PRUDENT ADMINISTRATION OF EMPLOYEE STOCK OWNERSHIP PLANS

Ronald J. Mann
Columbia Law School

A pervasive element of the landscape of employee stock ownership plans has been the unexamined assumption that trustees of those plans are as a practical matter exempt from the fiduciary duties that govern the trustees of other pension plans. After all, if the plan itself calls for investment in employer stock, what can be imprudent about operating the fund as intended? The long string of judicial decisions routinely rejecting criticisms of the trustees of those plans surely helped sustain that idea through the years. But the Supreme Court's decision last year in *Fifth Third Bancorp v. Dudenhoeffer* has definitively rejected that view. It is now clear that ERISA's fiduciary duties apply to every plan that owns employer stock – whether the stock is privately or publicly traded, whether the plan is entirely or partially invested in employer stock, even if it is a 401(k) plan. If the plan is established by an employer to provide pension benefits under ERISA, then those duties apply.

1. The Statutory Duties and ERISA Plans.—What is most remarkable about the situation is that the blithe assumption of an effective exemption from ERISA duties could have survived so long in the face of a statute that imposes the duties with such clarity. Section 404(a)(1) of ERISA imposes three duties on all fiduciaries of ERISA plans: a duty of loyalty (paragraph (A)), a duty of prudence (paragraph (B)), and a duty to diversify (paragraph (C)). The duty of loyalty obligates fiduciaries to act "for the exclusive" benefit of the plan's beneficiaries. The duty of prudence demands "the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of [such] an enterprise." The duty to diversify obligates the fiduciary to "diversif[y] the

investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so."

The statute directly addresses the extent to which the ownership of employer stock mitigates those burdens. Specifically, the statute states that "the diversification requirement of paragraph (1)(C) and the prudence requirement (only to the extent that it requires diversification) of paragraph (1)(B) is [***sic***] not violated by acquisition or holding of [employer stock]." It is easy to understand the removal of any obligation to diversify the investment in employer stock; an unqualified diversification requirement effectively would prevent any plan designed primarily to hold employer stock.

What is most important about the provision, however, is its treatment of the duty of prudence. To be sure, the statute limits the duty for plans that own employer stock, but "only to the extent that [the duty of prudence] requires diversification." Because it limits only a single aspect of the duty of prudence, the provision cannot be read sensibly unless all other aspects of the duty of prudence remain. Moreover, because the provision explicitly removes the duty to diversify and qualifies the duty of prudence, it strongly implies that the duty of loyalty applies to such plans without qualification.

As Justice Breyer explained for the Supreme Court in *Fifth Third*, the statute "establishes the extent to which [ERISA] duties are loosened in the ESOP context": it "modifies th[os]e duties * * * in a precisely delineated way." The result was obvious to the Court: aside from issues related to diversification, "ESOP fiduciaries are subject to the duty of prudence just as other ERISA fiduciaries are."

2. The Relevance of the Plan.—The most common basis for the idea that fiduciaries of plans that own employer stock are exempt from ERISA duties is the sense that the language of the relevant trust instrument compels (and thus validates) any decision to make or retain investments in employer stock. But that argument is no more consistent with ERISA than the more simplistic idea that

ERISA's fiduciary duties simply don't apply. Of course, ERISA does obligate fiduciaries to act "in accordance with the documents and instruments governing the plan." That obligation, however, applies only "insofar as such documents and instruments are consistent with [ERISA]." As the *Fifth Third* Court put it, "the duty of prudence trumps the instructions of a plan document, such as the instruction to invest exclusively in employer stock."

More generally, ERISA § 410(a) broadly invalidates any provision that purports to exculpate a fiduciary from liability for breach of those duties. The point was clear to the *Fifth Third* Court, which rejected out of hand the idea that "the plan documents waived the duty of prudence to the extent that it comes into conflict with investment in [employer] stock." The Court's explanation was brusque: "This argument fails * * * in light of this Court's holding that * * * trust documents cannot excuse trustees from their duties under ERISA."

3. What Prudence Requires.—It is easy enough to state that the fiduciaries of a plan that owns employer stock have a duty of prudence, but perhaps not so obvious what the duty entails. As suggested above, a fiduciary reasonably might ask: "How can I act imprudently if I purchase the stock that the plan requires? Is it my fault if the stock declines in value?" Questions of that sort reflect a fundamental misunderstanding of the fiduciary's duty of prudence. The duty of prudence is ***not*** a duty to produce a good investment outcome; neither is it a duty to avoid bad investment outcomes.

To the contrary, the duty is to a great extent procedural. At bottom, the question is whether the procedures that the fiduciary has followed to select and manage the investments are prudent. If the initial investment was made following a prudent process, then the success or failure of that investment after the fact does nothing to confirm that the investment was prudent or establish that it was imprudent.

That is not to say that the success or failure of the investments is irrelevant. The duty of prudence obligates the fiduciaries, using prudent procedures, to make

decisions that are designed and intended to produce a favorable return on the invested assets. In the context of a pension plan, the investment goal is to produce retirement income for a rolling population of beneficiaries at a variable distance from retirement. Accordingly, the appropriate response inevitably is to make investments in stocks that appear reasonably likely to appreciate in value over time, while taking prudent steps to limit the risks of substantial depreciation over time. In the absence of a duty to diversify – indeed with no practical ability to diversify – the problem of how to protect against catastrophic losses would be central to the concerns of a prudent fiduciary.

It bears noting that the prudence of an initial investment in no way exhausts the duty of the fiduciary. Even if the initial investment was prudent (as it normally is), the fiduciary must show prudence not only with respect to the initial investment decision, but also with respect to the management of that investment. The *Restatement of Trusts* pointedly obligates the fiduciary to "invest ***and manage*** the funds of the trust as a prudent investor would."

What that means, among other things, is that a prudent fiduciary would consider the possibility that ongoing events and circumstances might alter the prudence of an investment that was proper when made. The duty of prudence is not a one-time obligation for each investment; it is a periodic duty requiring consistent attention to the continuing propriety of the investment. As the Supreme Court put it this spring in *Tibble v. Edison International*, "a trustee has a continuing duty to monitor trust investments and remove imprudent ones. This continuing duty exists separate and apart from the trustee's duty to exercise prudence in selecting investments at the outset." What this means, in Justice Breyer's words, is that whenever the assets become "inappropriate as trust investments, the trustee is ordinarily under a duty to dispose of them within a reasonable time."

So, for example, if adverse information about a company makes it likely that the firm's stock will decline in price, fiduciaries might have exposure if they

had not taken steps to minimize losses related to that event: either by putting themselves in a position to respond at the time (by receiving the information and shifting investments appropriately) or by hedging their positions in advance against the consequent losses. *Fifth Third* itself provides an obvious example of the kinds of events that might call for a shift in investment strategy: market changes make a product line to which a company has shifted its emphasis increasingly unprofitable. But others are just as apparent: a fire that destroys a firm's manufacturing facility; financial distress of the firm's largest customer; the possibilities are regrettably endless.

In trusts (like pension plans) with long investment horizons, the duty to manage the investment is crucial. Consider the reality that more than 320 companies have been removed from the S&P 500 since 1980 because of financial distress. Indeed, one analyst calculates that approximately 40% of stocks have experienced catastrophic declines, when defined as a 70% decline from peak value with minimal recovery, in the last 35 years. J.P. Morgan, *Eye on the Market: The Agony and the Ecstasy* (2014). If nearly half of all investments are likely to collapse during the lifetime of the plan, then *Tibble* suggests it is patently imprudent for fiduciaries to ignore the possibility of catastrophic losses related to such collapses. Because plans that own employer stock are – almost by definition – less diversified than other plans, that duty becomes even ***more*** central to the prudent management of such a plan. In any situation, the central question would be whether the fiduciaries' process for monitoring and responding to ongoing developments matched the process that a similarly situated prudent fiduciary would follow.

If that standard sounds vague, it will not help matters that the Court in *Fifth Third* went out of its way to note that the fiduciaries of plans that own employer stock might find themselves "between a rock and a hard place" if they are uncertain how to respond to adverse circumstances. Nor will it provide any solace that the Court's answer to the problem is "careful, context-sensitive scrutiny of a

complaint's allegations." As those statements make clear, the question of prudence is so transparently fact-intensive that it often will be quite difficult (if not impossible) for a fiduciary to be certain that its process is adequate.

4. Prudence and Investments in Private Companies.—Although the duty of prudence applies equally to investments in privately traded and publicly traded instruments, it often will be harder to establish imprudence with respect to a publicly traded stock. The Court in *Fifth Third*, for example, emphasized that a fiduciary, absent "special circumstances," would not act imprudently if it relied on the price of the stock as reasonable. As the Court put it, "a fiduciary usually is not imprudent to assume that a major stock market provides the best estimate of the value of the stocks traded on it."

Only time will tell whether those rules will provide capacious protection for the fiduciaries of plans that own publicly traded employer stock. It is plain, however, that they create a challenging situation when the employer's stock is not publicly traded. On the one hand, *Fifth Third* has removed the presumption of prudence that has sheltered the fiduciaries of those plans for decades. At the same time, the Court's response to the practical difficulties that fiduciaries face is by its terms limited to fiduciaries managing publicly traded investments. In essence, the Court has left the fiduciaries managing private investments to their own devices.

Moreover, the fiduciaries of private companies have few options to respond to incipient distress. For a plan that owns publicly traded stock, a market sale is typically an option. Plans that own private stock will not have such an easy option. Indeed, the most obvious possibilities would be to persuade the employer to redeem the increasingly risky stock or to persuade the employer to sell or otherwise reorganize the company to resolve the financial distress. It should be obvious that the desire of the fiduciaries to protect the assets of a pension plan in those circumstances well might not be adequate to motivate any prompt or adequate corrective action by the employer.

The difficulties fiduciaries face in making any adequate response when distress approaches suggest that a prudent fiduciary would consider proactive steps to mitigate the losses from such distress in advance. For public investments, the appropriate responses are obvious: to diversify or hedge the risk in advance. Obviously, diversification of investments is not available as a long-term strategy for plans that own employer stock, whether the investments that they manage are publicly traded or not. Accordingly, the prudence of some type of hedge is apparent.

For private investments, one possibility that recently came to my attention is a plan for an ESOP Protection Trust, in which a large group of firms would make small annual contributions to a trust, with the contributions available to prop up the value of any plan that faces a major drop in stock price over the life of the plan. Because such a plan effectively spreads the risk of an adverse financial event among the investing firms, it has the salient benefit of protecting against a major price decline, without substantially diluting the primary purpose of the plan to align the future incentives of employees with the firm's long-term profitability and growth. Whether fiduciaries select that particular approach or another, the harsh reality remains: a fiduciary that takes no steps to protect against downside risks, in a market place in which instruments readily offer that protection, will have considerable exposure to allegations of imprudence in the empirically common event that the employer's stock collapses.

5. Loyalty and Plans That Own Employer Stock.—A final point relates to the duty of loyalty. It is common for plans that own employer stock to be supervised by fiduciaries that are key executives of the employer. Once we recognize that those fiduciaries are subject to ERISA's fiduciary duties, that arrangement immediately becomes problematic. The possibility of a conflict between the interests of the employer and the interests of the beneficiaries is apparent. To state the most obvious: if the fund tries to exit the employer's stock it only publicizes problems in the operations of the company, and validates the

concerns by demonstrating that firm insiders consider the problems serious. Fiduciaries faced with such a conflict well might find it impossible to avoid liability for a breach of their fiduciary duty of loyalty.

The problem did not seem serious before *Fifth Third*, because the lower courts' presumption protecting fiduciaries applied across the board to the duties of loyalty and prudence. As discussed above, however, the *Fifth Third* Court's recognition that ERISA itself can tolerate no such presumption has removed the possibility that any such presumption might protect insider fiduciaries from exposure to claims of a breach of the duty of loyalty. Without that presumption, the insider fiduciary of a plan that owns employer stock must exercise even more vigilance. The obvious potential for conflict suggests that the fiduciaries of such plans should endeavor to follow procedures of almost unquestionable prudence.

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Perhaps only two things can be said with certainty about the fiduciary duties for those administering funds that own employer stock in a post-*Fifth Third* world. First, it is no longer subject to debate that they are subject to the traditional ERISA duties of prudence and loyalty. Second, the content of those duties remains as unclear and murky for fiduciaries in this context as it does in any other. Together, those points suggest that those fiduciaries would be well-advised to take proactive steps to protect themselves.