adopted prior to the Act's effective date will continue for the foreseeable future.

C. LaRue v. DeWolff

On February 19, 2008, the United States Supreme Court ruled in *LaRue v. DeWolff*, 552 U.S. ___ (2008), that individual participants in defined contribution plans may bring breach of fiduciary duty claims under ERISA for losses to their individual account. While the decision paves the way for a greater number of individual fiduciary lawsuits, it is not likely to have much, if any, impact on the more troublesome fiduciary class action claims.

1. Background and Decision

The plaintiff in *LaRue* was a participant in his company's 401(k) plan. He alleged that the plan administrators breached their fiduciary duties by failing to follow his investment instructions, and he sought to recover the resulting \$150,000 in losses to his account. Because the provision under which the petitioner sought relief, ERISA §502(a)(3), is limited to "appropriate equitable relief," as opposed to monetary damages, the district court dismissed plaintiff's claim. On appeal, the plaintiff asserted that, in addition to his claim under ERISA §502(a)(3), he could recover under §502(a)(2) of ERISA. That Section gives plan participants, beneficiaries, and fiduciaries a private right of action to enforce the provisions of ERISA §409, which imposes liability upon fiduciaries who breach any of the responsibilities, obligations, or duties under ERISA. In particular, §409(a) provides that a fiduciary shall be personally liable to "make good to such plan any losses *to the plan* resulting from such breach" (Emphasis added). The narrow issue considered by the Supreme Court was whether a participant's individualized losses constituted "losses to the plan" so as to give the plaintiff a potential right of recovery under §502(a)(2). The Court concluded that they did.

In reaching its decision, the Court distinguished defined contribution plans, like the 401(k) retirement plan in that case, from defined benefit plans. The Supreme Court previously held in *Massachusetts Mut. Life Ins. Co. v. Russell*, 473 U.S. 134 (1985), that a participant in a defined benefit plan could not bring a lawsuit under §502(a)(2) to recover consequential damages arising out of a delay in processing her claim. According to the Court in *Russell*, recovery under §502(a)(2) must "inure[] to the benefit of the plan *as a whole*." *Id.* at 140 (Emphasis added). Although the *LaRue* court did not disturb that holding in the context of a defined benefit plan, it refused to apply it to defined contribution plans. According to the Court, misconduct by fiduciaries of a defined benefit plan does not affect a particular participant's entitlement to a defined benefit unless the misconduct threatens the existence of the plan itself. By contrast, a fiduciary's misconduct under a defined contribution plan "need not threaten the solvency of the entire plan to reduce benefits below the amount that participants would otherwise receive." As such, the Court held that, in the context of a defined contribution plan, it did not matter "[w]hether a fiduciary breach diminishes plan assets payable to all participants and

beneficiaries, or only to persons tied to particular individual accounts, it creates the kind of harms that concerned the draftsmen of §409.”

The Court remanded the case to the district court to decide the merits of the plaintiff’s claim. In doing so, the Court specifically noted that it did not address whether the plaintiff’s investment directions were made in accordance with the plan’s requirements, whether he was required to exhaust administrative remedies under the plan before seeking relief under §502(a)(2), or whether his claims were filed in a timely manner.

2. The Potential Impact

The following summarizes some of the implications for fiduciaries and their insurers arising from the *LaRue* decision.

a. More Fiduciary Claims

Because *LaRue* gives individuals the ability to pursue claims for monetary damages, one would assume a greater number of civil lawsuits will be filed in the future under ERISA. But, that may or may not occur. Even before *LaRue*, individual plan participants had the ability under ERISA §502(a)(1)(B) to seek relief for “benefits due” under the terms of their plan or to clarify their rights under the plan. However, claims for benefits under that provision generally are subject to an administrative review process and nearly all courts have recognized that a plan participant’s administrative remedies must be exhausted before the participant may pursue their claims in court.

Now, individual participants can bring claim directly under §502(a)(2). It is unclear, though, whether a plaintiff must comply with the administrative review process when bringing a §502(a)(2) claim. If such compliance is required, *LaRue* may not materially increase the number of civil lawsuits against fiduciaries, because such a claim would be largely the same as a §502(a)(1)(B) claim, which has been available for years.

The Court in *LaRue* specifically declined to opine whether a plaintiff is “required to exhaust remedies set forth in the Plan before seeking relief in federal court pursuant to §502(a)(2).” If lower courts determine such administrative steps are not necessary in order to bring a claim in federal court, an upsurge of new fiduciary litigation is likely.

While most individual claims under §502(a)(2) will probably involve relatively low potential damages, the costs and expenses of defending each claim could be significant. Moreover, the number of lawsuits filed against any insured may begin to resemble the claims experience observed in the employment context. From a fiduciary liability insurance perspective, that increased frequency may require insurers to increase their claims-handling capacity and may prompt insurers to reevaluate the appropriate self-insured retention applicable to each claim.

b. Benefits Due Exclusion

In most cases, a breach of fiduciary claim brought under ERISA §502(a)(2) by a plan participant as a result of *LaRue* will not likely involve unpaid “benefits” in a traditional sense.

Rather, most individual §502(a)(2) claims, like the plaintiff's claim in *LaRue*, will likely be for investment losses, lost earnings, excessive costs, or other wrongful erosion of the plaintiff's account balance.

In a concurring opinion in *LaRue*, Chief Justice Roberts opines that the petitioner's investment losses constitute "benefits due" and, therefore, should be recoverable under §502(a)(1)(B) without regard to §502(a)(2). According to Roberts, the petitioner "seeks the benefits that would otherwise be due him if, as alleged, the plan carried out his investment instructions. *LaRue's* claim, therefore, is a claim for benefits that turns on the application and interpretation of plan terms, specifically those governing investment options and how to exercise them." Roberts concludes that, because the plaintiff has a viable claim for relief under §502(a)(1)(B),² the plaintiff should not also have a right to bring his claim under §502(a)(2). Given that the Court's majority specifically allowed the plaintiff to pursue his claim under §502(a)(2), the Court's decision could be read as a rebuke of the Chief Justice's contention that the plaintiff's claim constitutes a claim for "benefits due."

However, Justice Roberts' expansive interpretation of "benefits due" is consistent with several other recent Court of Appeals' decisions, and suggests that the "benefits due" exclusion in nearly all fiduciary liability policies could be applied more broadly than it has historically. *See, e.g., Harzewski v. Guidant Corp.*, 489 F.3d 799, 807 (7th Cir. 2007) ("Benefits are benefits; in a defined-contribution plan they are the value of the retirement account when the employee retires, and a breach of fiduciary duty that diminishes that value gives rise to a claim for benefits measured by the difference between what the retirement account was worth when the employee retired and cashed it out and what it would have been worth then had it not been for the breach of fiduciary duty."); *Graden v. Conexant Sys. Inc.*, 496 F.3d 291 (3d Cir. 2007). To address that concern, some insurers now offer an "Investment Loss Coverage" endorsement that purports to carve-out of the "benefits due" exclusion these types of investment loss claims.

c. Class Certification

In the class action context, plan participants generally have been successful in maintaining class action lawsuits on behalf of a plan, even where the relief sought was intended to benefit only some of the plan participants. For instance, over the last several years, numerous so-called tag-along securities class action lawsuits have been filed and litigated under ERISA by and on behalf of participants in a company's 401(k) plan who invested in a fund comprised of company stock. Although those cases do not necessarily benefit plan participants who did not invest in the company stock fund, most courts have held that the lawsuits nevertheless may proceed as class actions under §502(a)(2). *See, e.g., In re Schering Plough ERISA Litigation*, 420 F.3d 231 (3d Cir. 2005); *Milofsky v. American Airlines, Inc.*, 442 F.3d 315 (5th Cir.

² Citing *Hess v. Reg-Ellen Machine Tool Corp.*, 423 F.3d 653 (7th Cir. 2005), Roberts writes that plan participants have in the past filed lawsuits under §502(a)(1)(B) alleging similar benefit denials in violation of plan terms. The claimants in *Hess* sought relief under §502(a)(1)(B) for a plan administrator's alleged failure to move retirement funds pursuant to participants' investment instructions, resulting in losses in their accounts. However, because the trial court dismissed the participants' claims on summary judgment and the Seventh Circuit affirmed that decision on appeal, neither court addressed whether those type of investment losses constituted "benefits" or whether a claim for investment losses was otherwise appropriate under §502(a)(1)(B).

2006) (“Plaintiffs, a subset of participants in the Super Saver-A 401(k) Capital Accumulation Plan for Employees of Participating AMR Corporation Subsidiaries, are entitled to further development of their breach of fiduciary duties claims, brought under ERISA sections 502(a)(2) and 409(a) . . .”). Accordingly, *LaRue* is not likely to have a meaningful affect on the frequency or success of such tag-along securities class actions.

II. INSURANCE ISSUES

D&O insurance policies typically exclude coverage for ERISA stock drop claims by an ERISA exclusion in the policy. Thus, any insurance coverage available to a defendant director or officer in this litigation will likely exist only under the company’s ERISA fiduciary liability program. Historically, that program has not been the subject of thorough analysis or negotiation by companies because it has been relatively cheap and infrequently triggered. With the rise of this new breed of ERISA exposure, companies will need to reexamine their fiduciary liability exposure. When reviewing the adequacy of a fiduciary insurance program in light of this new ERISA exposure, the following issues should be considered:

1. Coordinate with D&O Insurance. The scope of coverage afforded under the fiduciary policy should be coordinated as closely as possible with the scope of the ERISA exclusion in the D&O policy to limit any gap, or overlap, in coverage between the two policies. To minimize the risk of an inadvertent gap in coverage, a few Side A-Only D&O insurance policies do not contain an ERISA exclusion.
2. Evaluate Adequacy of Limits. Because a much larger potential liability exposure now exists for the fiduciary insurance program, the size of the fiduciary insurance program should be reevaluated. In many instances, more limits of liability may be needed, depending upon the amount of company stock held in retirement plans maintained by the company.
3. Evaluate Tie-In Limits. Because these ERISA class actions arise out of and allege essentially the same wrongdoing as alleged in securities class actions that are covered under D&O insurance policies, some D&O insurers are now requiring a tie-in of limits between the fiduciary and D&O insurance policies issued by the same insurer to the same company. Companies should consider the advantages and disadvantages of placing their D&O insurance and fiduciary insurance policies with different insurers, thus eliminating the need for a tie-in of limits. If a tie-in of limits endorsement is attached to the D&O and fiduciary policies issued by the same insurer, two issues should be addressed. First, does the tie-in apply only to a single claim covered under both policies or to all claims covered under one or both policies? Second, will the excess policies in the D&O and fiduciary programs drop down in the event the underlying policies are exhausted by reason of the tie-in of limits endorsement even though the underlying policy has not paid out its stated limit of liability? Even if a tie-in of limits endorsement is not required by the insurer, a potentially difficult allocation of loss between the two types of policies will likely be

required if defense costs or any settlement amount are covered in part under both policies.

4. Anticipate Significantly Higher Premiums. Fiduciary insurance historically has been priced comparatively low, largely reflective of the insurers' positive claim experience. However, in light of this new and potentially catastrophic exposure under the fiduciary policy, insurers are increasing the premiums for fiduciary insurance. This greater exposure to insurers is highlighted by the fact that, unlike many other types of ERISA class actions, the policy exclusion which eliminates coverage for benefits due under a plan will likely not apply to settlements or judgments in an ERISA stock drop case.
5. Duty to Defend. Unlike D&O insurance policies, most fiduciary insurance policies state that the insurer has the right and duty to defend any covered claim. Thus, the insurer will have the right to select defense counsel for the defendants in the ERISA class action, even though the directors and officers select their defense counsel in the tandem securities class action. Insureds may not want insurers to select counsel for their ERISA defense. When they do select counsel, insurers will have to be mindful of selecting a firm with both ERISA and class action defense capabilities.
6. Retention. Some fiduciary insurance policies apply one retention to all Insureds (including directors and officers) whether or not the Loss is indemnifiable. In light of the potentially large exposure in fiduciary cases today and the indemnification limitations that apply (see discussion below), the fiduciary policy should not apply a retention to non-indemnified loss (similar to the retention provisions in D&O policies).

III. INDEMNIFICATION FOR ERISA FIDUCIARIES

In light of the increased liability exposure of ERISA fiduciaries, companies and their ERISA fiduciaries should thoroughly understand and evaluate the adequacy of not only the ERISA fiduciary insurance coverage, but also the available indemnification from the company for the ERISA fiduciaries. The indemnification issues are important to evaluate not only in order to assure the fiduciaries have maximum financial protection if the insurance is unavailable or inadequate, but also because more companies are now exploring the possibility of purchasing only coverage for non-indemnifiable fiduciary losses (similar to a Side-A Only D&O policy) as a means to manage the escalating cost of this insurance.

As a general rule, a sponsoring company may indemnify its ERISA fiduciaries in most instances. However, under federal and state law, the availability of that indemnification is less predictable than the indemnification of directors and officers for non-ERISA matters. As a result, it appears unlikely fiduciary coverage for only non-indemnifiable loss will be as widely available as D&O Side-A only coverage. The following summarizes many of the indemnification issues unique to ERISA fiduciaries.

- A. ERISA Indemnification Provisions. A plan sponsor is generally permitted under Department of Labor regulations to indemnify a plan fiduciary, but indemnification provisions which encourage undesirable fiduciary behavior may be questioned by courts.

A fiduciary cannot by agreement be relieved of his responsibility or liability under ERISA. ERISA § 410(a). However, a plan, employer or fiduciary may purchase insurance protection for fiduciary breaches. If the plan purchases the coverage, the insurer must have the right to seek recourse from the fiduciaries for amounts paid by the insurer on account of fiduciary breaches. ERISA § 410(b).

Consistent with ERISA § 410, a plan may not agree to indemnify a fiduciary for fiduciary breaches, although an employer may do so. See Pamela Perdue, Qualified Pension and Profit-Sharing Plans, ¶ 3.06[3] at 3-304 (2d ed.). The Department of Labor has permitted indemnification agreements that do not relieve a fiduciary of responsibility or liability under ERISA. See 29 CFR § 2509.75-4. The regulations state that “[i]ndemnification provisions which leave the fiduciary fully responsible and liable, but merely permit another party to satisfy any liability incurred by the fiduciary in the same manner as insurance purchased under [ERISA] § 410(b)(3), are...not void under [ERISA] § 410(a).” Id. Thus, an employer is generally permitted under ERISA to indemnify a plan fiduciary.

However, the scope of permissible indemnification under ERISA may be limited under certain circumstances. For example, in Martin v. Nationsbank of Georgia, N.A., 16 EBC 2138 (N.D. Ga. 1993), a district court determined on summary judgment that an indemnification agreement violated ERISA. The agreement provided a plan trustee with complete indemnification if the trustee followed the directions of the ESOP participants in response to a tender offer, but eliminated indemnification for negligent or more severe misconduct if the trustee of the ESOP failed to follow such instructions. The court determined that the terms of the agreement created a financial incentive for the fiduciary to breach its fiduciary obligations under ERISA by blindly following participant directions, because the fiduciary’s “exercise of independent judgment would leave [the trustee] unprotected against charges of negligence, bad faith or willful misconduct.” Id. at 2141.

Another district court questioned the ability of an ESOP sponsor to indemnify the ESOP’s fiduciaries under any circumstances, reasoning that such indemnification by the company was to the detriment of the company’s owner, the ESOP. Donovan v. Cunningham, 541 F. Supp. 276, 289 (S.D. Tex. 1982), aff’d in part and rev’d in part on other grounds, 716 F.2d 1455 (5th Cir. 1983), cert. denied, 467 U.S. 1251 (1984). See Horahan and Hennessy, 365-2nd T.M., ERISA – Fiduciary Responsibility and Prohibited Transactions at A-67 - 68.

The implication of these cases is that while a plan sponsor’s indemnification of a plan fiduciary is generally permitted, indemnification provisions which by their terms encourage undesirable fiduciary behavior may not be enforced by a court.

- B. State Indemnification Provisions. A sponsor company's indemnification of plan fiduciaries is also subject to the indemnification statute in the state in which the company is incorporated.

State indemnification statutes typically permit a corporation to indemnify its directors, officers, employees and agents for loss incurred on account of claims against such persons in such capacity. Indemnification statutes also permit a corporation to indemnify any person who serves at the request of the corporation as a director, trustee, officer, employee or agent of another entity or other "enterprise." A number of indemnification statutes expressly define "enterprise" to include ERISA plans. See, e.g., § 145(i), Delaware General Corporation Law.

As a result, in many states, a sponsoring company may indemnify plan fiduciaries only if and to the extent the plan fiduciary is serving at the request of the sponsor company. Absent such request, no indemnification would be available. In addition, even if the plan fiduciary is serving at the request of the sponsor corporation, indemnification by the sponsor corporation will only be permissive under the statute and not mandatory, unless the corporation's bylaws or certificate of incorporation require indemnification of persons serving in an outside position at the request of the corporation. Many bylaw indemnification provisions do not require such outside position indemnification.

A few states expressly authorize a corporation to indemnify fiduciaries of its ERISA plans. See, e.g., § 207(f), California Corporations Code. In those states, indemnification of plan fiduciaries will be permitted whether or not the fiduciaries serve at the request of the corporation. However, such indemnification is simply permissive, unless mandated by the corporation's bylaws or certificate of incorporation.

In addition to the possible indemnification limitations summarized above, several of the limitations applicable to indemnification of directors and officers are also applicable to indemnification of ERISA fiduciaries under state law. For example, no indemnification will be available if the ERISA fiduciary fails to satisfy the requisite standard of conduct (e.g., the ERISA fiduciary must act in good faith and in the reasonable belief that his conduct was in or not opposed to the best interests of the corporation³). In addition, indemnification will not be available if the corporation is financially unable to fund the indemnification.

³ In some instances, the ERISA fiduciary is required to take actions which are arguably not in the best interests of the sponsor corporation, such as collecting amounts owed by the sponsor corporation to the plan. In those instances, a question may arise whether this statutory standard of conduct was satisfied by the plan fiduciary.

- C. Indemnification Planning. Based on the foregoing, corporations should examine the following primary issues when evaluating the quality of indemnification protection for its ERISA fiduciaries:
1. Review the applicable state indemnification statute to determine if an ERISA fiduciary must be serving at the request of the company in order to be indemnified. If so, be sure any person intended to be protected is clearly serving at the written request of the corporation as plan fiduciaries.
 2. Review the applicable state indemnification statute and internal indemnification provision of the corporation to confirm that the corporation is obligated to indemnify all of the persons intended to be protected without any material restrictions on that indemnification.
 3. Consider whether the terms of the indemnification provisions may create public policy concerns similar to those expressed by the cases summarized above. For example, such public policy concerns are more likely to arise with respect to ESOP fiduciaries.
 4. The internal indemnification provision should mandate indemnification “to the fullest extent permitted by law” in order to increase the possibility that indemnification will be available in suits by or on behalf of the sponsoring corporation.