ERISA Bond Claims Over Employer Stock Losses: The Landscape in a Post-Enron World

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I. Introduction

Administering employee benefit plans is a big business. Litigation over whether plans are properly administered also is big business. While we are only a few years into the twenty-first century, a series of high-profile corporate scandals and accompanying stock losses have hit employee benefit plan participants particularly hard. In the case of Enron, the total claims exceeded $1 billion. While unusual in its size and complexity, the Enron ERISA litigation is by no means an isolated example. WorldCom also engaged in massive accounting irregularities, including improperly capitalizing more than $3.8 billion in ordinary expenditures and overstating earnings from 1999 through the first quarter of 2002 by approximately $3.3 billion. Not surprisingly, the price of WorldCom stock, like that of Enron, collapsed, and it too filed for bankruptcy protection. ERISA litigation soon followed.[1]

Massive wrongdoing, however, is not a prerequisite for ERISA litigation. Kmart found its fortunes compromised in a Wal-Mart-dominated retail world. As its economic fortunes deteriorated, so did its stock. ERISA litigation soon arose alleging that former management and the members of Kmart's retirement plan investment committee breached fiduciary duties by continuing to invest in Kmart stock. The plaintiffs claimed that the plan fiduciaries should have discontinued using Kmart stock as a plan investment vehicle when they knew or should have known that the stock's price was unsustainable.[2] Similarly, plaintiffs in *In re Williams Companies ERISA Litigation* claimed that plan fiduciaries failed to disclose accurate information about Williams' stock and failed to prudently monitor and divest the plan's investment in company stock.[3] This new wave of ERISA litigation over company stock fund performance involves some of the most well-known names in the U.S. corporate landscape.[4] Duke Energy, Global Crossing, Lucent

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[1] *See* In re Worldcom, Inc. ERISA Litig., 263 F. Supp. 2d 745 (S.D.N.Y. 2003).

[2] Rankin v. Rots*,* 278 F. Supp. 2d 853 (E.D. Mich. 2003).

[3] 271 F. Supp. 2d 1328 (N.D. Okla. 2003).

[4] In the wake of the Enron collapse, more than 115 lawsuits alleging 401(k) plan losses were filed against thirty-five companies. Brett Nelson, *Open Season on 401(k)s*, FORBES, Nov. 25, 2002, at 60. *See*

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Technologies, Nortel Networks, Providian Financial, Qwest, RJ Reynolds, SBC Communications, Stone & Webster, Tyco, Waste Management, and Xerox have all been subject to ERISA litigation alleging breaches of fiduciary duty involving the performance of company stock.[5]

Where Plan beneficiaries seek to recover large monetary losses from companies whose economic fortunes have been severely compromised, it is not surprising that insurers and sureties can soon become involved in significant ERISA litigation.[6] For example, a recent Enron-related lawsuit seeks to recover losses associated with the wrongdoing of its former finance chief, Andrew Fastow, from three of the company's insurers. Enron seeks to recover under a crime loss indemnity policy and excess insurance policies for the losses it claims were caused by the wrongful acts of Fastow and other Enron employees. Enron claims that the insurers must indemnify it for losses incurred as a result of theft by Fastow and others who allegedly obtained money through a scheme involving a special-purpose vehicle in the Cayman Islands.[7] Other Enron insurers, including the employee benefit plan fiduciary insurance carriers, have agreed to fund a preliminary partial settlement in the amount of $85 million dollars. At Global Crossing, there was a $325 million dollar partial settlement, including $80 million to former employees. At Lucent, employees settled for $69 million dollars.

In addition to crime policies and ERISA fiduciary coverage, ERISA obligates every employee benefit plan fiduciary and every person who handles funds or other property of the plan to be bonded to protect the plan against loss from acts of fraud or dishonesty. This article provides a review of the Enron ERISA litigation, an overview of the current law and issues regarding claims of breach of fiduciary duty involving employer stock, and an introduction to the role of ERISA bonds in this burgeoning area.

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also H. Douglas Hinson & Patrick C. DiCarlo, *Fiduciary Duties and Investments In Employer Securities*, 29 J. PENSION PLAN & COMPLIANCE 20 (2003) (noting that losses to 401(k) plans heavily invested in company stock "have spawned a significant number of class action suits challenging the propriety of investments in employer securities").

[5] For an interesting article discussing this new wave of ERISA litigation, see Bill Boies, Nancy Ross, and Amy Toehring, *401(k) Litigation Over Company Stock Fund Performance: It's Only Just Begun*, 15 BENEFITS L.J. 33 (Winter 2002).

[6] As one commentator has noted:

> In the wake of the dot.com bust, the economy's related nosedive, and the Enron bankruptcy fiasco, fiduciaries of defined benefit pension plans should undertake a heightened level of scrutiny in selecting and monitoring the investment of their pension plan assets. Many experts and practitioners feel that the number of lawsuits filed against plan trustees may soon snowball, similar to the explosion witnessed with tobacco and asbestos litigation. As one attorney for an investment advisory firm recently noted, "The next two decades will be a gravy train for attorneys representing disgruntled former retirement plan participants." Indeed, if the recent spike in the demand for fiduciary liability insurance is any indicator, plan fiduciaries across the country are gearing up for a potential barrage of fiduciary lawsuits. One major insurer reports a 40-percent increase in requests to underwrite fiduciary liability insurance for new customers in the first quarter of 2002, when compared with the same period in 2001.

Craig Pett & Russell Shurtz, *Avoiding Fiduciary Pitfalls in Selecting and Monitoring Investment Managers*, 15 BENEFITS L.J. 27, 28 (Autumn 2002).

[7] *See* Insurance Day (Aug. 27, 2004).

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II. Enron and ERISA

Whether Enron becomes the twenty-first century's version of the Studebaker collapse remains to be seen. When Studebaker, the carmaker, went out of business, terminating the pensions of approximately 11,000 employees, an earth tremor shook the retirement planning business.[8] The Studebaker failure triggered the enactment of the Employee Retirement Income Security Act of 1974.[9] ERISA covers every employee benefit plan unless there is a specific exemption.[10] Like Studebaker, the Enron collapse was both complex and catastrophic. Over 20,000 Enron employees found their retirement programs decimated by the company's collapse. They sued, seeking to recover $1 billion allegedly lost from their retirement plans when the company failed.

A. THE ERISA LAWSUIT

The Enron ERISA lawsuit involved three ERISA plans. The common thread was that in all three plans the amount of a participant's benefit was determined, at least in part, on the value of Enron's stock.[11] The 401(k) Savings Plan allowed participants to direct the investment of their 401(k) contributions. They could choose from a wide range of mutual funds, plus a fund that invested exclusively in employer stock. The company's matching contributions were in the form of employer stock. Participants were required to hold the stock in their matching accounts until age fifty, at which time they could sell that stock and invest the proceeds into one of the other investment options. Approximately sixty percent of total plan assets were invested in employer stock.

Enron's Employee Stock Ownership Plan[12] was also a focus of the suit. This plan was designed to invest primarily in employer stock. Each participant had an account into which shares of employer stock were credited over time. At age fifty-five, employees had a right to begin selling the stock held in their accounts and thereby diversify their account. The third plan at issue was the company's Cash Balance Plan. Under this plan, benefits that a participant accrued were partially offset by the benefit accrued under the ESOP.[13]

The defendants included Enron, the Administrative Committee for the plans, the individual members of the Administrative Committee, former Chief Executive Officer Kenneth Lay, and other officers and directors of Enron. Plaintiffs also sued Enron's

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[8] *See* Amy J. Maggs, *Enron, ESOPs, and Fiduciary Duty*, 16 BENEFITS L.J. 42 (Autumn 2003) ("It is not surprising that Enron has been compared to Studebaker, the car manufacturer that went out of business, terminating a pension plan that covered approximately 11,000 employees. It is widely accepted that the failed promises of Studebaker triggered the enactment of the Employee Retirement Income Security Act of 1974.").

[9] Pub. L. No. 93-406, 1974 U.S.C.C.A.N. (88 Stat. 829) 935 [hereinafter ERISA]; 29 U.S.C. § 1001 (1974). Hereinafter, the Public Law session will generally be cited in the text, while the U.S. Code section will be parallel cited in the footnotes.

[10] 29 U.S.C. §§ 1003(a) & (b), 1051, 1081(a), 1101(a).

[11] Hereinafter employer stock.

[12] Hereinafter ESOP.

[13] For those who are interested, many filings are available on the World Wide Web at www.enronerisa.com.

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auditor, Arthur Andersen & Co., and Northern Trust Company, the former trustee and administrator of the retirement plans.

In a nutshell, the complaint alleged that the defendants breached their fiduciary duties by the following: (1) calculating the offset under the Cash Balance Plan using the artificially inflated price of Enron stock; (2) allowing the Savings Plan and the ESOP to continue to acquire and hold employer stock after defendants knew or should have known it was an imprudent investment; (3) failing to disclose to participants the facts that would have enabled participants to make an informed judgment regarding their continued acquisition and holding of employer stock; (4) affirmatively inducing participants to continue to invest their 401(k) contributions in employer stock after defendants knew or should have known it was an imprudent investment; (5) "locking down" the Savings Plan[14] during the switch to a new trustee and a new record keeper, at a time when they knew or should have known of facts that made such a lockdown imprudent;[15] and (6) calculating the offset under the Cash Balance Plan using the artificially inflated price of Enron stock.

B. THE *ENRON* ERISA DECISION

The defendants brought twenty-three motions to dismiss. Federal district court Judge Melinda Harmon issued a 327-page ruling, which for the most part favored the plaintiffs.[16] Given that this ruling is longer than most Russian novels, it is difficult to concisely state its analysis and rulings on the various issues under consideration. Suffice it to say that the court addressed many of the current issues in ERISA retirement plan litigation. Among the important ERISA issues covered by the court are the following:

1. Corporate Liability versus Personal Liability of Fiduciaries

The Enron plans, like most plans, gave fiduciary authority to entities rather than to individuals.[17] The plans gave fiduciary responsibility to the "Company" and to the "Administrative Committees" appointed by the Company to act for the Company in matters relating to the Plans. Plaintiffs sued the entities and also sued the individual

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[14] Such a "lock down" prohibits any transfers among investment options.

[15] Allegations against Northern Trust included the claim that it breached its fiduciary duties when it froze the Savings Plan and the ESOP without adequate notice after the plans were switched to a new trustee. This "lockdown" period occurred between October 17, 2001, and November 14, 2001, during which time Enron's stock fell from $33.84 to $10.00 per share.

[16] In re Enron Corp., Sec., Derivative, & ERISA Litig., 284 F. Supp. 2d 511 (S.D. Tex. 2003) [hereinafter Enron].

[17] Just who is a fiduciary under ERISA is not always subject to easy analysis. The term "fiduciary" has a functional definition. Basically, a person is a fiduciary to the extent that such person has or exercises certain fiduciary powers. *See generally* ERISA § 3(31)(A); 29 U.S.C. § 1002. The same entity can be both a fiduciary and a non-fiduciary, depending upon what it is doing. A plan sponsor, for example, may act as a fiduciary some of the time but as a non-fiduciary at other times, such as when it is engaging in settlor activities. Common settlor functions include designing, establishing, amending, or terminating retirement plans. *See* Hughes Aircraft Co. v. Jacobson, 525 U.S. 432 (1999); Lockheed Corp. v. Spink, 517 U.S. 882 (1996). *See also* Frank Cummings, *ERISA Litigation: An Overview of Major Claims and Defenses*, SJ079 ALI-ABA 955, 997 (2004). Because fiduciaries can be personally liable for the losses caused by their breaches, it is not uncommon to find parties disputing just who is a fiduciary.

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employees who acted on behalf of those entities, alleging that the individuals were personally liable for breaching their fiduciary duties.

Under the traditional rule, an employee doing his or her job is not personally liable for employment related acts. The *Enron* court noted the traditional rule that employees acting within the scope of their employment are not personally liable for the actions they take on behalf of the corporation.[18] While the corporation can be held liable, the individual is not putting his or her own personal assets at risk.

Some ERISA cases follow the traditional rule. Some courts have held that ERISA reflects the traditional rule: "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 [ERISA] unless it can be shown that these officers have individual discretionary roles as to plan administration." [19]

Other ERISA cases hold that individuals are personally liable. Other courts have rejected the traditional rule and imposed personal liability on the individuals who actually took or failed to take action on behalf of the corporation.[20] Courts imposing personal liability frequently note that ERISA § 409 states that "any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries by this title shall be personally liable to make good to such plan any losses . . . ."[21] These courts conclude that the references to "person" and "personally liable" must mean that Congress intended individual liability. But ERISA defines "person" to include a corporation.[22] So all that section 409 really says is that whoever or whatever is determined to be the "fiduciary" is obligated to make good the losses. It does not speak to the question of whether the fiduciary is (i) the entity, or (ii) the individual through which the entity acts.

The *Enron* court imposed personal liability on the individuals. The court stated as follows:

> In view of the broad language, the functional and flexible definition of "fiduciary," and the expansive liability policy of the statute, as well as the holding in *Musmeci* [a recent Fifth Circuit case], this Court agrees with those courts which reject a *per se* rule of nonliability for corporate officers acting on behalf of the corporation and instead make a functional, fact-specific inquiry to assess "the extent of responsibility and control exercised by the individual with respect to the Plan" to determine if a corporate employee . . . has exercised sufficient discretionary authority

[18] 284 F. Supp. 2d at 567.

[19] Confer v. Custom Eng'g Co., 952 F.2d 34, 37 (3d Cir. 1991). From a policy standpoint, this seems like a sensible rule because savvy employees will avoid serving in positions where they are putting their own assets at risk. The employees willing to serve would be those who do not understand the risks, and those are precisely the people that are undesirable as fiduciaries.

[20] *See, e.g.,* Kayes v. Pacific Lumber Co., 51 F.3d 1449, 1459-61 (9th Cir. 1995).

[21] 29 U.S.C. § 1109.

[22] *Id.* at §§ 2(9), 3(9).

and control to be deemed an ERISA fiduciary and thus personally liable for a fiduciary breach.[23]

2. Fiduciary Duty to Disclose Information

ERISA and the Department of Labor[24] regulations implementing ERISA contain elaborate rules describing the specific plan information that must be disclosed to plan participants and beneficiaries and the times at which those disclosures must be made. Those rules are relatively straightforward, bright-line rules. Courts have taken ERISA's general fiduciary duties and crafted a much broader, much more amorphous duty to disclose information in certain circumstances. ERISA's general fiduciary provisions are drawn from the common law of trusts and impose four basic duties, including a "duty of loyalty," which is the duty to act solely in the best interests of participants and beneficiaries and for the exclusive purpose of providing benefits and defraying the reasonable expenses of administering the plan.[25]

In *Varity Corp v. Howe,*[26] the United States Supreme Court held that it was a breach of the fiduciary duty of loyalty to knowingly lie to plan participants about their benefits: "To participate knowingly and significantly in deceiving plan beneficiaries in order to save the employer money at the beneficiaries' expense is not to act solely in the best interest of the participants and beneficiaries. . . . Lying is inconsistent with the duty of loyalty owed by all fiduciaries and codified in section 404(a)(1) of ERISA."[27] This was the first time the Supreme Court had held that ERISA's fiduciary duties applied to matters of plan communication as opposed to matters of plan investment. The Supreme Court specifically noted that it was not reaching the question of "whether ERISA fiduciaries have any fiduciary duty to disclose truthful information on their own initiative, or in response to employee inquiries."[28]

Varity triggered a flood of "breach of duty to disclose" litigation.[29] Like a failure to warn claim in the products liability arena, it is not difficult for a plaintiff to allege that

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[23] 284 F. Supp. 2d at 569-70.

[24] Hereinafter DOL.

[25] ERISA § 404(a)(1); 29 U.S.C. § 1104(a)(1). Arguably, the duty of loyalty to all plan participants is different than the loyalty to the interest of a single participant where that interest is inconsistent with the Plan and the majority of other plan participants. Other fiduciary duties are as follows: (1) a duty of care, skill, prudence, and diligence (ERISA § 404(a)(1)(B); 29 U.S.C. § 1104(a)(1)(B)); (2) a duty of diversification, unless inappropriate (ERISA § 404(a)(1)(C); 29 U.S.C. § 1104(a)(1)(C)); and (3) a duty to follow governing documents if consistent with law (ERISA § 404(a)(1)(D); 29 U.S.C. § 1104(a)(1)(D)). Fiduciaries also must not engage in prohibited transactions. ERISA § 406.

[26] 516 U.S. 489 (1996).

[27] *Id.* at 506.

[28] *Id.*

[29] *See* In re Unisys Corp., 242 F.3d 497, 501 (3d Cir. 2001) (discussing a possible affirmative duty to correct plaintiffs' mistaken belief that they were entitled to lifetime health benefits); Krohn v. Huron Mem'l Hosp., 173 F.3d 542, 548 (6th Cir 1999) (finding an affirmative duty to disclose where plaintiff's husband made specific inquiry regarding disability plan benefits); In Re Ikon Office Solutions, Inc., Sec. Litig., 191 F.R.D. 457, 464 n.7 (Pa. 2000) (noting that "fiduciaries may have a duty to trust beneficiaries that requires disclosure of matters within their knowledge apart from any duty to disclose towards the general public").

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any problem could have been avoided if the defendant had simply provided more or better information to the plaintiff. Some courts have imposed a broad affirmative duty to disclose information whenever the fiduciary knows or should know that silence might be harmful.

The *Enron* court noted that, while the Fifth Circuit has recognized an affirmative duty to disclose, it is not as broad as the duty imposed by some other courts: "it views the plan administrator as having a fiduciary duty to plan participants as a whole, but not to individual participants with particular problems who do not make a specific request for information."[30] The affirmative duty to disclose arises only when there are "special circumstances" with a potentially "extreme impact" on a "plan as a whole": in other words, in situations like Enron.[31]

In *Enron*, plaintiffs alleged that the fiduciaries knew or should have known of the fraudulent accounting practices, or at the very least the concerns and investigations related to those accounting practices, and should have disclosed that information to participants so that they could protect themselves. It appears that one member of the Administrative Committees, Cindy Olson, actually knew of the Watkins' memorandum warning that Enron might implode in a wave of accounting scandals. Olson never informed the other Committee members or the plan participants of these concerns. Plaintiffs are trying to cast a net beyond Olson and expand the group of potential defendants.

One novel approach the plaintiffs are using is to try and impose "failure to disclose" liability on people who were higher up in the chain of command. More specifically, the plaintiffs allege the following:

- Enron and Enron's Board had the power to appoint the members of the Administrative Committee, and, therefore, they are fiduciaries.[32]

- The power to appoint a fiduciary includes a duty to monitor the fiduciary and a duty to remove if necessary.

- Furthermore, the appointing fiduciaries had a fiduciary duty to disclose to the members of the Committee any information that those Committee members needed in order to adequately perform their jobs.

In other words, Ken Lay and any other members of the Board of Directors, who were allegedly aware of the fraudulent accounting treatment and the concerns or investigations related to the accounting treatment, had a fiduciary duty to promptly relay

[30] 284 F. Supp. 2d at 558.

[31] *Id.* at 559.

[32] Some of Enron's directors argued that they could not be held liable under this theory because the relevant documents granted the power of appointment to Enron in general, not the Board in particular. The court gave short shrift to that argument, stating that Enron could act through its Board and that "[s]hould there be a dispute whether the Outside Directors were actually the Company officials involved in the appointments, it can be raised on summary judgment after discovery." 284 F. Supp. 2d at 660.

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that information to the members of the Administrative Committee, who then had a duty to disclose that information to plan participants so they could protect themselves from the resulting scandal. That proposition bears watching. In informal comments, the DOL has supported that view, although the DOL's view is apparently that not every bad fact has to be disclosed, just potentially "ruinous" facts.

Some defendants argued that disclosure was not required as a matter of law because the selective disclosure of inside information to the Administrative Committee or plan participants would have violated the federal securities laws.[33] The *Enron* court accepted the basic premise that, "[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. . . . A trustee has no duty to violate the law to serve his beneficiaries."[34]

However, the court rejected the suggestion that this absolved the insiders of all liability for failure to disclose. The court noted as follows:

- The insiders could have disclosed the material information to the public at large. While that would not have allowed the plans and their participants to get out at the inflated value, it would have moved the drop in the price of Enron stock to an earlier point in time, which would have eliminated the losses that plaintiffs incurred after that date.

- The decision not to purchase stock can be based on inside information, so the Committees could have stopped purchasing additional shares of Enron stock. The Committees could have eliminated Enron stock as an investment option for future participant contributions and as the form of the employer match. Once again, while not eliminating all

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[33] As one commentator noted:

> Another potential conflict facing officers and employees acting as ESOP trustees concerns the use of nonpublic information. Corporate officers and employees of public companies may possess information about the employer that is not generally known in the investment community. Labor Department regulations and the *Bierwirth* decision [680 F.2d 263 (2d Cir. 1982)] require that fiduciaries consider all information available to them in making investment decisions. This creates a dilemma. If the nonpublic information is material, the ESOP trustees would violate the securities laws by acting upon it for the benefit of the ESOP before it becomes publicly known, while not acting upon it could be a violation of their duties as trustees.

BNA Corporate Practice Series, No. 62-2 § III. *See also* Labor Reg. § 2550.404a-1(b), which provides that a fiduciary will have met the prudence standard of ERISA "if the fiduciary (A) 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 . . . and (B) has acted accordingly." *See also* Donovan v. Cunningham, 716 F.2d 1455 (5th Cir. 1983).

[34] 284 F. Supp. 2d at 565.

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> losses, it would have eliminated the losses that plaintiffs incurred after that date.[35]

In essence, then, the insider trading defense limits damages, not liability.

3. Directed Trustees

ERISA allows for the allocation of fiduciary responsibility. An ERISA plan will frequently have numerous persons or entities who are acting in a fiduciary capacity. Obviously, such a division of labor makes a great deal of sense. A modern retirement plan could not function if all of the various fiduciaries had equal liability for, and therefore had to agree on, all investment decisions made on behalf of a plan. ERISA, accordingly, adopts the basic approach that, if a plan document expressly allocates fiduciary responsibility and specifies which fiduciary is responsible for which decisions, then that division of responsibility will be respected. The fiduciary who made the decision has full fiduciary liability, and the fiduciaries who did not have responsibility for that decision will not be held liable, except in cases where they have actual knowledge that the other fiduciary is breaching its duties.[36]

ERISA generally requires that "all assets of an employee benefit plan shall be held in trust" and then states that the responsibility for investing those assets resides, at least initially, with the trustee: "the trustee or trustees shall have exclusive authority and discretion to manage and control the assets of the plan . . . ."[37] ERISA also recognizes, however, that in modern retirement plans the responsibility for investing some or all plan assets is frequently allocated to someone other than the trustee and, therefore, provides an exception to the general rule "to the extent that:

> (1) the plan expressly provides that the trustee or trustees are subject to the direction of a named fiduciary who is not a trustee, in which case the trustees 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 this Act . . . ."[38]

a. When is a directed trustee required to disregard directions?

The directed trustee provision of ERISA is not very clear. What does it mean when it says that the party directed can only follow directions that are "proper" and "not contrary to ERISA"? There are at least three possible interpretations.

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[35] Another proposed solution is for the company to appoint an outside, independent trustee that does not normally have access to inside information. *See* BNA Corporate Practice Series, 62-2 § III.

[36] *See generally* ERISA §§ 402, 403, and 405; 29 U.S.C. §§ 1102, 1103, and 1105; JOINT EXPLANATORY STATEMENT OF THE COMMITTEE OF CONFERENCE, H. CONF. REP. NO. 93-1280, *reprinted in* 1974 U.S.C.C.A.N. 5038 (explaining in detail the rules on allocation of responsibility and the corresponding limits on liability).

[37] 29 U.S.C. § 1103(a).

[38] ERISA § 403(a); 29 U.S.C.§ 1103(a). This is ERISA's "directed trustee" provision.

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(i) Option 1–A directed trustee's duties are actually no different from those of a discretionary trustee

One possible interpretation is that, because a directed trustee can only follow directions that are not contrary to ERISA, the directed trustee is liable whenever it turns out that the directing fiduciary was breaching its duties by giving the direction. This is strict liability; it makes no difference whether the directed trustee actually knew or even could have known of the breach.

Under this approach, a directed trustee's duties are essentially no different from those of a discretionary trustee. For example, if the named fiduciary directs the trustee to purchase stock in Amalgamated Widgets, the directed trustee has a duty to make sure that the investment is not contrary to the fiduciary duty provisions set out in ERISA, that is, that Amalgamated Widgets is a prudent investment for the plan, that the plan's investment in Amalgamated Widgets is in the best interests of participants and beneficiaries in the plan, that the plan's investments will remain diversified after the transaction, that the investment is not a prohibited transaction, and so on. This is the same process the trustee would go through if it were a discretionary trustee and had responsibility for investment decisions in the first instance.

A fairly compelling argument can be made that this cannot possibly be what Congress intended. First, it renders the directed trustee provision a nullity. Second, that interpretation would be a significant departure from ERISA's overall approach to fiduciary liability, which allows fiduciary responsibility to be allocated among fiduciaries and gives those fiduciaries who are not responsible for the decision protection from liability. Under ERISA § 405(a), where fiduciary duties are allocated in the documents, a fiduciary who is not responsible for a decision can be held liable only if "he participates knowingly in, or knowingly undertakes to conceal, an act or omission of another fiduciary, knowing such act or omission is a breach," or "if he has knowledge of a breach by such other fiduciary, unless he makes reasonable efforts under the circumstances to remedy the breach."[39] Congress clearly intended for this to be an "actual knowledge" standard and not the much more amorphous "knew or should have known" standard.[40]

[39] 29 U.S.C. § 1105(a).

[40] The Conference Committee Report states as follows:

> Under the labor provisions of the conference substitute, a fiduciary of a plan is to be liable for the breach of fiduciary responsibility by another fiduciary of the plan if he knowingly participates in a breach of duty committed by the other fiduciary. Under this rule, the fiduciary must know the other person is a fiduciary with respect to the plan, must know that [the other person] participated in the act that constituted a breach, and must know that it was a breach. . . .
>
> In addition, a fiduciary is to be liable for the breach of fiduciary responsibility by another fiduciary of the plan, if he knowingly undertakes to conceal a breach committed by the other. For the first fiduciary to be liable, he must know that the other is a fiduciary with regard to the plan, must know of the act, and must know that it is a breach. . . .
>
> Also, if a fiduciary knows that another fiduciary of the plan has committed a breach, and the first fiduciary knows that this is a breach, the first fiduciary must take reasonable steps under the circumstances to remedy the breach.

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Actual knowledge means actual knowledge – there is no duty of reasonable inquiry, and no duty to investigate what the other fiduciary is doing.

A strict liability approach would be a departure from that approach. A directed trustee would be the only fiduciary with a duty to review de novo the decisions of the fiduciary to whom responsibility for the decision had been allocated by the documents. This "belt-and-suspenders" approach, where two fiduciaries must separately approve each investment decision, would significantly increase the cost of operating the plan and would also cause the plan to miss out on many time-sensitive investment opportunities.

(ii) Option 2–A directed trustee can follow directions unless it has "actual knowledge" of the directing fiduciary's breach

Under this approach, there is no duty of reasonable inquiry and no duty to investigate**.** When statutory language is unclear, courts often turn to the legislative history to determine the intent of Congress. ERISA's legislative history provides a pretty clear indication that Congress intended for directed trustees to follow directions and intended for them to have significant protection against liability when doing so:

> If the plan provides that the trustees are subject to the direction of named fiduciaries, then the trustees are not to have the exclusive management and control over the plan assets, but generally are to follow the directions of the named fiduciary. Therefore, if the plan sponsor wants an investment committee to direct plan investments, he may provide for such an arrangement in the plan. . . . If the plan so provides, the trustee who is directed by an investment committee is to follow that committee's directions unless it is clear on their face that the actions to be taken under those directions would be prohibited by the fiduciary responsibility rules of the bill or would be contrary to the terms of the plan or trust.[41]

This legislative history should inform the meaning of the terms "proper" and "not contrary to" that are used in the statute. Given ERISA's general approach to fiduciary liability, where one fiduciary can be held liable for another fiduciary's decision only if the first fiduciary has actual knowledge of the breach.[42] It would not be surprising for Congress to impose a similarly high threshold with respect to a directed trustee. In fact, it would be odd for Congress to do otherwise.

JOINT EXPLANATORY STATEMENT OF THE COMMITTEE OF CONFERENCE, H. CONF. REP. No. 93-1280 (1974), *reprinted in* 1974 U.S.C.C.A.N. 5038, 5080.

[41] *Id.* at 5038, 5079.

[42] ERISA § 405(a); 29 U.S.C. § 1105(a).

(iii) Option 3–A directed trustee can follow directions unless it "knows or should know" that the directing fiduciary is breaching its duty

Under the common law of trusts, a trustee taking direction from another fiduciary could not follow the directions if the trustee "knew or should have known" that they were a breach of duty. As stated in a leading treatise on trust law:

> [W]here the holder of the power [to direct the trustee] holds it as a fiduciary, the trustee is not justified in complying with his directions if the trustee knows or ought to know that the holder of the power is violating his duties to the beneficiaries as fiduciary in giving the directions.[43]

Since ERISA's fiduciary provisions are drawn from the common law of trusts, some courts have held that ERISA's directed trustee provision should be interpreted in the same fashion.[44] That is also the interpretation advocated by the Department of Labor in its *Enron amicus* briefs.[45]

The counterargument is that, while ERISA looks to the common law of trusts as a starting point, "trust law does not tell the entire story. . . . [E]ven with respect to the trust-like fiduciary standards ERISA imposes, Congress 'expected[ed] that the courts will interpret this prudent man rule (and other fiduciary standards) bearing in mind the special nature and purpose of employee benefit plans.'"[46]

Congress has clearly modified the common law of trusts when it comes to matters relating to allocation of fiduciary responsibility. While the common law of trusts holds that one fiduciary has a duty to take action if he knows *or should know of* a breach by another fiduciary, ERISA § 405(a) specifically rejects that approach and substitutes the more stringent requirement of actual knowledge.

b. The Enron Court Adopted the "Knew or Should Have Known" Test

The directed trustee in *Enron* did not fare well. The court rejected the actual knowledge/clear on their face test and instead adopted the much more amorphous "knew or should have known" test:

> At least where the facts alleged (and ultimately the evidence) provide reason for the directed trustee to have known *or should have known* of a breach of fiduciary duty, this Court finds that those cases which construe § 403(a)(1) to require something more than a duty to check

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[43] IIA SCOTT ON TRUSTS § 185 at 574 (4th ed. 1987). *See also* RESTATEMENT (SECOND) OF TRUSTS § 185, cmt. e (1959).

[44] *See, e.g.,* FirsTier Bank, N.A. v. Zeller, 16 F.3d 907 (8th Cir. 1994).

[45] It is interesting to note that the DOL conducted a lengthy investigation into Enron's collapse. When the DOL filed its subsequent lawsuit, however, the directed trustee was not named as a defendant.

[46] *Varity*, 516 U.S. at 486.

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> superficial compliance, which in actuality would serve no purpose, effectuate ERISA's underlying policies and purposes far better.[47]

Given the court's approach to fiduciary issues in general, this decision comes as no surprise. What is surprising is the court's dicta regarding the duties of a directed trustee with respect to investments in employer stock. The court stated as follows:

> This Court will accordingly apply a fact-specific approach to determining that duty here. In this context, in an ESOP there should be some duty on the part of a directed trustee to keep apprized of the company's financial condition to the extent that the trustee can determine whether its stock is an appropriate, i.e., prudent, investment.[48]

The court then reiterated as follows:

> In any ERISA retirement plan, where the plaintiffs . . . allege with factual support that the directed trustee knew or should have known from a number of significant waving red flags and/or regular reviews of the company's financial statements that the company was in financial danger and its stock greatly diminished in value, yet the named fiduciary . . . directed the trustee to continue purchasing the employer's stock, there is factual question whether the evidence is sufficient to give rise to a fiduciary duty by the directed trustee to investigate the advisability of purchasing the company stock to insure that the action is in compliance with ERISA as well as the plan.[49]

These comments are surprising because the plaintiffs in *Enron* had not asserted a "duty to sell" claim against the directed trustee. The claims against the directed trustee had been limited to the claim that the directed trustee should have postponed the lockdown (Count II) and should have diversified the plans' investments, given the unique language of those plans (Count III). The allegations regarding the continued purchase and holding of Enron stock were in Count I of the Complaint, and that Count was asserted only against the *Enron* defendants, not the directed trustee.

4. ERISA Remedies for Breach of Fiduciary Duties

a. Two Types of Fiduciary Claims

ERISA authorizes a wide range of remedies and penalties for breaches of fiduciary duties. Fiduciaries may be removed from office or otherwise enjoined.[50] They may be required to pay excise taxes[51] or penalties.[52]

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[47] 284 F. Supp. at 599 (emphasis added); 29 U.S.C. § 1103(a).
[48] 284 F. Supp. at 591.
[49] *Id.* at 601-02.
[50] ERISA §§ 409, 502(a)(2), 502(a)(3); 29 U.S.C. §§ 1109(a), 1132(c), (i), (l) & (m).
[51] ERISA § 502(i); 29 U.S.C. § 1132(i); 26 U.S.C. § 4975.
[52] ERISA § 502(l); 29 U.S.C. § 1132(l).

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Fiduciaries also may be liable for damages, as well as subject to injunctions and "other appropriate equitable relief," including certain forms of restitution.[53] It is these last three categories of remedies–damages, injunctions, and other appropriate equitable relief–that are the focus of these materials

Under ERISA, a claim for breach of fiduciary duty can be brought under two different sections of ERISA's civil enforcement provision: section 502(a)(2) or section 502(a)(3).[54] There are dramatic differences between the two types of action.

Claims for breach of fiduciary duty under section 502(a)(2) can be brought by an individual plan participant, but that individual participant must sue in a representative capacity on behalf of the plan as a whole.[55] Claims for individual relief are not permitted. The remedies that can be obtained under section 502(a)(2) are broad. The fiduciary can be required to:

- make good to the plan any losses to the plan resulting from the breach;
- restore to the plan any profits of the fiduciary which have been made through the use of assets of the plan by the fiduciary; and
- and shall be subject to such other equitable or remedial relief as the court may deem appropriate, including removal of the fiduciary.[56]

In contrast, claims for breach of fiduciary duty brought under section 502(a)(3) can be brought by an individual participant on his or her own behalf and do not need to be brought in a representative capacity on behalf of the plan.[57] Under section 502(a)(3), therefore, a participant can obtain individual relief. However, the remedies that can be obtained under section 502(a)(3) are not as broad because that section only authorizes equitable relief.[58] Money damages, as the classic form of legal relief, cannot be obtained in a section 502(a)(3) action. A claim for equitable restitution, where the claimant is seeking return of identifiable funds that properly belong to the claimant and that are being held by the defendant, can be brought under section 502(a)(3).[59] However, a claim for legal restitution, where the defendant does not hold the funds at issue and the claimant is simply seeking to hold the defendant personally liable, is not a claim for equitable relief and is not actionable under section 502(a)(3).[60] Such a claim is no different than a claim for money damages.

[53] ERISA §§ 409, 502(a)(2), 502(a)(3); 29 U.S.C. §§ 1109(a), 1132(a) & (g).
[54] 29 U.S.C. § 1132(a)(2) & (3).
[55] Mass. Mut. Life Ins. Co. v. Russell, 473 U.S. 134, 140-42 (1985).
[56] *See* 29 U.S.C. § 1109(a) (which is enforced through 29 U.S.C. § 1132(a)(2)).
[57] *Varity*, 516 U.S. at 496.
[58] Mertens v. Hewitt Assocs., 508 U.S. 248, 255 (1993).
[59] *See* Great-West Life & Annuity Ins. Co. v. Knudson, 534 U.S. 204 (2002); 29 U.S.C. § 1132.
[60] *Great-West Life*, 554 U.S. at 204.

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b. ERISA Causes of Action

(i) ERISA § 502(a)(2)

As a general rule, with one narrow exception mentioned below, money damages for fiduciary breach are available under just one section of ERISA § 502(a)(2),[61] which provides a cause of action to the Secretary of Labor as well as to plan participants, beneficiaries, and fiduciaries to obtain "appropriate relief" under section 409,[62] to redress fiduciary violations. Section 409 in turn provides that breaching fiduciaries "shall be personally liable to make good to [the] plan any losses to the plan resulting from each . . . breach." Because of this language, actions brought under section 502(a)(2) can seek the traditional legal relief of money damages, although damages that will be paid to the plan as a whole, because the action provided by section 502(a)(2) is not an action for individual relief.[63]

(ii) ERISA § 502(a)(3)

For individual relief, a plan participant or beneficiary must turn to section 502(a)(3). That section authorizes only injunctions and "other appropriate equitable relief." The Supreme Court repeatedly has held that the "equitable relief" authorized by section 502(a)(3) is limited to traditional forms of equitable relief; it does not include legal relief that equitable courts would sometimes award, such as damages.[64] The holdings in *Mertens*[65] and *Great-West*[66] do not entirely preclude awards of money to individuals; they just preclude awards of money *damages*. A court may award money if the substance of the relief was typically available in equity.

(iii) ERISA § 502(a)(9)

Section 502(a)(9)[67] also supplies an action for "appropriate relief" "in the event that the purchase of any insurance contract or insurance annuity in connection with termination of an individual's status as a participant covered under a pension plan with respect to all or any portion of the participant's pension benefit under such plan constitutes a violation of part 4 of this title or the terms of the plan." Appropriate relief is that which "assure[s] receipt by the participant or beneficiary of the amounts provided or to be provided by such insurance contract or annuity, plus reasonable prejudgment interest on such amounts." Damages relief thus may be available under section 502(a)(9) but only in a narrow range of cases.

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[61] 29 U.S.C. § 1132(a)(2).
[62] *Id.* at § 1109.
[63] *Mass. Mut. Life Ins. Co.*, 473 U.S. at 134.
[64] *See, e.g., Great-West,* 534 U.S. at 204; *Mertens*, 508 U.S. at 248.
[65] *Id.*
[66] 534 U.S. at 204.
[67] 29 U.S.C. § 1132(a)(9).

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5. Availability and Scope of Damages Under Section 502(a)(2)

There are four primary questions presented in a section 502(a)(2) claim for damages:

- What damages are available?
- Who has the burden of proving damages?
- How are the damages measured?
- Who can be made to pay the damages?

a. Damages Caused by a Breach

Section 409 makes a fiduciary liable only for losses "resulting from" a breach. The courts have unanimously interpreted this language as creating a causation requirement.[68] "ERISA holds a [fiduciary] liable for a breach of fiduciary duty only to the extent that losses to the plan result from the breach."[69]

The fundamental rule is that fiduciaries are not liable for losses that the plan would have suffered regardless of their breach.[70] The rule has the following three principal applications.

- **Duty to investigate.** One common application of the rule is to violations of the duty to conduct a reasonable investigation before acting. If the investigation were inadequate, but an adequate investigation would have resulted in the same decision, then the breach did not cause any resulting losses and the fiduciary is not liable for them.[71]

- **Duty to diversify.** A second application of the rule is to instances in which it was prudent for a fiduciary to hold some amount of a particular investment, but imprudent to hold as much as the fiduciary actually did. In those cases, the fiduciary is liable only for the losses caused by the excess holdings.[72]

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[68] *See, e.g.,* Friend v. Sanwa Bank of Cal., 35 F.3d 466 (9th Cir. 1994).

[69] *Id.* at 469.

[70] *See, e.g.,* Kuper v. Iovenko, 66 F.3d 1447, 1459-60 (6th Cir. 1995); *Friend*, 35 F.3d at 469 (9th Cir. 1994); Roth v. Sawyer-Cleator Lumber Co., 16 F.3d 915, 919 (8th Cir. 1994); Diduck v. Kaszycki & Sons Contractors, Inc., 974 F.2d 270, 279 (2d Cir. 1992); DeBruyne v. Equitable Life Assur. Soc'y of U.S., 920 F.2d 457, 464-65 (7th Cir. 1990); Ironworkers Local #272 v. Bowen, 695 F.2d 531, 536 (5th Cir. 1983); Brandt v. Grounds, 687 F.2d 895, 898 (7th Cir. 1982).

[71] *See, e.g.,* Kuper, 66 F.3d at 1459-60; *Roth*, 16 F.3d at 919; Fink v. Nat'l Sav. & Trust Co., 772 F.2d 951, 962 (D.C. Cir. 1985) (Scalia, J., concurring in part and dissenting in part).

[72] *See, e.g.,* Cal. Ironworkers Field Pension Trust v. Loomis Sayles & Co., 259 F.3d 1036, 1046-47 (9th Cir. 2001).

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- **Participant-directed accounts.** A third application is provided by ERISA § 404(c), which states that "if a participant or beneficiary exercise control over the assets in his account . . . no person who is otherwise a fiduciary shall be liable . . . for any loss, or by reason of any breach, which results from [the] participant's or beneficiary's exercise of control."[73] Under this section, a fiduciary is not liable for losses if the participant's actions, rather than the fiduciary's breach, caused the losses.[74]

The corollary to the rule that a plaintiff can only recover damages for a loss caused by the breach is the rule that, when a plan has not suffered any loss, plaintiffs cannot recover damages, despite the fact of a breach.[75] Both the Fifth and Eighth Circuits have held that, absent a loss to the plan, the plaintiff lacks a cause of action entirely.[76]

(i) Damages for Co-fiduciary Breaches and Knowing Participation by a Non-fiduciary

The same rules on causation apply to breaches by co-fiduciaries.[77] Plaintiffs can recover damages from a co-fiduciary only for losses that are caused by the co-fiduciary's breach. An example is a co-fiduciary's failure to take reasonable steps to remedy the other fiduciary's breach.[78] Similarly, in jurisdictions that recognize a cause of action against non-fiduciaries for knowing participation in a fiduciary breach, the non-fiduciary is liable for a loss only if its participation was "a substantial factor in the sequence of responsible causation."[79]

(ii) Punitive Damages

In *Massachusetts Mutual Life Insurance Co. v. Russell*,[80] the Supreme Court held that individuals could not recover punitive damages either under section 502(a)(2) or under an implied cause of action. It expressly preserved the question, however, whether

[73] 29 U.S.C. § 1104(c).

[74] *See, e.g.,* In re Unisys Savings Plan Litig., 74 F.3d 420, 445-46 (3d Cir. 1996).

[75] *See, e.g.,* Wsol v. Fiduciary Mgmt. Assocs., Inc., 266 F.3d 654, 656 (7th Cir. 2001); Mira v. Nuclear Measurements Corp., 107 F.3d 466, 471-73 (7th Cir. 1997); Kemmerer v. ICI Americas Inc., 70 F.3d 281, 291 (3d Cir. 1995) (individuals who did not prove personal loss could not bring suit for individual damages); *Roth*, 16 F.3d at 919-20; Etter v. J. Pease Constr. Co., 963 F.2d 1005, 1009 (7th Cir. 1992).

[76] Coyne & Delany Co. v. Selman, 98 F.3d 1457, 1466 n.11 (4th Cir. 1996) (calling "harm" an "element of a cognizable breach of fiduciary duty claim"); McDonald v. Provident Indem. Life Ins. Co., 60 F.3d 234, 237-38 (5th Cir. 1995); Physicians HealthChoice, Inc. v. Trustees of Auto. Employee Ben. Trust, 988 F.2d 53 (8th Cir. 1993).

[77] ERISA § 405; 29 U.S.C. § 1105.

[78] *Silverman*, 138 F.3d at 104, 105.

[79] *Diduck,* 974 F.2d at 284.

[80] 473 U.S. at 134.

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a plan could recover punitive damages under section 502(a)(2).[81] Subsequent decisions have plugged that gap, holding that punitive damages are not available under ERISA.[82]

b. Burden of Proof: Shifting Burden?

By virtue of the text of section 409, causation of damages is initially an element of the plaintiff's claim.[83] But some courts have held that once the plaintiff proves a breach and a prima facie case of loss, the burden of production, or even persuasion, switches to the fiduciary to prove that the breach did not cause the loss. There are several variations on this theme:

(i) Switching the burden of production but not persuasion

The Second Circuit has referred to the burden as requiring the plaintiff to prove a prima facie case of damages—breach, loss, and causation—whereupon the defendant must produce evidence to rebut the case. All along, however, the burden of proof of causation remains on the plaintiff.[84]

(ii) Switching the burden of persuasion

The Fifth and Eighth Circuits hold that, once the plaintiff has proved a breach and a prima facie case of loss to the plan, or profits to the fiduciary, the burden of proof shifts to the fiduciary to prove that the loss (or profits) was not caused by the breach.[85]

(iii) Other positions

One can infer that the Seventh Circuit would not follow the approach of the Fifth and Eighth Circuits from *DeBruyne v. Equitable Life Assurance Society of the U.S.*,[86] which dismisses a claim for lack of proof of causation, even though the court assumed a breach and plaintiff had shown a loss to the plan.

In a slightly different context, the Sixth Circuit has held that the plaintiff bears the burden of proving that an inadequate investigation by the fiduciary caused the damages by leading the fiduciary to make a decision different than the one that a prudent fiduciary would have made on an adequate investigation.[87]

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[81] *Id.* at 144 n.12; 29 U.S.C. § 1132.

[82] *See, e.g.,* Harsch v. Eisenberg, 956 F.2d 651, 660-61 (7th Cir. 1992); *Diduck*, 974 F.2d at 286. Other courts had reached that conclusion even prior to Russell. *See, e.g.,* Dependahl v. Falstaff Brewing Corp., 653 F.2d 1208, 1216 (8th Cir. 1981).

[83] 29 U.S.C. § 1109.

[84] *Silverman*, 138 F.3d at 105-06; *Diduck*, 974 F.2d at 279.

[85] Felber v. Est. of Regan, 117 F.3d 1084, 1087-88 (8th Cir. 1997); McDonald v. Provident Indem. Life Ins. Co., 60 F.3d 234, 236 (5th Cir. 1995); *Roth*, 16 F.3d at 917; Martin v. Feilen, 965 F.2d 660, 671-72 (8th Cir. 1992). *See also* Donovan v. Bryans, 566 F. Supp. 1258, 1265 (E.D. Pa. 1983) (burden of persuasion shifted to defendants to disprove causation).

[86] 920 F.2d at 464-65.

[87] *Kuper*, 66 F.3d at 1459-60.

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c. Measuring Damages

(i) Basic Measure of Loss

Courts have interpreted section 409 as a primarily remedial provision, drafted with the goal of restoring the trust beneficiaries to the position they would have occupied but for the breach of trust.[88] In an imprudent investment case, the Second Circuit held that restoring the plan meant comparing "what the Plan actually earned on the [imprudent] investment with what the Plan would have earned had the funds been available for other purposes."[89] In a later case, the court elaborated, "[i]f, but for the breach the [plan] would have earned even more than it actually earned, there is a 'loss' for which the breaching fiduciary is liable."[90] The time frame over which a loss is measured depends on the circumstances of the case.[91]

(ii) Offsetting Losses

If a fiduciary commits two distinct breaches of trust, one resulting in a loss and the other resulting in a gain to the plan, some courts hold that the fiduciary is not permitted to offset the loss with the gain. Nor is it permitted to offset the loss with gains from other, prudent investments. However, if the two or more breaches are not separate and distinct, the loss is measured by their aggregate performance.[92]

It is doubtful whether the no-offset rule can be applied to prudent investing claims. In *Leigh v. Engle*,[93] the Seventh Circuit applied the no-offset rule to a case involving a breach of loyalty, but it expressly left the door open to measuring the investments as a portfolio in a breach of prudence case. The district court in *In re Unisys Savings Plan Litigation,*[94] refused to consider the challenged investments in isolation and instead held that plaintiffs had not been damaged because the portfolio as a whole had not suffered a loss.

(iii) Prejudgment Interest

Some decisions hold that a court has discretion under section 409 to award, or not award, prejudgment interest on awards of damages as part of the "appropriate relief."[95]

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[88] *See, e.g.,* Martin, 965 F.2d at 671; Call v. Sumitomo Bank of Cal., 881 F.2d 626, 633-34 (9th Cir. 1989); Donovan v. Bierwirth, 754 F.2d 1049, 1056 (2d Cir. 1985).

[89] *Id.* at 1056.

[90] *See* GIW Industries, Inc. v. Trevor, Stewart, Burton & Jacobsen, Inc., 895 F.2d 729, 733 (11th Cir. 1990); Dardaganis v. Grace Capital Inc., 889 F.2d 1237, 1243 (2d Cir. 1989); Reich v. Valley Nat'l Bank of Ariz., 837 F. Supp. 1259, 1288-89 (S.D.N.Y. 1993); *cf.* Pension Benefit Guar. Corp. v. Solmsen, 743 F. Supp. 125, 127-29 (E.D.N.Y. 1990) (setting prejudgment interest rate according to what plan would have earned with funds); Dasler v. E.F. Hutton & Co., Inc., 694 F. Supp. 624, 634 (D. Minn. 1988).

[91] *Roth*, 61 F.3d at 603-04; *Bierwirth*, 754 F.2d at 1056.

[92] *Cal. Ironworkers Field Pension Trust*, 259 F.3d 1036, 1047-48 (9th Cir. 2001).

[93] 858 F.2d 361, 368 (7th Cir. 1988)

[94] No. 91-3067, 1997 WL 732473, at *30 (E.D. Pa. Nov. 24, 1997).

[95] *See, e.g., Diduck*, 974 F.2d at 286; Shaw v. Int'l Ass'n of Machinists and Aerospace Workers Pension Plans, 750 F.2d 1458, 1465 (9th Cir. 1985); Katsaros v. Cody, 744 F.2d 270, 281 (2d Cir. 1984); McLaughlin v. Cohen, 686 F. Supp. 454, 458 (S.D.N.Y. 1988); Leigh v. Engle, 669 F. Supp. 1390, 1405-06

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The Fourth Circuit has gone further and announced a "general principle that a fiduciary is liable not only for profits or losses caused by a breach of duty but also for simple interest at the legal rate running from the time of the breach."[96]

(iv) Resolving Uncertainties in Measuring Damages

In calculating the amount of damages, some courts have held that doubts and ambiguities are resolved against the breaching fiduciary.[97] This rule has several applications:

(A) Calculating What the Plan Would Have Made

In calculating the loss from an imprudent investment, the Second Circuit has instructed that a district court should presume that the funds "would have been treated like other funds being invested during the same period in proper transactions. Where several alternative investment strategies were equally plausible, the court should presume that the funds would have been used in the most profitable of these."[98]

(B) Calculating the Amount of Overpayment

In *Brink v. DaLesio,* the Fourth Circuit held that a fiduciary who breached a duty of loyalty in negotiating a lease for the plan bore the burden of proving which part of the lease payments were fair and that plaintiffs were entitled to damages for whatever portion of the rent the fiduciary could not vindicate.[99]

(C) Calculating the Amount the Fiduciary Could Prudently Have Invested

In *Bruner v. Boatmen's Trust Co.*,[100] the court awarded the full amount of a plan's loss for a particular investment because, even though the plan could have prudently placed some money in the investment, the fiduciaries had submitted no evidence to prove the prudent amount and the uncertainty was resolved against them.

d. Joint and Several Liability, Contribution, and Indemnification

Of the courts that have addressed the issue, most hold that breaching fiduciaries are jointly and severally liable for the amount of the plan's loss.[101] The law is not settled

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(N.D. Ill. 1987), *aff'd,* 858 F.2d 361 (7th Cir. 1988); Donovan v. Bryans, 566 F. Supp. 1258, 1265-66 (E.D. Pa. 1983); 29 U.S.C. § 1109.

[96] Brink v. DaLesio, 667 F.2d 420, 429 (4th Cir. 1981).

[97] *Roth,* 61 F.3d at 602; Kim v. Fujikawa, 871 F.2d 1427, 1430-31 (9th Cir. 1989); *Leigh*, 727 F.2d at 138-39; *Bierwirth*, 754 F.2d at 1056; *Brink*, 667 F.2d at 426. *See also Dasler*, 694 F. Supp. at 634.

[98] *Bierwirth*, 754 F.2d at 1056. *See also* Dardaganis*,* 889 F.2d at 1244.

[99] *Brink*, 667 F.2d at 426.

[100] *Bruner*, 918 F. Supp. at 1354-55,

[101] *See, e.g.,* Lowen v. Tower Asset Mgmt., Inc., 829 F.2d 1209, 1220-21 (2d Cir. 1987) (holding fiduciaries and participating non-fiduciaries jointly liable for disgorgement of profits); Donovan v. Walton, 609 F. Supp. 1221, 1231 (D.C. Fla. 1985); Davidson v. Cook, 567 F. Supp. 225, 240 (E.D. Va. 1983)

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on the issue whether a fiduciary who has been held liable for the full amount of a loss can recover from his co-fiduciaries through contribution or equitable indemnification. Many decisions hold that contribution and equitable indemnification are available, emphasizing ERISA's incorporation of common law trust principles, which allow for contribution, and the inequity of making one fiduciary bear the entire liability for the group.[102] A number of other decisions, although not as many and typically not as recent, hold that an action for contribution or equitable indemnification does not exist because ERISA does not expressly create one.[103]

Decisions just within the Seventh Circuit demonstrate how unstable the law on contribution has been. In *Free v. Briody,*[104] the court acknowledged a right of contribution. But in *Donovan v. Robbins*,[105] it implied that *Free* might be incorrect. In *Mutual Life Insurance Co. v. Yampol*,[106] the court held that a right of contribution did not exist. But in *Lumpkin v. Envirodyne Industries, Inc.*,[107] the court again said that it did. The district court now considers the issue settled in favor of the right, at least in the Seventh Circuit.[108] But one has to wonder.

e. Contractual Indemnification, But Not Exoneration

Section 410 of ERISA[109] speaks directly to the permissible limits of contractual exculpation and indemnification:

> (a) Except as provided in section 405(b)(1) and 405(d) [governing delegation of investment duties], any provision in an agreement or instrument which purports to relieve a fiduciary from responsibility or liability for any responsibility, obligation, or duty under this part shall be void as against public policy.
>
> (b) Nothing in this subpart shall preclude—

(holding breaching fiduciaries jointly and severally liable*); Bryans*, 566 F. Supp. at 1265, 1269 (holding fiduciaries jointly and severally liable for losses to the plan).

[102] *See, e.g.,* In re Masters Mates & Pilots Pension Plan, 957 F.2d 1020, 1027 (2d Cir. 1992); Chemung Canal Trust Co. v. Sovran Bank/Maryland, 939 F.2d 12, 15-18 (2d Cir. 1991); Site-Blauvelt Engineers, Inc. v. First Union Corp., 153 F. Supp. 2d 707, 709-10 (E.D. Pa. 2001); Cooper v. Kossan, 993 F. Supp. 375, 377 (E.D. Va. 1998); Green v. William Mason & Co., 976 F. Supp. 298, 300-01 (D.N.J. 1997); Petrilli v. Gow, 957 F. Supp. 366, 371 (D. Conn. 1997).

[103] *See, e.g.,* Kim v. Fujikawa, 871 F.2d 1427, 1432-33 (9th Cir. 1989); *Call*, 881 F.2d at 630-31; Roberts v. Taussig, 39 F. Supp. 2d 1010, 1011 (N.D. Ohio 1999); Youngberg v. Bekins Co., 930 F. Supp. 1396, 1399-1403 (E.D. Cal. 1996); Physicians Healthchoice, Inc. v. Trustees of Automotive Employee Ben. Trust,764 F. Supp. 1360 (D. Minn. 1991); Hunt v. Magnaell, 766 F. Supp. 727, 730 (D. Minn. 1990). Notably, however, a district court in the Ninth Circuit has distinguished *Kim* and *Call* in the context of equitable indemnification, which it found that ERISA recognized.

[104] 732 F.2d 1331, 1336-38 (7th Cir. 1984).

[105] 752 F.2d 1170, 1178-79 (7th Cir. 1985).

[106] 706 F. Supp. 596, 598 (N.D. Ill 1989).

[107] 933 F.2d 449, 464 (7th Cir. 1991).

[108] Harris Trust and Savings Bank v. Salomon Bros, Inc., 832 F. Supp. 1169, 1177 (N.D. Ill. 1993).

[109] 29 U.S.C. § 1110.

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> (1) a plan from purchasing insurance for its fiduciaries or for itself to cover liability of losses occurring by reason of the act or omission of a fiduciary, if such insurance permits recourse by the insurer against the fiduciary in the case of a breach of a fiduciary obligation by such fiduciary;
>
> (2) a fiduciary from purchasing insurance to cover liability under this part from and for his own account; or
>
> (3) an employer or an employee organization from purchasing insurance to cover potential liability of one or more persons who serve in a fiduciary capacity with regard to an employee benefit plan.

An interpretive bulletin issued by the Department of Labor applies section 410 to permit indemnification agreements "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."[110] Thus, the regulation would allow indemnification by an employer or an employee organization. It would not allow indemnification by the plan itself.

Therefore, a fiduciary cannot by contract eliminate its fiduciary duties or provide that it will not be liable for their breach.[111] As a general rule, a plan may pay the costs of a successful defense, but not an unsuccessful one.[112] At least some cases hold that the plan may advance the costs of the defense before judgment.[113] Notwithstanding the regulations providing that employers may indemnify a fiduciary for expenses, occasional courts have declared void agreements by an employer to indemnify a fiduciary against personal liability or expense arising out of performance of its fiduciary duties.[114] As a general matter, settlement agreements are not considered a precluded exoneration or indemnification.[115]

f. Remedy of Disgorgement

Section 409 requires fiduciaries to disgorge "profits . . . made through use of assets of the plan by the fiduciary."[116] So even if a plan has not suffered a loss, the court still may order disgorgement. Although disgorgement is an equitable remedy,[117] it is briefly treated here because it results in award of money; and, more importantly, the rules for disgorgement directly correspond to the rules for damages:

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[110] 29 C.F.R. § 2509.75-4.

[111] *See, e.g.,* IT Corp. v. Gen. Am. Life. Ins. Co., 107 F.3d 1415, 1418-19 (9th Cir. 1997).

[112] *See, e.g.,* Packer Eng'g Inc. v. Kratville, 965 F.2d 174, 175-76 (7th Cir. 1992) (indemnification allowed for expenses fiduciary incurs in successful defense); Leigh, 858 F.2d at 369; Martin v. Walton, 773 F. Supp. 1524 (S.D. Fla. 1991) (indemnification not allowed for expenses incurred in unsuccessful defense).

[113] Moore v. Williams, 902 F. Supp. 957, 966-67 (N.D. Iowa 1995) (allowing advances).

[114] *See, e.g.,* Delta Star, Inc. v. Patton, 76 F. Supp. 2d 617, 640-41 (W.D. Pa. 1999).

[115] *See, e.g.,* Leavitt v. Northwestern Bell Tel. Co., 921 F.2d 160, 161-62 (8th Cir. 1990).

[116] 29 U.S.C. § 1109.

[117] Herman v. S.C. Nat'l Bank, 140 F.3d 1413, 1422 (11th Cir. 1998).

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Disgorgement is available only for profits caused by use of the plan's assets. The language "through use of assets of the plan" in section 409 creates a causation requirement. If the fiduciary has made profits through use of plan assets, the court may order the fiduciary to disgorge them.[118] If a fiduciary has invested both his own assets and assets of the plan, only profits caused by use of the plan's assets must be disgorged.[119] And if the breach has not caused any profits, there is nothing to disgorge, and the plaintiff cannot recover any award.[120] At least one court has held that the burden of proving which profits were made independently of the plan's assets falls on the breaching fiduciary.[121]

g. Other Appropriate Equitable Relief

Section 502(a)(3) of ERISA enables a participant, beneficiary, or fiduciary to sue individually, as opposed to on behalf of the plan, to obtain certain types of equitable relief for violations of ERISA or to enforce the terms of an ERISA plan:

> A civil action may be brought . . . by a participant, beneficiary, or fiduciary (A) to enjoin any act or practice which violates any provision of this subchapter or the terms of the plan, or (B) to obtain other appropriate equitable relief (i) to redress such violations or (ii) to enforce any provisions of this subchapter or the terms of the plan.[122]

Under section 502(a)(3), injunctions, other than those seeking to compel the payment of money damages, are considered to be equitable rather than legal relief.[123] This article focuses on the difficult and often controversial issue of the meaning of the term "other appropriate equitable relief."

A form of relief will not be available unless it is affirmatively authorized under ERISA; that is, remedies will not be implied.[124] Notwithstanding this rule, some courts have found additional remedies in federal common law.[125] Nevertheless, it can be assumed that a remedy under section 502(a)(3) must be derived from the expressed language of the section.

Equitable remedies are appropriate under section 502(a)(3) only when there are no other remedies available under section 502 for the injury alleged. Section 502(a)(3),

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[118] *See, e.g., Leigh*, 727 F.2d at 122; *cf.* Amal. Clothing & Textile Workers Union, 861 F.2d 1406 (9th Cir. 1988) (awarding constructive trust against fiduciary profits and distributing profits directly to participants); *Dasler*, 694 F. Supp. at 634.

[119] *Felber*, 117 F.3d at 1087.

[120] *Wsol*, 266 F.3d at 656, 658; Etter v. J. Pease Constr. Co., 963 F.2d 1005, 1009-10 (7th Cir. 1992).

[121] *Leigh*, 727 F.2d at 138-39; *see also* Leigh v. Engle, 858 F.2d 361, 366 (7th Cir. 1988).

[122] 29 U.S.C. § 1132(a)(3).

[123] *See Great-West,* 534 U.S. at 211 n.1.

[124] *Id.* at 209; *see also Mertens*, 508 U.S. at 254; *Mass. Mut. Life Ins. Co*., 473 U.S. at 146-47.

[125] *See, e.g., Coop. Benefit Adm'r, Inc.*, 265 F. Supp. 2d 662, 671-72 (M.D. La. 2003) (holding that, while *Great-West* foreclosed restitution remedy, unjust enrichment action was available under federal common law).

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very broadly worded, has been defined as a "catchall remedial section" that provides a "safety net" of remedies.[126] The remedies under that section, however, must be "appropriate." Such remedies are only those granting "relief for injuries caused by violations that section 502 does not elsewhere remedy."[127] Therefore, if there is a remedy expressly provided for elsewhere in section 502—most commonly, a claim for benefits under section 502(a)(1)(B)—no equitable remedy is permitted under section 502(a)(3).

Appropriate equitable remedies are available under section 502(a)(3) only if the remedy is for the purpose of redressing violations of ERISA or enforcing the terms of an ERISA plan.[128] In the case of section 502(a)(3), the statutory language limits the availability of appropriate equitable relief to situations in which there has been a violation of ERISA or an effort is made to enforce the terms of an ERISA plan. That said, courts have been willing to assume these requirements are met where the parties have not disputed the issue.[129]

Section 502(a)(3) only permits the granting of relief that was typically available in equity before the merger of the courts of law and equity.[130] In the United States, that merger was completed with the adoption of the Federal Rules of Civil Procedure in 1934.[131] The Supreme Court has made it clear that the term equitable relief, as it is used in section 502(a)(3), has a very precise meaning. It refers only to those types of remedies that were typically available in equity. The Court has determined that it does not refer to the broader category of remedies that "a common-law court of equity could provide in such a case," which as a historical matter included both equitable and legal remedies.[132] The Court adopted this restrictive reading of the term equitable on a five-to-four vote in *Great-West*.[133] The majority opinion was vigorously attacked by the dissenting justices and has met with strong criticism in the academic literature.[134] The slim margin for the majority and heavy criticism suggests the possibility that the Court may revisit the issue in the future.

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[126] *Varity*, 516 U.S. at 512 (internal quotations omitted).

[127] *Id.*; *see also* Geissal v. Moore Medical Corp., 338 F.3d 926, 933 (8th Cir. 2003); *Enron*, 284 F. Supp. 2d at 604 (no remedy under § 502(a)(3) where remedy exists under § 502(a)(1)) (citing Musmeci v. Schwegmann Giant Super Markets, Inc., 322 F.3d 339, 349 n.5 (5th Cir. 2003)) (other citations omitted).

[128] *See* 29 U.S.C. § 1132(a)(3).

[129] *See Mertens*, 508 U.S. at 253-55 (where parties expressly disclaimed reliance on the question of whether there was remediable wrong, court "decide[d] th[e] case on the narrow battlefield the parties [had] chosen").

[130] *See Great-West*, 534 U.S. at 209-21.

[131] *See* 4 CHARLES ALAN WRIGHT & ARTHUR R. MILLER, FED. PRAC. & PROC. §§ 1003 & 1041 (3d ed. 2002).

[132] *Mertens*, 508 U.S. at 255-59; *see also Great-West*, 534 U.S. at 209-21.

[133] *Id.*

[134] *See id.* at 221-24 (Stevens, J. dissenting); *id.* at 224-34 (Ginsburg, J. dissenting); *see also* John H. Langbein, *What ERISA Means by "Equitable": The Supreme Court's Trail of Error in Russell, Mertens and Great-West*, 103 COLUM. L. REV. (forthcoming) (available at <<http://papers.ssrn.com/abstract=371104>>) [hereafter Langbein]; Tracy A. Thomas, *Justice Scalia Reinvents Restitution*, 36 LOY. L.A. L. REV. 1063 (2003).

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h. Inappropriate Relief

To date, the Supreme Court has done a better job of defining those remedies that were not typically available in equity than those that were. Thus, it is helpful to begin by discussing those remedies that are not available under section 502(a)(3) before addressing those remedies that presumably are available under the section.

Remedies that clearly do not qualify as equitable relief under section 502(a)(3) include the following:

- Money damages sought to compensate for breach of a legal duty;
- Injunctions to compel the payment of money damages to remedy a legal injury;
- Specific performance of a past due monetary obligation;
- Restitution in quasi-contract. That is restitution in the form of money for some general benefit conferred; and
- Legal relief awarded in actions that may be viewed as equitable in nature because they involve claims based on trust law.[135]

(i) Money Damages

Money damages sought for the purpose of compensating for breach of a legal duty are a form of legal relief and, thus, are not recoverable under section 502(a)(3). This rule encapsulates the sharp distinction the Supreme Court drew between legal relief, which is not recoverable under section 502(a)(3), and equitable relief, which is. Remedies are not "equitable" where they seek "to obtain a judgment imposing a . . . personal liability upon the defendant to pay a sum of money."[136] And "[m]oney damages are, of course, the classic form of legal relief."[137] Claims for personal liability for money damages are legal because the money acts as a proxy for some other harm. Where instead, the money claimed is "particular funds or property in the defendant's possession," the relief is equitable.[138] In application this means that compensatory and punitive damages, which by definition are monetary relief for some other harm, are legal remedies and thus not allowed under section 502(a)(3).[139]

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[135] *See Great-West*, 534 U.S. at 210-13, 219-20.
[136] *Id.* at 213.
[137] *Mertens*, 508 U.S. at 255 (emphasis in original) (citations omitted).
[138] *Great-West*, 534 U.S. at 213-14.
[139] *See* Gerosa v. Savasta & Co., Inc., 329 F.3d 317, 321 (2d Cir. 2003) (citing *Great-West*, 534 U.S. at 210) (other citations omitted).

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(ii) Injunctions Compelling Payment

An injunction to compel the payment of money, or specific performance of a past due monetary obligation, is not allowed under section 502(a)(3).[140] "In determining the propriety of a remedy [under Section 502(a)(3)] courts must look to the real nature of the relief sought, not its label."[141] Thus, neither an injunction to compel an otherwise legal remedy, nor an order to specifically perform the payment of money damages, are considered "equitable" under section 502(a)(3), even though these forms of relief generally were available in courts of equity. As the Supreme Court has stated, "a statutory limitation to injunctive relief would be meaningless [otherwise], since any claim for legal relief can, with lawyerly inventiveness, be phrased in terms of an injunction."[142]

(iii) Restitution in Quasi-Contract

Restitution in the form of money in compensation for some benefit conferred is not available under section 502(a)(3).[143] Restitution, as a remedy, developed as a merger of forms of relief provided with respect to breaches of quasi-contracts in law and the enforcement of constructive trusts in equity.[144] Because the Supreme Court has determined that only those remedies exclusively available from the equity court, that is, constructive trusts and equitable liens, will be treated as "equitable" for purposes of section 502(a)(3), only the "equitable" form of restitution is available under that section.[145]

A constructive trust and equitable lien both require that "money or property identified as belonging in good conscience to the plaintiff [can] clearly be traced to particular funds or property in the defendant's possession."[146] If the funds have been disbursed, or the property is no longer identifiable, the claim is not "equitable" and no remedy exists under section 502(a)(3).[147]

(iv) Actions Based on Trust Law

Actions viewed as based on trust law but which seek legal relief, as opposed to equitable relief, such as an action by a plan participant against a fiduciary for money damages, are not maintainable under section 502(a)(3).[148] The Supreme Court has expressly rejected the argument that the "special equity-court powers applicable to trusts

[140] *See Great-West*, 534 U.S. at 210-12.

[141] *Gerosa*, 329 F.3d at 321.

[142] *Great-West*, 534 U.S. at 211 n.1; *see also* Bauhause USA, Inc. v. Copeland, 292 F.3d 439, 442-45 (5th Cir. 2002) (disallowing claim for "declaratory judgment" where nature of relief was legal).

[143] *See Great-West*, 534 U.S. at 212-16.

[144] *See* John H. Langbein, (unpublished abstract at 78-80, available at http://papers.ssrn.com/abstract=371104).

[145] *See Great-West*, 534 U.S. at 213-14.

[146] *Id.* at 213-14.

[147] *Id.* at 214; *see also Gerosa*, 329 F.3d at 321-22; Rego v. Westvaco Corp., 319 F.3d 140, 144-45 (4th Cir. 2003).

[148] *See Great-West*, 534 U.S. at 219-20.

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define the reach of § 502(a)(3)."[149] Thus, simply because a plan participant asserts a claim against a fiduciary–a claim generally viewed as one based on trust law principles–does not mean that every form of relief sought against the fiduciary will be viewed as equitable in nature.

Notwithstanding the Supreme Court's clear ruling on this issue, the Secretary of Labor continues to file *amicus* briefs arguing as follows: (1) actions based on trust law were the exclusive province of the courts of equity; (2) ERISA is modeled after trust law; and, therefore, (3) all remedies available in trust law should be available under section 502(a)(3).[150] The persistence of the Secretary in making this argument is no doubt a reflection of the controversy surrounding the issue of what is meant by the term "other appropriate equitable relief."

i. Appropriate Relief

As noted above, given the state of the law today, it is much easier to say what is not equitable relief for purposes of section 502(a)(3) than it is to say what is. The Supreme Court has said that remedies "typically available in equity" are generally available under section 502(a)(3). That would seem to suggest that equitable relief in the form of an accounting, reformation, or rescission would qualify. However, even these traditional equitable remedies are subject to the same general limitation that the Supreme Court has placed on the equitable remedies of injunction and restitution: they may not be disguised means of providing legal relief, money damages.

The Supreme Court has indicated that, when determining whether a remedy qualifies as equitable under section 502(a)(3), the courts should consult the well-recognized treatises on equity as well as the applicable Restatements.[151] Although courts are just beginning to apply the Supreme Court's ruling in *Great West*, some judicial guidance can be gleaned from the cases that have been decided. This is especially true with respect to cases involving requests for injunctions and restitution:

(i) Injunctions Not Seeking to Compel the Payment of Money

Injunctions, and other highly flexible equitable remedies, are available under section 502(a)(3) only if the true nature of the relief sought is equitable.[152] In *Sunderlin v. First Reliance Standard Life Insurance Co.*,[153] the court found that the defendants had improperly denied plaintiff benefits, failed to provide a review of the denial, lost the plaintiff's claim file, and failed to provide the plaintiff with a summary plan description.

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[149] *Id.* at 219-20 (citing *Mertens*, 508 U.S. at 256); *see also Rego*, 319 F.3d at 145; *Enron*, 284 F. Supp. 2d at 612 (discussing applicability of trust law to section 502(a)(3) in the wake of *Great-West*).

[150] *See Great-West*, 534 U.S. at 219; *Enron,* 284 F. Supp. 2d at 607, Callery v. U.S. Life Ins. Co., No. 03-4097, Brief of the Secretary of Labor as *Amicus Curiae* in Support of the Appellant and Reversal of the District Court, filed Aug. 20, 2003 (10th Cir.); Ostler v. OCE-USA, Inc., No. 01-3801, Brief of the Secretary of Labor as *Amicus Curiae* in Support of the Appellant, filed Feb. 8, 2002 (7th Cir.).

[151] *See Great-West*, 534 U.S. at 217 (referencing "Dobbs, Palmer, Corbin, and the Restatements").

[152] *Id.* at 210; *Gerosa*, 329 F.3d at 321.

[153] 235 F. Supp. 2d 222, 235 (W.D.N.Y. 2002).

To remedy this, the court ordered a variety of forms of relief under section 502(a), including benefits under the plan and an injunction. Specifically, the court enjoined the plan administrator under section 502(a)(3) to "create a new claim file, and to provide proof of its creation" to the plaintiff, and to "provide plaintiff with a completed summary plan description within 20 days."

(ii) Purely "Equitable" Forms of Restitution

Where the requirements of a constructive trust can be met, restitution of specific property or funds, including money, is available under section 502(a)(3).[154] The imposition of a constructive trust is appropriate where the property sought is identifiable, has not been dissipated, is still in the participant's control, and in good conscience belongs to the plaintiff.

In *Administrative Committee of the Wal-Mart Stores, Inc. Associates' Health and Welfare Plan v. Varco*,[155] the plan administrator brought a subrogation claim against a participant to recover medical expenses paid by the plan. There, the participant had recovered money in a personal injury action, and the specific funds recovered were being held in a reserve bank account under the participant's name. The court held that the administrator's claim satisfied the requirements of a claim for restitution under section 502(a)(3). Citing *Great-West*, the court based its holding on the fact that the action met the criteria for a constructive trust: the funds sought were identifiable, had not been dissipated, were still in the participant's control, and in good conscience (because of the subrogation clause in the plan) belonged to the administrator.[156]

j. Enron Decision Rejects an Expansion of Section 502(a)(3) Remedies

In *Enron*, plaintiffs attempted to distinguish *Mertens* and *Great-West* on the grounds that those cases involved claims against non-fiduciaries, while the plaintiffs were suing fiduciaries. Plaintiffs adopted an argument that has been advanced by the DOL in several recent *amicus* briefs. Plaintiffs noted that "under the common law of trusts, where a beneficiary sues a fiduciary for breach of fiduciary duty, equity required the fiduciary to restore the beneficiary 'to the position he would have been in if the trustee had not committed the breach of trust.'"[157] In other words, when a claim is asserted against a fiduciary, money damages are an equitable remedy, and plaintiffs contend that they, therefore, constitute "equitable relief" under section 205(a)(3). The *Enron* court rejected that argument based on *Mertens*, *Great-West*, and several lower court decisions. "No matter how artfully pled, 'make-whole' relief for a claim of breach of fiduciary duty by a trustee cannot cloak a claim for compensatory damages."[158]

[154] *See Great-West*, 534 U.S. at 213-14.
[155] 338 F.3d 680, 686-88 (7th Cir. 2003).
[156] *See Varco*, 338 F.3d at 687.
[157] *Enron*, 284 F. Supp. 2d at 607.
[158] *Id.* at 612.

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III. When Does Investment in Employer Stock Become Imprudent?

Many ERISA plans either invest entirely in the stock of the plan sponsor,[159] or offer an employer stock fund to participants as an investment option.[160] With the recent demise of Enron, Worldcom, and other companies that sponsored employer stock plans, one of the key questions in ERISA litigation today is at what point does the plan's investment in employer stock become imprudent and thus require the fiduciary to sell it?

The starting point in answering this question is the standard applied by the courts. The statutory and policy rationale for that standard then should be reviewed. The authors conclude this inquiry with a word of caution for fiduciaries who may be tempted to blindly rely on this standard.

A. "IN DANGER OF IMPENDING COLLAPSE" STANDARD

Two Circuits as well as several district courts have considered the question of prudence that is presented in this article: when is it prudent for a fiduciary to continue holding employer stock in a plan that was created for that very purpose? The courts have converged on a single standard: a fiduciary of an employer stock plan acts prudently in continuing to hold employer stock as long as the employer is not in danger of impending collapse.[161]

The Sixth Circuit's decision in *Kuper v. Iovenko*[162] is one of the leading cases on this issue. The case arose out of Quantum Chemical Corporation's sale of one of its divisions to Henkel Corporation. Henkel became the employer of the employees in that division, and those employees' assets in Quantum's ESOP plan were transferred to the Henkel Investment Plan.[163] The transfer, however, took eighteen months, and during that time the value of the Quantum stock in the ESOP fell eighty percent, from more than $50.00 per share to slightly more than $10.00 per share.[164] The fiduciaries, moreover, were aware of events that would cause the stock to fall. The chief executive officer even sold his own shares of the stock before the fall.[165] All the fiduciaries had in their favor regarding the prudence of the investment was the fact that "several investment advisors recommended holding [the] stock" during the relevant period.[166] For the Sixth Circuit,

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[159] Such as an ESOP.

[160] Such as a 401(k) plan.

[161] *Kuper*, 66 F.3d at 1447; Moench v. Robertson, 62 F.3d 553 (3d Cir. 1995); Steinman v. Hicks, 352 F. Supp. 3d 1101 (7th Cir. 2003); In re Duke Energy ERISA Litig., 281 F. Supp. 2d 786 (W.D.N.C. 2003); Stein v. Smith, 270 F. Supp. 2d 157 (D. Mass. 2003); Wright v. Ore. Metallurgical Corp., 222 F. Supp. 2d 1224 (D. Or. 2002); In re McKesson HBOC, Inc. ERISA Litig., No. C00-2003ORMW, 2002 WL 31431588 (N.D. Cal. Sept. 30, 2002); Bevel v. Higginbottom, No. CIV-98-474-X, 2001 WL 1352896 (E.D. Okla. Oct. 4, 2001); Landgraff v. Columbia/HCA Healthcare Corp., No. 3-98-0090, 2000 WL 33726564 (M.D. Tenn. May 24, 2000).

[162] 66 F.3d at 1447.

[163] *Id.* at 1450-51.

[164] *Id.* at 1451.

[165] *Id.* at 1451, 1459-60.

[166] *Id.* at 1460.

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that was enough. Given the nature of employer stock plans, it held that the fiduciaries had not acted imprudently, and it affirmed the grant of judgment in their favor.[167]

In *Moench v. Robertson*,[168] the Third Circuit held that fiduciaries of an ESOP were entitled to a presumption that they acted prudently by continuing to invest plan assets in employer stock. The court ruled, however, that the plaintiff may overcome that presumption by establishing that the fiduciaries abused their discretion by continuing the investment. The plaintiff can make this showing, the court said, by producing evidence that "circumstances not known to the settlor and not anticipated by him would defeat or substantially impair the accomplishment of the purposes of the trust."[169] Because the value of the employer stock in question had precipitously declined, the court held that the fiduciaries might have violated their duty of prudence by continuing the plan's investment in employer stock and remanded the case for trial.

In *Wright v. Oregon Metallurgical Corp.*,[170] the court granted a Rule 12(b)(6) motion to dismiss a claim that fiduciaries had breached their duty of prudence in continuing to hold employer stock in an employer stock plan.[171] The plaintiffs pleaded that the sponsor of their plan had been acquired by another company and that after the acquisition the stock price of the new company decreased substantially.[172] The court rejected their breach-of-prudence claim because it was based on nothing "more than stock price fluctuations or a decline in value of the employer's stock."[173] At all times, the court noted, the employer was "a viable concern."[174] The plaintiffs, therefore, could not meet the standard of proving "a 'precipitous decline' in the employer stock price . . . combined with evidence that the . . . fiduciaries knew the sponsoring company was being seriously mismanaged and faced an impending collapse."[175]

B. RATIONALES FOR "IMPENDING COLLAPSE" STANDARD

There are a number of special rules governing employer stock plans.

1. Eligible individual account plans

Employer stock plans can hold up to 100% of their assets in employer stock. ERISA calls this kind of plan an "eligible individual account plan." An eligible individual account plan is defined as an individual account plan—a defined contribution plan—that is a profit sharing, stock bonus, thrift, or savings plan, an employee stock ownership plan, or certain types of pre-ERISA money purchase plans.[176]

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[167] *Id.* at 1447.
[168] 62 F.3d at 553.
[169] *Id.* at 570.
[170] 222 F. Supp. 2d at 1224.
[171] *Id*. at 1234
[172] *Id.* at 1228.
[173] *Id.* at 1233.
[174] *Id.* at 1234.
[175] *Id.* at 1233.
[176] ERISA § 496(d)(3)(B); 29 U.S.C. § 1107(d)(3)(B).

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2. Congressional purpose to promote employee ownership

Employer stock plans serve unique goals within ERISA's scheme. As a result, they are correspondingly given unique statutory treatment. First, employer stock plans, "unlike pension plans, are not intended to guarantee retirement benefits."[177] Instead, they are intended to help businesses raise capital and to encourage employee stock ownership as an end in itself. "Congress expressly intended that the [employer stock plan] would be both an employee retirement benefit plan and a 'technique of corporate finance' that would encourage employee ownership."[178]. In employer stock plans, "the concept of employee ownership constitute[s] a goal in and of itself."[179]

3. Special tax advantages

To encourage employers to create employer stock plans, Congress gave them special advantages under the tax code. For example, when an employee takes a distribution from a plan in the form of employer stock, only the basis of the stock is taxed as ordinary income at the time of distribution. The remaining "net unrealized appreciation" is taxed only when the participant later disposes of the stock and then only as a long-term capital gain.[180]

4. No ten percent limit

Ordinarily, ERISA prohibits a plan from holding more than ten percent of its assets in employer stock.[181] But an employer stock plan is expressly exempted from that limit.[182] Consequently, employer stock plans may hold up to 100% of their assets in employer stock.

5. No duty to diversify

Fiduciaries of employer stock plans are expressly exempted from the duty to diversify holdings of employer stock to allow them to implement Congress's goal of promoting employee ownership. Section 404(a)(1)(B) of ERISA requires fiduciaries to act with prudence, and section 404(a)(1)(C) requires them 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."[183] But the very next subsection exempts the fiduciaries of employer stock plans from these duties to the extent they would require the fiduciaries to diversify holdings of employer stock:

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[177] *Moench,* 62 F.3d at 568.

[178] *Martin*, 965 F.2d at 664 (citing 129 Cong. Rec. S16629, S16636 (Daily ed. Nov. 7, 1983) (statement of Sen. Long)); *see also Cunningham,* 716 F.2d 1455, 1458 n.2 (5th Cir. 1983) (same).

[179] *Moench*, 62 F.3d at 568.

[180] ERISA § 2005(e)(4)(B); 26 U.S.C. § 402(e)(4)(B); 26 C.F.R. § 1.402(a)-1(b)(1)(i)(B).

[181] ERISA § 407(a)(2); 29 U.S.C. § 1107(a)(2).

[182] ERISA § 407(b)(1); 29 U.S.C. § 1107(b)(1) ("Subsection (a) of this section shall not apply to any acquisition or holding of qualifying employer securities . . . by an eligible individual account plan.").

[183] 29 U.S.C. §§ 1104(a)(1)(B) & (C).

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> In the case of an eligible individual account plan (as defined in section 407(d)(3)), the diversification requirement of paragraph (1)(C) and the prudence requirement (only to the extent that it requires diversification) of paragraph (1)(B) is not violated by acquisition or holding of . . . qualifying employer securities (as defined in section 407(d)(4) and (5)).[184]

All fiduciaries, including fiduciaries of employer stock plans, are held to the standard of prudent behavior.[185] However, because a fiduciary's duties are shaped by the goals of its plan, "the special statutory rules applicable to [employer stock plans] inevitably affect the fiduciary's duties under § 1104."[186] Indeed, Congress took the unusual step of warning courts directly not to treat the fiduciaries of employer stock plans as if they were serving ordinary pension plans:

> The Congress . . . has made clear its interest in encouraging employee stock ownership plans as a bold and innovative method of strengthening the free private enterprise system which will solve the dual problems of securing capital funds for necessary capital growth and of bringing about stock ownership by all corporate employees. The Congress is deeply concerned that the objectives sought by this series of laws will be made unattainable by regulations and rulings which treat employee stock ownership plans as conventional retirement plans, which reduce the freedom of the employee trusts and employers to take the necessary steps to implement the plans, and which otherwise block the establishment and success of these plans.[187] The standard of what is prudent is determined by the character and aims of the plan that the fiduciary serves.[188] Different plans serve different purposes, and the requirements of prudence therefore differ as well.[189]

Section 404 of ERISA provides that "a fiduciary shall discharge his duties with respect to a plan . . . with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."[190] The definition of the duty shows that its content is shaped by the design of the plan because the hypothetical "prudent" fiduciary is held to consider the plan's "character" and "aims."[191] ERISA also expressly requires fiduciaries to carry out their duties "in accordance with the documents and instruments governing the plan" unless those instruments contradict ERISA itself.[192]

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[184] ERISA § 404(a)(2); 29 U.S.C. § 1104(a)(2).

[185] *See, e.g.,* Matassarin v. Lynch, 174 F.3d 549, 568 (5th Cir. 1999); *see also* Eaves v. Penn, 587 F.2d 453, 460 (10th Cir. 1978).

[186] *Martin*, 965 F.2d at 665.

[187] Tax Reform Act of 1976, 29 U.S.C. § 1 (1976).

[188] *See, e.g.,* Donovan v. Cunningham, 716 F.2d at 1467.

[189] *Id.*

[190] 29 U.S.C. § 1104(a)(1)(B) (emphasis added).

[191] *Id.*

[192] ERISA § 404(a)(1)(D), 29 U.S.C. § 1104(a)(1)(D).

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A compelling argument can be made that the "Impending Collapse" standard the courts have applied is correct because it harmonizes the roles of plan sponsor and fiduciary and it appropriately adapts the duties of the fiduciary to the goals of the plan. Congress has declared that, for employer stock plans, employee ownership is an end in itself. It is, therefore, prudent for fiduciaries to continue holding employer stock unless there is a danger that ownership will become meaningless—that is, unless there is a danger the employer is no longer viable. This is essentially the standard set by the common law of trusts on which ERISA is based.[193] Fiduciaries of a trust that is created to hold a particular investment breach their duty by following the trusts' direction only when "circumstances . . . have changed since the giving of the instruction so that it would be obviously dangerous to make the investment."[194] Put another way, the fiduciaries have a duty to sell the investment only "if it would be clearly extremely detrimental to the beneficiaries to retain it."[195]

Furthermore, because Congress has declared that employee ownership is an end in itself for employer stock plans, refusing to account for that goal in the test for prudence would "transfor[m] ESOPs into ordinary pension benefit plans, which then would frustrate Congress' desire to encourage employee ownership."[196] Any lesser standard than impending collapse would effectively preclude the existence of employer stock plans. Fiduciaries can find themselves in a "no-win" situation. Holding employer stock in a down market invites suit; whereas selling is also risky. Fiduciaries who sell the employer stock from a plan, only to see the stock go up, can face a lawsuit alleging that there was a presumption in favor of holding the stock and that they breached their fiduciary duties in deciding to sell.[197]

The "impending collapse" standard is consistent with the rule that fiduciary liability is not to be judged based on hindsight: imposing liability for normal fluctuations in the value of employer stock would put fiduciaries in the untenable position where their conduct is judged solely in hindsight, based on whether the stock did well or poorly. But hindsight is not the measure of fiduciary conduct.[198]

C. CAUTION IN RELYING TOO HEAVILY ON THE "IMPENDING COLLAPSE" STANDARD

Although a strong case can be made for the application of the "impending collapse" standard, there can be no guarantee that every court will adopt it. There are

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[193] *See* Pegram v. Herdich, 530 U.S. 211, 224 (2000) (ERISA's fiduciary provisions "have the familiar ring of their source in the common law of trusts").

[194] GEORGE G. BOGERT & GEORGE T. BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 706 at 241 (West 2d rev. ed. 1982).

[195] *Id.* at 242.

[196] *Moench*, 62 F.3d at 570.

[197] *See, e.g.*, Schoenholtz v. Doniger, 657 F. Supp. 899 (S.D.N.Y. 1987); Schoenholtz v. Doniger, 628 F. Supp. 1420 (S.D.N.Y. 1986) (finding liability and awarding damages, respectively, against fiduciaries who prevented employer stock plan from awarding stock and forced it to invest in money market funds); Thompson v. Avondale Indus., Inc., No. Civ.A. 99-3439, 2003 WL 359932 (E.D. La. Feb. 14, 2003) (addressing breach of duty claim predicated on fiduciaries' decision to sell employer stock).

[198] *See DeBruyne*, 920 F.2d at 465 ("'The fiduciary duty of care,' as the district court so cogently stated it, 'requires prudence, not prescience.'").

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several reasons for fiduciaries of employer stock plans to be cautious in relying on that standard.

Plaintiffs routinely challenge the correctness of the "impending collapse" standard. They also challenge its applicability. In *Enron*, for example, the plaintiffs contend that the fiduciaries of the Enron plan had a duty to diversify the employer stock fund component of that plan, notwithstanding that they conceded the plan qualifies as an eligible individual account plan. They base their contention on specific language in the Enron plan that they allege requires the fiduciaries to diversify the employer stock fund.[199]

In addition, fiduciaries should take heed of the cautionary note the *Moench* court struck when discussing the issue of a fiduciary's divided loyalties:

> In considering whether the presumption that an ESOP fiduciary who has invested in employer securities has acted consistently with ERISA has been rebutted, courts should be cognizant that as the financial state of the company deteriorates, ESOP fiduciaries who double as directors of the corporation often begin to serve two masters. And the more uncertain the loyalties of the fiduciary, the less discretion it has to act. Indeed, "'[w]hen a fiduciary has dual loyalties, the prudent person standard requires that he make a careful and impartial investigation of all investment decisions.'"[200]

Moreover, in *Enron*, the DOL addressed the deferential standard of review the courts accorded the fiduciaries' decisions to retain employer stock in *Moench* and *Kuper*, and the DOL expressly declined to take a position on that standard.[201]

Employer stock plan litigation has sharply increased in recent years. This is likely to lead to more court decisions on the question of when a fiduciary must dispose of employer stock. Although the *Enron* litigation has not yet progressed to that stage, it is encouraging to see that in its ruling on the defendants' motions to dismiss, the district court in *Enron* cited *Moench* and *Kuper* for the proposition that "an ESOP trustee is entitled to a presumption that it acted consistently with ERISA in investing plan assets in the employer 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."[202]

ERISA § 404(c) provides as follows: "If a participant or beneficiary exercises control over the assets in his account (as determined under regulations of the Secretary

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[199] *See Enron*, 284 F. Supp. 2d at 575.

[200] *Moench*, 62 F.3d at 572 (quoting *Martin,* 965 F.2d at 670).

[201] *See* Amended Brief of the Secretary of Labor as Amicus Curiae Opposing the Motions to Dismiss at p. 33 ("Plaintiffs' claim that Defendants imprudently purchased or retained Enron stock cannot be defeated by the language in the Enron plan document requiring the assets to be primarily invested in Enron stock. This is true whether or not this court adopts the somewhat more deferential standard of review for such decisions in *Moench* and *Kuper*. Ultimately, the court must decide whether based on all the facts and circumstances, the Defendants acted prudently, and this decision cannot be appropriately made upon a motion to dismiss for failure to state a claim.").

[202] *Enron*, 284 F. Supp. 2d at 534.

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[of Labor]) . . . no person who is otherwise a fiduciary shall be liable under [ERISA] for any loss, or by reason of any breach, which results from such participant's or beneficiary's exercise of control."[203] Section 404(c) is treated as a defense to a breach of fiduciary duty claim, which may be asserted by a fiduciary of a plan qualifying for 404(c) protection. The extent to which this defense may impact the application of the "impending collapse" standard is not developed in the case law and is beyond the scope of these materials. The *Enron* court did, however, address the 404(c) defense. [204]

The same uncertainty exists with respect to the application of the insider trading rules in employer stock litigation. The case law is still in its formative stages in this area, although there can be little question that plan fiduciaries are not free to ignore the securities law.

IV. ERISA Fidelity Bonds and Employer Stock Losses

A. STATUTORY REQUIREMENTS

1. Who Must Be Bonded

According to ERISA, "every fiduciary of an employee benefit plan and every person who handles funds or other property of such a plan (hereafter in this section referred to as "plan official") shall be bonded as provided in this section."[205] "Plan official" includes "any persons performing functions for the plan normally performed by administrators, officers and employees of a plan [including] pension consultants, and planners, and attorneys who perform 'handling' functions . . . the terms would not include . . . securities brokers who purchase and sell securities or armored motor vehicle companies."[206]

2. Amount of Bond

According to ERISA, the amount of the bond shall be determined as follows:

> The amount of such bond shall be fixed at the beginning of each fiscal year of the plan. Such amount shall be not less than 10 per centum of the amount of funds handled. In no case shall such bond be less than $1,000 nor more than $500,000, except that the Secretary . . . may prescribe an amount in excess of $500,000, subject to the 10 per centum limitation of the preceding sentence . . . . For purposes of fixing the amount of such bond, the amount of funds handled shall be determined by the funds handled by the person, group, or class to be covered by such bond and by

[203] 29 U.S.C. § 1104(c)(2)

[204] *See Enron,* 284 F. Supp. 2d at 579-80.

[205] ERISA § 412(a); 29 U.S.C. § 1112(a).

[206] 29 C.F.R. § 2580.412-3(d). *See also* 29 C.F.R. § 2580.412-4 ("[I]n a given case, the question of whether a person was 'handling' such 'funds or other property' so as to require bonding would depend on whether his relationship to this property was such that there was a risk that he, alone or in connivance with others, could cause a loss of such 'funds or other property' through fraud or dishonesty.").

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> their predecessor or predecessors, if any, during the preceding reporting year.[207]
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> [T]he Act permits the use of blanket, schedule and individual forms of bonds so long as the amount of the bond penalty is sufficient to meet the requirements of the Act for any person who is an administrator, officer or employee of a plan handling funds or other property of the plan. Such person must be bonded for 10 percent of the amount he handles, and the amount of the bond must be sufficient to indemnify the plan for any losses in which such person is involved up to that amount.[208]

3. Scope of Coverage

"Such bond shall provide protection to the plan against loss by reason of acts of fraud or dishonesty on the part of the plan official, directly or through connivance with others."[209] "It is not required to provide the same scope of coverage that is required in faithful discharge of duty bonds."[210]

"The term 'fraud or dishonesty' shall be deemed to encompass all those risks of loss that might arise through dishonest or fraudulent acts in handling of funds. . . . As such, the bond must provide recovery for loss occasioned by such acts even though no personal gain accrues to the person committing the act and the act is not subject to punishment as a crime . . . provided that with the law of the state in which the act is committed, a court would afford recovery under a bond providing protection against fraud or dishonesty. As usually applied under state laws, the term 'fraud or dishonesty' encompasses such matters as larceny, theft, embezzlement, forgery, misappropriation, wrongful abstraction, wrongful conversion, willful misapplication or any other fraudulent or dishonest act."[211]

4. Bond Terms

ERISA provides that certain minimum bond term requirements are set forth:

a. Naming of Insureds

Bonds shall allow for enforcement or recovery by those persons usually authorized to act for the plan. In most cases, naming the plan as insured will suffice. In other cases, a rider may be required to make certain that any reimbursement collected under the bond will be for the benefit and use of the plan suffering a covered loss.[212]

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[207] ERISA § 412(a); 29 U.S.C. § 1112(a).
[208] 29 C.F.R. § 2580.412-16(a)-(d).
[209] ERISA § 412(a); 29 U.S.C. § 1112(a).
[210] 29 C.F.R. § 2580.412-8.
[211] *Id.* at § 2580.412-9.
[212] *Id.* at § 2580.412-18.

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b. Amount and Term

According to regulations, the amount of the bond must be fixed or estimated at the beginning of the plan year. There is nothing in ERISA that prohibits a bond for a period longer than a year. However, at the beginning of each reporting year the bond must be in the requisite amount.[213]

c. Discovery Period

A discovery period of no less than one year after the termination or cancellation of the bond is required. At a minimum, standard forms must allow the insured the right to purchase a discovery period of one year in the event of termination or cancellation.[214]

d. Use of Existing, Separate, or Additional Bonds

ERISA neither prevents nor prescribes the form of any additional coverage that may be obtained beyond the statutory requirements. Existing or standard bond forms may be utilized so long as they meet ERISA's requirements or can be made to meet those requirements through rider, modification, or separate agreement. The decision of whether to bond persons separately or jointly or to obtain separate bonds for given plans is left to the judgment of the parties concerned, so long as the bonding program meets ERISA's requirements.[215]

5. Failure to Obtain Bond

It is unlawful for a plan official to receive, handle, disburse, or otherwise exercise control over plan funds or other property without being properly bonded. It is also unlawful for a plan official, or anyone else having authority to direct such functions, to permit them to be performed by any plan official who is not properly bonded.[216]

B. REPRESENTATIVE BOND PROVISIONS

A number of formats are currently in use by companies to provide the required ERISA bond coverage, with that coverage typically being encompassed within a comprehensive policy. Following are several examples:

1. Commercial Crime Policy

h. Employee Benefit Plan(s)

(1) The "employee benefit plan(s)" shown in the Declarations are included as insureds under Insuring Agreement A.

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[213] *Id.* at § 2580.412-19.
[214] *Id.*
[215] *Id.* at § 2580.412-20.
[216] ERISA § 412(b); 29 U.S.C. § 1112(b).

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(2) If any "employee benefit plan(s)" is insured jointly with any other entity under this policy, you or the Plan Administrator must select a Limit of Insurance for Insuring Agreement A that is sufficient to provide a limit of insurance for each Plan that is at least equal to that required if each Plan were separately insured.

(3) With respect to losses sustained or discovered by any such Plan, Insuring Agreement A is replaced by the following:

We will pay for loss of or damage to "funds" and "other property" resulting directly from fraudulent or dishonest acts committed by an "employee" whether identified or not acting alone or in collusion with other persons.

(4) If the first Named Insured is an entity other than a Plan, any payment we make to that Insured for loss sustained by any Plan will be held by that Insured for the use and benefit of the Plan(s) sustaining the loss.

2. Commercial Crime ERISA-INFLATION GUARD ENDORSEMENT

If at the inception of this policy you have a Limit of Insurance for your "employee benefit plan(s)" that is equal to or greater than that required by ERISA, we agree to automatically increase that Limit of Insurance . . . to equal the amount required by ERISA at the time you incur the loss. However, in no event shall the overall Limit of Insurance, including the insurance provided by this increase endorsement, exceed the statutory maximum Limit of Insurance required by ERISA for any plan.

3. Commercial Crime WELFARE AND PENSION PLAN ERISA COMPLIANCE ENDORSEMENT

[T]his endorsement applies to the Crime General Provisions (Loss Sustained Form) and all Crime Coverage Forms forming part of the Policy . . .

In compliance with certain provisions of [ERISA]:

"Employee" also includes any natural person who is:

a. A trustee, an officer, employee, administrator or a manager, except an administrator or a manager who is an independent contractor, of any Employee Welfare or Pension Benefit Plan (hereafter called Plan) Insured under this insurance; and

b. Your director or trustee while that person is handling funds or other property of any Plan insured under this insurance.

NOTE: There is no modification of the Covered Loss definition.

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4. Crime Loss Indemnity Policy

INSURING CLAUSE (G) – EMPLOYEE BENEFIT PLAN(S)

Loss sustained by an Employee Benefit Plan and discovered by the Insured or an Employee Benefit Plan during the Policy Period directly caused by any fraudulent or dishonest acts committed by any Employee of the Insured or any trustee, director, officer or employee of an Employee Benefit Plan, including any third party administrator or custodian acting alone or in collusion with others.

In compliance with [ERISA], payment by the Underwriter to the First Named Insured shall be held by such Insured for the use and benefit of the Employee Benefit Plan(s) sustaining such loss.

5. ERISA Compliance Bond

A. COVERAGE

We will pay only for loss of "property" sustained by you resulting directly from dishonest or fraudulent acts committed by an "employee" acting alone or in collusion with others. Such dishonest or fraudulent acts must be committed by the "employee" with the manifest intent:

1. to cause you to sustain such loss; and

2. to obtain financial benefit . . . for the "employee" or another person or entity.

NOTE: The coverage does not track ERISA requirements.

6. Crime Policy for Mercantile Entities

J. EMPLOYEE BENEFIT PLANS

. . . .

This Policy insured those Plans which are named as additional Insureds . . . for loss through fraud or dishonesty as defined in Section 2580.412-9 of the Employee Retirement Income Security Act as amended. For any Plans not specifically named as insureds, this Policy is deemed to be in compliance with, and satisfy the bonding requirements of Section 2580.412-11 of the act. This insurance provides a Limit of Insurance which is equal to 10% of the amount of the Funds handled or $500,000, whichever is less, for each Plan bonded and the minimum Limit of Insurance for any Plan shall be $1,000. The Limit of Insurance available for any Plan loss will be determined by the amount of funds handled on the date when any covered loss occurs subject to the foregoing limitations.

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C. ERISA BONDS AND EMPLOYER STOCK LOSSES

Whether an ERISA bond responds to an employer stock loss claim depends upon a number of factors. First and foremost is whether the losses are the result of fraud or dishonesty. In many employer stock loss cases, the allegations against the plan fiduciaries are that they failed to properly discharge their duties. This is negligence, not dishonesty. As such, the insurance instrument most likely implicated is a fiduciary liability policy rather than an ERISA bond.[217] Whether and to what extent fiduciary liability insurance responds to employer stock loss claims is beyond the scope of this article. That said, many of the issues raised in this article with respect to these claims can affect coverage. The still unresolved questions with respect to standing, remedies, inside information, and diversification that are played out in employer stock cases can all have a bearing on coverage. As one commentator noted:

> While the new wave of 401(k) ERISA litigation is still rising, a few predictions and conclusions can already be offered. First, the genie will not go back into the bottle. Plan administrators and plan fiduciaries should expect ERISA litigation about abnormal declines in company stock prices, just as public company directors and officers have come to expect such litigation under the securities laws. Second, there are major battles still to be fought in these cases about proper claims, proper parties, and proper remedies, as well as the core question of the proper standard for fiduciary conduct in the context of business problems and stock price declines. These issues predictably will be resolved different ways in different cases about different companies, leading to conflicts in the case law. Third, aggressive plaintiffs' counsel will use the context of highly publicized collapses like Enron and Global Crossing to push for favorable early court decisions and settlements. Defendants and their counsel need to remind the courts that ERISA does not require fiduciaries to have a crystal ball, and that employer stock price declines will happen (especially

[217] Fiduciary liability insurance and ERISA bonds are distinct products. An ERISA bond provides potential coverage to a plan for loss due to fraud or dishonesty of covered individuals. Fiduciary insurance protects the sponsor and the fiduciaries against third-party claims alleging a fiduciary breach. As a general rule, fiduciary liability policies do not respond to liability predicated upon a fiduciary breach that was fraudulent, criminal, or a willful violation of the ERISA statutes. *See* Fire Cas. & Surety Bulletin E.1-1, 1.3 (November 1998) ("Of course, everyone makes mistakes. And, it is impossible to please every client every time. To counteract such things and to protect himself or herself from a liability claim, a fiduciary should have liability insurance coverage, coverage that takes into account the guidelines and provisions of ERISA. . . . A number of policies are available for the protection of fiduciaries, as well as those who may be legally responsible for the acts of fiduciaries, but none of them are standard. The underwriting rules for these policies are largely a matter of judgment and company underwriting philosophy, and a rather comprehensive application is usually required of the fiduciary. Most of the policies provide coverage on a "claims made" basis and all of them carry a mandatory deductible, although some variation is found in the amount of and method of applying the deductible.") Under ERISA, if plan assets are used to purchase this coverage, there is a right of subrogation against the fiduciary. This is not the case if the policy is purchased by the fiduciary or the plan sponsor. As a consequence, fiduciary liability insurance is really only insurance if purchased without plan assets.

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> in a severe general market decline) and are simply not enough of a basis to justify an award of damages to company stock fund participants.[218]

Without fraud or dishonesty involved in the decline of employer stock, an ERISA bond cannot be implicated. Moreover, it is pretty clear that ERISA's bonding requirements are not intended to cover plan losses due to stock declines. One does not purchase a $500,000 bond to adequately protect against plan losses due to stock declines, even those fraudulently induced. Instead, the ERISA bond is tailored more for the situation where a fiduciary embezzles plan assets.

Where employee stock has declined due to some fraud or dishonesty, a number of questions need to be answered before one can properly assess whether an ERISA bond responds to the loss. What does the policy language say? As the previous section of this article illustrates, these "bonds" vary from company to company. Is the party claimed to have committed the dishonesty covered by the bond? In an Enron-like situation, the fraud and dishonesty was committed by top management rather than the individuals responsible for administering the plans. If the bond covers "fiduciaries" or those "who handle funds or other property" of the plan, then an issue arises as to whether the parties committing the fraud are fiduciaries, as they most likely do not handle plan funds. This question can depend in large measure on how the plan document is drafted.[219] Therefore, it is important to review the plan documents and the policy language to evaluate whether coverage exists in a given case.

The decision in *Joseph Rosenbaum, M.D., Inc. v. Hartford Fire Insurance Co.*[220] is of interest insofar as it stands for the proposition that an ERISA bond covers only that which it says it covers rather than what the statute might require for total coverage to be provided. In that case, the plaintiff sued its insurer claiming that coverage under the plan's ERISA bond was improperly denied for losses allegedly caused by an individual who invested plan assets in second mortgages in California residential real estate. On its face, the Hartford bond provided coverage only for named trustees and specified employees—and neither designation included the implicated individual. The plaintiff was undeterred, arguing that (1) the individual was a fiduciary under ERISA; (2) ERISA required that he be bonded; and, therefore, (3) the Hartford ERISA bond must include him. The court disagreed, holding as follows:

> But the Hartford policy does not say that it provides all bonding of any kind required by ERISA. . . . Hartford's ERISA compliance endorsement

[218] Bill Boies, Nancy G. Ross & Amy Doehring, *supra* note 5, at 48-49.

[219] *See* James P. Baker, *The Good, The Bad, and the Ugly: Delegating Fiduciary Responsibility After Enron?* 30 EMPLOYEE RELATIONS L.J. 16, 17 (Summer 2004) ("Whether or not a person is a fiduciary is of critical importance. When economic disasters befall companies and retirement plan accounts become worthless, ERISA fiduciaries can be held personally liable to make good retirement plan losses resulting from their actions or from their inactions. What has become apparent from the recent decisions in *Kmart*, *WorldCom*, and *Enron* is that a court reviewing an employee benefit plan disaster will carefully sift through the governing plan's language concerning the allocation and delegation of fiduciary responsibility to determine who is a plan fiduciary, and who is potentially liable to make good the retirement plan's losses.").

[220] 104 F.3d 258 (9th Cir. 1996).

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> does not bond everyone who must be bonded. It bonds only those classes of persons it designates. . . .
>
> The statute does not require that any bond be construed to cover all persons required to be bonded. It requires plan officials who receive, handle, disperse or exercise custody of plan money to be bonded . . . If Mr. Glickman had to be bonded, then perhaps the Rosenbaums as trustees should not have invested the ERISA plan's money . . . without ascertaining whether he was.[221]

Rosenbaum could well lead a court to conclude that a bond encompasses upper management where it uses the term "employee," rather than a more limiting term such as "fiduciary." Still, other results are possible. Notwithstanding broader language in the policy, a court might conclude that, if a bond were issued pursuant to ERISA, it should be construed as covering only those parties required by ERISA to be covered.[222]

Even where the bond arguably covers the parties engaged in the fraudulent activity, there is still the issue of whether that activity directly caused the plan's losses. In many cases, the fraudulent activity by upper management is in the nature of "cooking the books" or otherwise concealing the unsound nature of the company's finances. The company's finances, however, are still unsound and the stock was going to take a nosedive sooner or later. Under these circumstances, the question becomes just what caused the plan's loss.

Fraud by upper management raises the issue of whether the insurer is entitled to rescind the bond. Like the question of policy interpretation, rescission may be affected by the statutory nature of the coverage:

> Recently in several high profile cases, including WorldCom and HealthSouth, lawyers representing ERISA plaintiffs have argued that, because the insured entity's fidelity bond includes an insuring agreement insuring losses incurred by the insured's employee stock ownership plan, such policies are "statutory bonds" that cannot be rescinded.[223]

The issue of whether plan participants have standing in actions involving ERISA bonds has not been consistently resolved. In *Isola v. Hutchinson*,[224] an individual plan

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[221] 104 F.3d at 262-63.

[222] *See* Water Works, Gas & Sewer Bd. of City of Oneonta, Inc. v. P.A. Buchanan Contracting Co., 318 So. 2d 267, 268 (Ala. 1975). *But see* Ill. State Toll Highway Comm'n ex rel. Patten Tractor & Equip. Co. v. M.J. Boil & Co., 186 N.E.2d 390 (Ill. Ct. App. 1962) (surety may agree to provide greater coverage than that required by statute); Wal-Board Supply Co. v. Daniels, 629 S.W.2d 686 (Tenn. Ct. App. 1981) (payment bond issued on a public construction project provided broader coverage than required by statute and was therefore construed as a private bond).

[223] Lisa A. Block & Michael Keeley, *Rescission of "Statutory Bonds" in the Wake of Enron, WorldCom and HealthSouth*, FIDELITY & SURETY LAW COMMITTEE NEWSLETTER, at 1 (Summer 2004) (ABA/Tort Trial and Ins. Practice Section, Chicago, Ill.) (authors argue that there is nothing in ERISA that would abrogate a surety's remedy of rescission).

[224] 780 F. Supp. 1299 (N.D. Cal. 1991).

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participant was allowed to maintain an action against, among others, the insurers who provided the ERISA bond. However, in *Bernstein v. Hanover Insurance Co.*,[225] the court dismissed an individual's action on the ground that the bond insured was the plan, itself, such that no individual plan participant had standing to sue. There is a reported case on the ancillary issue of whether plan participants have standing to intervene where insurers have raised rescission as a defense to payment. In *In re HealthSouth Corporation Insurance Litigation*,[226] the court denied intervention in an insurance coverage dispute, holding, among other things, that the plan participants' interests were adequately protected by insureds who were defendants in the case.

Two reported cases have addressed the issue of whether and under what circumstances the discovery period is tolled by fraudulent concealment. In *J. Geils Band Employee Benefit Plan v. Smith Barney Shearson, Inc.*,[227] the court held that the "fraudulent concealment" doctrine was incorporated into ERISA and that an objective standard applies to determine the actual date of discovery. In that case, the court held, as a matter of law, that the plan participants were on notice of alleged fraudulent or dishonest acts more than six years before filing suit, such that the claims were time-barred.

In *Alleyne v. McCusker*,[228] the court denied the insurer's motion to dismiss, even though the plaintiffs conceded that notice was not provided within the one-year period prescribed in the policy, based upon the alter ego doctrine:

> The Court finds that given the purposes of ERISA's bonding requirement, to protect the beneficiaries of covered trusts, that plaintiffs may not be barred from recovery here as long as they can prove that the wrongdoers, who caused the losses, so controlled the trust as to make discovery within the contractual period impossible. Such adverse domination will be a matter of fact for the plaintiffs to prove at trial.

V. Conclusion

Employer stock claims under ERISA are on the rise and likely to be with us for some time. The ride will be a bumpy one. Whether an ERISA bond responds to a plan's losses from employer stock declines raises a number of interesting and complex issues. While there is a not a great deal of case law currently in existence, it is likely only a matter of time before this changes.

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[225] 849 F. Supp. 862 (E.D.N.Y. 1994).
[226] 219 F.R.D. 688 (N.D. Ala. 2004).
[227] 76 F.3d 1245 (1st Cir. 1996).
[228] No. CV 82-6428-WMB, 1983 WL 207495 (C.D. Cal. Dec. 6, 1983).

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