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Conflicts of Interest Arising Under ERISA's Fiduciary Standards: Can the Trustee Ever be Prudent, As Long As He Faces Dual Loyalties?

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Abstract

The drafters of the Employment Retirement Income Security Act¹ faced the formidable task of restructuring the regulation of private pension plans throughout America.

KEYWORDS: conflicts, loyalties, standards

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I. Introduction to the Conflict of Interest Problem

The drafters of the Employment Retirement Income Security Act¹ faced the formidable task of restructuring the regulation of private pension plans throughout America. It would be unreasonable to assume that all of the problems inherent to the pre-ERISA pension system would be resolved by the ERISA enactment and its 1976 amendments. While Congress did take great steps to establish uniform guidelines imposing fiduciary standards over the plan trustee,² it failed to curb all trustee misconduct.

This note centers on section 408(c)(3) of ERISA,³ a provision which permits corporate officers to act as trustees to ERISA pension plans. Because of the enactment of section 408(c)(3), the potential for conflicts of interest exists for corporate trustees whose loyalties are divided between the administration of the pension trust fund and the company's business interests. This problem will continue to expose ERISA pension plan assets to loss of funds at the hands of an officer/trustee, who because of his loyalty to his corporation disregards his duties to plan participants. Indeed, an original drafter of ERISA noted that "even now, despite ERISA, the temptation of parties-in-interest to attempt to manipulate the assets of Employee Pension Funds for their own personal or institutional advantage is very great, and especially great when funds for making capital investment or serving other corporate objectives are in short supply."⁴

1. Hereinafter referred to as ERISA.

2. *See infra* notes 23-51 and accompanying text.

3. ERISA § 408(c)(3), 29 U.S.C. § 1108(c)(3) (1982).

4. *Retirement Income Incentives Act of 1981: Hearings on S. 1541 Before the Sub. Comm. on Labor of the Senate Comm. on Human Resources*, 97 Cong., 1 Sess. 846-54 (1982)(statement by Michael S. Gordon).

In fact, Congress was aware of numerous examples of "party-in-interest" corruption and abuse prior to ERISA. Accordingly, Michael S. Gordon, an original drafter of ERISA, recalled the following conflict of interest involving Genesco, Inc.:

In 1962 Genesco, Inc. used its employee pension fund to acquire Flag-

Section 404 of ERISA, the fiduciary standards section, represents one-half of the dual loyalty that the officer faces and this section commands him to disregard his obligations to the management of the corporation (the second half of his dual loyalty) and act in a prudent fashion to the pension plan.⁵ In application it is likely that section 408(c)(3) requires the officer/trustee to ignore corporate profit maximizing goals to better serve the ERISA trust participants.⁶ This artificial expectation asks the officer/trustee to exchange the proverbial activist derby worn by the corporate manager for the more conservative top hat belonging to Cardozo's prudent man.⁷ This role change from

Utica Corp., a knitwear manufacturing concern. Flagg-Utica wanted Genesco stock rather than cash for cash payment to its stockholders would have been taxable immediately. But rather than buy on the open market, Genesco dipped into the pension fund for 150,000 shares; it paid the fund \$5,250,000, or an average between the high and low Big Board quotes on the day chosen for the transaction. By buying the stock from its pension fund, Genesco probably saved money; if the company had bought so heavily on the stock exchange the market price per share probably would have climbed, increasing the cost of the purchase. And because management controlled the fund, Genesco kept control of the \$5,250,000; that sum remained available for further acquisitions. Subsequently, Genesco agreed with the SEC that it would restrict transactions in Genesco securities on behalf of its Employee Stock Bonus Trust and pension plan as well as restricting purchase by the Company from the stock bonus or pension plans during negotiations with other companies. Again, the IRS never sought to challenge the tax-exempt basis of the Genesco pension funds on the basis of the prohibited transaction rules in the IRS tax regulations that then existed. Subsequently, hearings before this Subcommittee disclosed that Genesco had used pension fund assets to finance similar corporate acquisitions, involving complex real estate leaseback transactions. Ultimately, some of these transactions resulted in serious losses to the plan.

Id. at 853, citing *Private Welfare and Pension Plan Study*, 1971, Part II, Hearings Before the Subcommittee on Labor of the U.S. Senate Committee on Labor and Public Welfare, 92d Cong., 1st Sess., at 599 *et seq.*

5. ERISA § 404, 29 U.S.C. § 1104 (1982).

6. With primary emphasis on a profit maximization goal, the aspiring corporate officer may take actions and make decisions in a manner that would be judged imprudent under § 404 ERISA, 29 U.S.C. § 1104. *See generally* R. BREALEY AND S. MEYERS, *Principles of Corporate Finance* 637-47 (1981).

7. *See* S. REP. NO. 93-127 93d Cong., 2d Sess. 3, *reprinted in* 1974 U.S. CODE CONG. & AD. NEWS 4639, 4680-841, 5073-84. Judge Mishler, in *Donovan v. Bierwith*, 538 F. Supp. 463, 470 (E.D.N.Y. 1981), *modified*, 680 F.2d 263 (2d Cir. 1982), *cert. denied*, 459 U.S. 1069 (1982)(quoting Chief Judge Cardozo in *Meinhard v. Salmon*, 249 N.Y. 458, 164 N.E. 545 (1928)), observed:

[M]any forms of conduct permissible in a work a day world for those act-

corporate officer to the prudent trustee cannot reasonably occur without traces of corporate profit maximizing goals impacting upon each investment decision by the officer/trustee. A conflict of interest occurs when the officer/trustee succumbs to prudent corporate investment decisions that are deemed imprudent under ERISA. This note examines this dual loyalty problem.⁸ First, this discussion concerns the historical background to ERISA's fiduciary standards section. Second, the focus centers on the fiduciary standard section. Third, the discussion of the dual loyalty problem turns to common business conditions that create conflict of interest. Fourth, in contrast to the dual loyalty problem, the note examines a standard of review that gauges an officer/trustee's administrative decisions. After a consideration of this standard, the study reviews the potential for inadequate compensation to plan participants resulting from fiduciary breach. Finally, this note advocates the repeal

ing at arm's length are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. 'Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.' As to this there has been a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions.

Id.

8. The cases discussed in this note involve two types of ERISA pension plans: (1) the profit sharing plan and (2) the Employee Stock Ownership Plan (ESOP or Qualified Pension Plan). The court in *Durkee v. Welch*, 49 F.2d 339, 341 (S.D. Cal. 1931), defines a profit sharing plan as follows:

Profit sharing ordinarily signifies the participation of employees with their employer in a given share of the profits of an enterprise by reason of their labor and not by reason of their capital investment therein. . . . The general understanding of a profit-sharing arrangement between employers and workers is that the worker shall share in the earnings and profits of his employer, but is not accountable or liable for losses or deficits in the business, and there is also, generally, present in profit-sharing transactions the element of contribution by the employer to the project.

Id.

See the definition of an ESOP in I.R.C. § 4975(e)(7) (1985), which provides for "a qualified stock bonus plan, or a combination stock bonus plan/money purchase pension plan, that invests in 'qualified employer securities.'" See generally, 29 CFR § 2550.407d-6(1)(1984). All of the examples of fiduciary breach in the following cases concern an officer/trustees' investment in equity securities, as opposed to debt instruments. While it is possible for an officer/trustee to invest in certain debentures, that investment is subject to the Internal Revenue Code's standards set forth in sections 503(e) and 4975(e)(8). Therefore, this note will not discuss the prudence of an officer/trustee's decision to invest in a debt instrument.

of section 408(c)(3) by Congress, and its substitution with a two-tiered investment counseling requirement based on a formula that considers the number of employees and the total assets in the plan.⁹

II. Historical Background to ERISA's Fiduciary Standards Section

Congress passed ERISA in response to years of abuse in the area of private pension and welfare plans.¹⁰ The Act's fiduciary standards section made "applicable the law of trusts . . . [and] established uniform fiduciary standards which prevent transactions that dissipate or endanger plan assets, and provide effective remedies for breaches of trust."¹¹ Historically, misconduct by trustees in the administration of pension trusts often resulted in the dissipation of plan assets.¹² Based on the amount of asset dissipation, the plans lost their tax exempt status, and the I.R.S. imposed penalties which were felt most severely by plan participants and beneficiaries who found their distributions diminished by an even greater tax burden.¹³ In some cases, the entire retirement benefit dissipated as a result of trustee mismanagement.¹⁴ Prior to the enactment of ERISA, Congress had examined these problems associated with the administration of private pension funds.¹⁵ In an attempt to ameliorate these problems, Congress enacted the Welfare and Pension Disclosure Act in 1958,¹⁶ and enacted the Labor Management Reporting Act (Landrum-Griffin Act) in 1959.¹⁷ Both acts failed to provide adequate legislative regulation over a pension trustee's fiduciary responsibility to plan participants and their beneficiaries' assets.¹⁸ In-

9. See *infra* note 169.

10. S. REP. NO. 93-127, 93d Cong., 2d Sess. 3, reprinted in 1974 U.S. CODE CONG. & AD. NEWS 4639, 5186 (Statement of Sen. Harrison Williams).

11. *Id.*

12. 19B *Business Organizations*, S. Young, Pension and Profit Sharing Plans § 17.01[1].

13. See S. REP. NO. 93-127, 93d Cong., 2d Sess. 3, reprinted in 1974 U.S. CODE CONG. & AD. NEWS 4639, 4642-43.

14. See *supra* n.12.

15. See S. REP. NO. 93-127, 93d Cong., 2d Sess. 3, reprinted in 1974 U.S. CODE CONG. & AD. NEWS 4639, 4640-41.

16. Priv. L. No. 85-836, 72 Stat. 997 (1958) amended by Priv. L. No. 87-420, 76 Stat. 35 (1962).

17. Priv. L. No. 86-257, 73 Stat. 519 (1959).

18. See S. REP. NO. 93-127, 93d Cong., 2d Sess. 3, reprinted in 1974 U.S. CODE CONG. & AD. NEWS 4639, 4642-43.

stead of direct fiduciary regulation, Congress left the door open for courts to develop common-law trust principles that would constitute the standards by which a plan trustee would be held responsible to pension participants and their beneficiaries.¹⁹

The drafters of ERISA understood that more precise and stricter fiduciary standards were necessary to safeguard qualified pension fund assets.²⁰ Therefore, in 1974, the drafters succeeded in persuading Congress to recognize that neither the individual states nor the federal government safeguarded employee benefit plan assets from such abuses as self-dealing, imprudent investing and misappropriation of plan funds.²¹ With these policy interests in mind, Congress approved the fiduciary standard section of ERISA, and enacted a uniform standard for trustees in the specialized field of employee benefit plans.²²

III. The Fiduciary Standards Section and Codified Exceptions

As private pension plans grew in popularity, Congress recognized the need to regulate a trustee's fiduciary relationship to plan participants.²³ Section 404,²⁴ the ERISA fiduciary standards section, signifies Congress' policy concerns towards curbing runaway trustee mismanagement and misconduct.²⁵ This section requires that every duty carried out by a plan trustee must be "performed with respect to a plan *solely in the interest* of the plan participants and for the exclusive purpose of (i) providing benefits to the participants and beneficiaries; and (ii) defraying reasonable expenses of administering the plan."²⁶ The drafters of ERISA designed this fiduciary standard section based on a

19. See *Freund v. Marshall & Ilsley Bank*, 485 F. Supp. 629, 635 (W.D. Wis. 1979). See also S. REP. NO. 93-127, 93d Cong., 2d Sess. 3, reprinted in 1974 U.S. CODE CONG. & AD. NEWS 4639, 5186 (Statement of Sen. Harrison Williams).

20. S. REP. NO. 93-127, 93d Cong., 2d Sess. 3, reprinted in 1974 U.S. CODE CONG. & AD. NEWS 4680-841, 5073-84.

21. *Id.* at 4839-43.

22. *Marshall v. Teamsters Local 282 Pension Trust*, 458 F. Supp. 986, 990-92 (E.D.N.Y. 1978).

23. See, S. REP. NO. 93-127, 93d Cong., 2d Sess. 3, reprinted in 1974 U.S. CODE CONG. & AD. NEWS 4639, 4680-841, 5073-84.

24. See *Retirement Income Incentives Act of 1981: Hearings on S. 1541 Before the Sub. Comm. on Labor of the Senate Comm. on Human Resources*, 97 Cong., 1 Sess. 846-54 (1982)(statement by Michael S. Gordon).

25. See S. REP. NO. 93-127, 93d Cong., 2d Sess. 3, reprinted in 1974 U.S. CODE CONG. & AD. NEWS 4639, 4680-841, 5073-84.

26. ERISA § 404, 29 U.S.C. § 1104 (1982).

model that combines the prudent man rule established of common-law trust and a modern supplement to common-law trust, the diversification rule.²⁷

A. Ambiguity Surrounding the Prudent Man Rule and Diversification Requirement

The court in *Harvard College v. Armory*,²⁸ established the common-law standard that now exists in codified form as the prudent man rule. This rule provides that a trustee:

shall conduct himself faithfully and exercise a sound discretion. . . . [H]e is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.²⁹

Congress modified this common-law standard when it enacted its statutory form in section 404(a)(1)(B) of ERISA. Accordingly, an ERISA plan fiduciary must discharge his investment duties: "with the care, skill and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."³⁰

27. S. REP. NO. 93-127, 93d Cong., 2d Sess. 3, reprinted in 1974 U.S. CODE CONG. & AD. NEWS 4639, 5084-85.

28. 26 Mass. (9 Pick.) 446 (1830) (excusing trustee from liability for investing in trade company stock).

29. *Id.* at 461.

30. ERISA § 404(a)(1)(b), 29 U.S.C. § 1104(a)(1)(B) (1982). Section 1104 dealing with ERISA's Fiduciary Standards provides:

(a)(1) Subject to sections 1103(c) and (d), 13423, and 1344 of this title, a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and —

(A) for the exclusive purpose of:

(i) providing benefits to participants and their beneficiaries; and

(ii) defraying reasonable expenses of administering the plan;

(B) with the care, skill prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matter would use in the conduct of an enterprise of a like character and with like aims;

(C) by diversifying the investments of the plan so as to minimize the

The ERISA plan officer/trustee, abiding by the prudent man rule, must make investments consonant to the stated security level of the trust.³¹ Often, courts look beyond the success of an investment when judging whether a trustee has violated the prudent man rule.³² These courts recognize that "safety in income and principal are usually primary objectives to a qualified pension trust fund . . . [and] . . . a prudent investor will not be solely concerned with capital growth."³³ The courts note that even though a trustee has not lost money on an investment, and in fact has received an "extraordinary" return, that does not preclude a cause of action against the trustee for improperly risking

risk of large losses, *unless* under the circumstances it is clearly prudent not to do so; and

(D) in accordance with the documents and instruments governing the plan *insofar as such documents and instruments are consistent* with the provisions of this subchapter.

(2) In the case of an *eligible individual account plan* (as defined in section 1107(d)(3) of this title), 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 real property* or qualifying employer securities (as defined in section 1107(d)(4) and (5) of this title).

(b) Except as authorized by the Secretary by regulations, no fiduciary may maintain the indicia of ownership of any assets of a plan outside the jurisdiction of the district courts of the United States.

(c) In the case of a pension plan which provides for individual accounts and permits a participant or beneficiary to exercise control over assets in his account, if a participant or beneficiary exercises control over the assets in his account (as determined under regulations of the Secretary) —

(1) such participant or beneficiary shall not be deemed to be a fiduciary by reason of such exercise, and

(2) no person who is otherwise a fiduciary shall be liable under this part for any loss, or by reason of any breach, which results from such participant's or beneficiary's exercise of control.

ERISA § 404, 29 U.S.C. § 1104 (1982) (emphasis added).

31. G. BOGERT, *Law of Trusts* § 106, at 388 (1973).

32. See *Marshall v. Glass/Metal Ass'n & Glaziers*, 507 F. Supp. 378, 384 (D. Hawaii 1980). "The application of ERISA's prudence standard does not depend upon the ultimate outcome of an investment, but upon the prudence of the fiduciaries under the circumstances prevailing when they make their decision and in light of the alternatives available to them." *But see American Com. Ass'n v. Retirement Plan*, 488 F. Supp. 479, 483 (S.D.N.Y. 1980), "The mere fact that there may have been a decline in the value of the Plan's portfolio or a diminution of income in a given year does not by itself establish imprudent management."

33. A. SCOTT, *The Law of Trusts* § 227.1 (3d ed. 1967 & 1982 Supp.).

pension trust assets.³⁴ However, the prudent man rule, as it stands in ERISA's fiduciary standard section, provides little help to the officer/trustee faced with business conditions that dictate a managerial decision directly opposite to that officer's responsibilities as a trustee. Added to the problems facing the officer/trustee are the requirements of the diversification rule.

Unfortunately, the diversification rule fails to alleviate the dilemma faced by the officer/trustee in complying with the prudent man rule. In pertinent part, the requirement to diversify provides that a plan trustee must "diversify 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."³⁵ Ostensibly, the requirement to diversify is an attempt by Congress to harness the discretion of the plan trustee who is making investment decisions over the assets in the ERISA plan. Interpreting Congress' intent as enacted in the fiduciary standards section of ERISA, the courts have been unable to produce uniform authority that would clarify the ambiguity surrounding the requirement to diversify.³⁶

Although case precedent lacks uniformity in this area, the requirement to diversify remains the best strategy for prudent maintenance of the trust corpus.³⁷ Theoretically, the officer/trustee should aim to diversify its investment portfolio at a riskless posture, such that high growth and risky potential investments may be offset by low growth

34. See *supra* note 31.

35. ERISA § 404(a)(1)(C), 29 U.S.C. § 1104(a)(1)(C) (1982).

36. The Court in *Marshall v. Teamsters*, 458 F. Supp. at 986, determined that: In some jurisdictions, lack of diversification is a per se breach of the trustees' investment duty of prudence; in others it is not. Section 404(a)(1)(c) requires diversification under circumstances where commitment of a high percentage of the assets of a plan to a particular investment or class of investments casts doubt on the prudence of the investments.

Teamsters, 458 F. Supp. at 990 (citations omitted).

Compare this finding with the rationale of the court in *Joy v. North*, 692 F.2d 880 (2d Cir. 1982), *cert. denied*, ___ U.S. ___, 103 S. Ct. 1498 (1983):

The circumstances surrounding a corporate decision are not easily reconstructed in a courtroom years later, since business imperatives often call for quick decisions, inevitably based on less than perfect information. The entrepreneur's function is to encounter risks and to confront uncertainty, and a reasoned decision at the time made may seem a wild hunch viewed years later against a background of perfect knowledge.

Id.

37. See generally Markowitz, *Portfolio Selection*, 7 JOURNAL OF FINANCE 77-91. H. MARKOWITZ, *Efficient Diversification of Investments*, (1952). F. REILLEY, INVESTMENTS, 633-54 (1982).

and low risk investments to create a well-balanced base.³⁸ The courts,

38. See F. REILLEY, *INVESTMENTS* 559-77 (1982).

Markowitz showed that the variance of the [investments] rate of return was a meaningful measure of risk under a reasonable set of assumptions and derived the formulas for computing the variance of the portfolio. . . . The Markowitz model is based on several assumptions regarding investor behavior:

(1) Investors consider each investment alternative as being represented by a probability distribution of expected returns over some holding period.

(2) Investors maximize one-period expected utility and possess utility curves that demonstrate diminishing marginal utility of wealth.

(3) Individuals estimate risk on the basis of the variability of expected returns.

(4) Investors base decisions solely on expected return and risk; ie their utility curves are a function of expected return an variance (or standard deviation) of returns only.

(5) For a given risk level, investors prefer higher returns to lower returns. Similarly, for a given level of expected return, investors prefer less risk to more risk.

Id. at 559. Consider the following computation of the expected return for an individual risky asset and the computation of the expected return of a portfolio.

<u>Probability</u>	<u>Potential Return (P_i)(%)</u>	<u>Expected Return (%)</u>
.25	.08	.0200
.25	.10	.0250
.25	.12	.0300
.25	.14	.0350

$$E(R) = .1100$$

<u>Weight (W_i) (% of the portfolio)</u>	<u>Expected Return (R_i)</u>	<u>Expected Portfolio Return (W_i × R_i)</u>
.20	.10	.0200
.30	.11	.0330
.30	.12	.0360
.20	.13	.0260
		.1150

$$E(R_{\text{portfolio}}) = \sum_{i=1} W_i R_i$$

$$\text{Variance } (\sigma^2) = \sum_{i=1} [R_i - E(R_i)]^2 P_i$$

R_i = possible (individual investment) rates of return

W_i = weight (%) of the investment to the total portfolio

E(R_i) = expected rate of return (per individual investment)

P_i = probability of the possible rate of return

however, apply the ERISA diversification requirement on an investment-by-investment basis,³⁹ which prevents plan trustees from pursuing progressive portfolio management strategies that could ultimately provide greater return to the plan participant at the same low risk level.⁴⁰ Instead of looking at the rate of return earned after the particular investment progresses, courts assess diversification and prudence under prevailing circumstances taken into account when the investment deci-

An envelope curve may be derived and plotted as the result of various combinations of assets and portfolios (given the portfolio expected return and standard deviations of each combination). "The envelope curve that contains the best of all combinations is referred to as the efficient frontier. Specifically, *the efficient frontier is that set of portfolios that has the maximum return for every given level of risk or the minimum risk for every level of return.*"

Id. at 577 (emphasis supplied).

39. The Markowitz portfolio theory considers the aggregate risk factor of the portfolio as a measure of the investment manager's performance. Thus, this theory is not based upon an investment-by-investment analysis. Markowitz, *supra* note 37, at 77-91.

40. *Id.* See the example set forth in *Joy*.

Shareholders can reduce the volatility of risk by diversifying their holdings. In the case of the diversified shareholder, the seemingly more risky alternatives may well be the best choice since great losses in some stocks will over time be offset by even greater gains in others:

INVESTMENT A

Estimated Probability of Outcome	Outcome Profit or Loss	Value
.4	+ 15	6.0
.4	+ 1	.4
.2	-13	-2.6
1.0		3.8

INVESTMENT B

Estimated Probability of Outcome	Outcome Profit or Loss	Value
.4	+ 6	2.4
.4	+ 2	.8
.2	+ 1	.2
1.0		3.4

Although A is clearly 'worth' more than B, it is riskier because it is more volatile. Diversification lessens the volatility by allowing investors to invest in 20 or 200 A's which will tend to guarantee a total result near the value. Shareholders are thus better off with the various firms selecting A over B, although after the fact they will complain in each case of the 2.6 loss.

Joy, 692 F.2d at 886 note 6 (quoting KLEIN, BUSINESS ORGANIZATION AND FINANCE 147-49 (1980)).

sion began.⁴¹ This ambiguity between an accepted theory of finance and judicial practice hinders the progressive officer/trustee seeking high rates of return with slightly higher risk levels, because an investment-by-investment analysis will reject high risk projects at an earlier stage than if the court had viewed that investment's risk factor in light of the overall risk of the portfolio.⁴²

The conflict between prudent trust practices and prudent corporate-profit maximization goals exists despite the issuance of a Department of Labor regulation which attempts to define practical implementation for the diversification requirement.⁴³ Although the Code of Federal Regulations purports to illustrate factors that are consonant with modern portfolio diversification theories, some of these elements are incompatible to the judiciary's investment-by-investment analysis of a trustee's capital spending decisions.⁴⁴ Combined with the prudent

41. *Withers v. Teachers' Retirement System*, 47 F. Supp. 1248, 1255 (S.D.N.Y. 1978).

42. See Markowitz, *supra* note 37 at 77-91.

43. 29 C.F.R. § 2550.404a-1(B)(1) (1984)(investment duties). In pertinent part, this Department of Labor regulation declares that:

(b) Investment Duties. (1) With regard to an investment or investment course of action taken by a fiduciary of an employee benefit plan pursuant to his investment duties, the requirement of *section 1104 (a)(1)(B)* of the Act set forth in subsection (a) of this section is satisfied if the fiduciary:

(i) has given appropriate consideration to those facts and circumstances that, given the scope of such fiduciary's investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action involved, including the role of investment or investment course of action plays in that portion of the plan's investment portfolio with respect to which the fiduciary has investment duties; and (ii) has acted accordingly.

2(ii) Consideration of the following factors as they relate to such portion of the portfolio:

- (A) The compensation of the portfolio with regard to diversification;
- (B) The liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan; and
- (C) The projected return of the portfolio relative to the funding objectives of the plan.

44. In particular, § 2550.404a-1(b)(2)(ii)(C), when read alone, might allow clearance to invest in a high risk security that complements the projected (expected) return of the portfolio. But, an "investment by investment" approach could reject the same investment.

Congress' endeavor to clarify its own diversification requirement was noted in the legislative history:

The degree of investment concentration that would violate this require-

man rule, this regulatory contradiction tends to increase the number of the conflicting standards of fiduciary conduct that confront the officer/trustee.⁴⁵

B. Prohibited Transactions - Section 406

In addition to its fiduciary standard section, ERISA is designed to prohibit transactions that involve transfers between an ERISA trustee and a party-in-interest.⁴⁶ Specifically, a fiduciary shall not:

ment to diversify cannot be stated as a fixed percentage, because a prudent fiduciary *must consider the facts and circumstances of each case*. The factors to be considered include (1) the purposes of the plan; (2) the amount of the plan assets; (3) financial and industrial conditions; (4) the type of investment, whether mortgages, bonds or shares of stock or otherwise; (5) distribution as to geographical location; (6) distribution as to industries; (7) the dates of maturity.

S. REP. NO. 93-127, 93d Cong. 2d Sess. 3, *reprinted in* 1974 U.S. CODE CONG. & AD. NEWS 4639, 5084-85 (emphasis added).

45. Compare this finding with *Teamsters*, 458 F. Supp. at 986.

46. 29 U.S.C. § 1002(14) (1982) defines a "party-in-interest" as:

(A) any fiduciary (including but not limited to, any administrator, officer, trustee, or custodian), counsel, or employee of such employee benefit plan;

(B) a person providing services to such plan;

(C) an employer any of whose employees are covered by such plan;

(D) an employee organization any of whose members are covered by such plan;

(E) an owner, direct or indirect, of 50 percent or more of—

(i) the combined voting power of all . . .

(ii) the capital interest or the profits interest in a partnership, or

(iii) the beneficial interest of a trust or unincorporated enterprise,

which is an employer or an employee organization described in subparagraph (C) or (D);

(F) a relative (as defined in paragraph 15 of any individual described in subparagraph (A), (B), (C), or (E));

(G) a corporation, partnership, or trust or estate of which (or in which) 50 percent or more of—

(i) the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of such corporation,

(ii) *the capital interest* or profits interest of such partnership, or—

(iii) the beneficial trust of such trust or estate is owned directly or indirectly, or held by persons described in subparagraph (A), (B), (C), (D), or (E);

(H) an employee, officer, director (or an individual having powers or responsibilities similar to those of officers or directors), or a 10 percent or

- (1) deal with the assets of the plan in his own interest or his own account,
- (2) in his individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries, or
- (3) receive any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan.⁴⁷

more shareholder directly or indirectly, of a person described in subparagraph (B), (C), (D), (E), or (G), or of the employee benefit plan; or
 (I) a 10 percent or more (directly or indirectly in a capital or profits) partner or joint venturer of a person described in subparagraph (B), (C), (D), (E), or (G).

The Secretary, after consultation and coordination with the Secretary of the Treasury, may by regulation prescribe a percentage lower than 50 percent for subparagraph (E) and (G) and lower than 10 percent for subparagraph (H) or (I). The Secretary may prescribe regulations for determining the ownership (direct or indirect) of profits and beneficial interests, and the manner in which indirect stockholdings are taken into account. Any person who is a party in interest with respect to a plan to which a trust described in § 501(c)(22) of Title 26 is permitted to make payments under § 1403 of this title shall be treated as a party in interest with respect to such trust.

47. ERISA § 406(b)(1-3), 29 U.S.C. § 1106(b)(1-3) (1982). In addition to § 1106, the Internal Revenue Code provides for a tax on prohibited transactions. In pertinent part, the I.R.C. taxes a "disqualified person" on each prohibited transaction.

§ 4975. *Tax on prohibited transactions*

(a) *Initial taxes on disqualified person.* - There is hereby imposed a tax on each prohibited transaction. The rate of tax shall be equal to 5 percent of the amount involved with respect to the prohibited transaction for each year (or part thereof) in the taxable period. The tax imposed by this subsection shall be paid by any disqualified person who participates in the prohibited transaction (other than a fiduciary acting only as such).

(b) *Additional taxes on disqualified person.* - In any case in which an initial tax is imposed by subsection (a) on a prohibited transaction and the transaction is not corrected within the taxable period, there is hereby imposed a tax equal to 100 percent of the amount involved. The tax imposed by this subsection shall be paid by any disqualified person who participated in the prohibited transaction (other than a fiduciary acting only as such).

A 'disqualified person' is defined as:

(2) *Disqualified Person.* - For purposes of this section, the term 'disqualified person' means a person who is —

- (A) a fiduciary;
- (B) a person providing services to the plan;
- (C) an employer any of whose employees are covered by the plan;

Standing alone, section 406 appears to prohibit a trustee from ever engaging in party-in-interest transactions. However, sections 407 and 408 provide the pension trustee an avenue to acquire or retain a limited amount of employer securities for the pension plans.⁴⁸ Unfortunately, the officer/trustee, with ambitions to control the corporation, often misunderstands these sections to imply a clear exception to the prohibited transaction provision.⁴⁹

(D) an employee organization any of whose members are covered by the plan;

(E) an owner, direct or indirect, of 50 percent or more of—

(i) the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of a corporation,

(ii) the capital interest or the profits interest of a partnership, or

(iii) the beneficial interest of a trust or incorporated enterprise, which is an employer or an employee organization described in subparagraph (C) or (D);

(F) a member of the family (as defined in paragraph (6)) of any individual described in subparagraph (A), (B), (C), or (E);

(G) a corporation, partnership, or trust or estate or which (or in which) 50 percent or more of—

(i) the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of such corporation,

(ii) the capital interest or profits interest of such partnership, or

(iii) the beneficial interest of such trust or estate,

is owned directly or indirectly, or held by persons described in subparagraph (A), (B), (C), (D), or (E);

(H) an officer, director (or an individual having powers or responsibilities similar to those of officers or directors), a 10 percent or more shareholder, or a highly compensated employee (earning 10 percent or more of the yearly wages of an employer) of a person described in subparagraph (C), (D), (E), or (G); or

(I) a 10 percent or more (in capital or profits) partner or joint venturer of a person described in subparagraph (C), (D), (E), or (G).

The Secretary, after consultation and coordination with the Secretary of Labor or his delegate, may by regulation prescribe a percentage lower than 50 percent for subparagraphs (E) and (G) and lower than 10 percent for subparagraphs (H) and (I).

I.R.C. § 4975 (a),(b), (f)(2) (1984).

This author does not intend to provide an exhaustive review of the I.R.C. provisions for prohibited transactions of an ERISA trustee. Accordingly, the tax consequences surrounding an ERISA trustee's conflict of interest abuse are beyond the scope of this Note.

48. See ERISA § 407(a)(2), 29 U.S.C. § 1107(a)(2) (1982) ERISA § 408(e)(1), 29 U.S.C. 1108(e)(1) (1982).

49. The court in *Donovan v. Bierwith* rejected appellant's claim that § 1107 pro-

C. Exceptions to the Prohibited Transactions Rule - Sections 407 and 408

Section 407(a)(2) establishes a loophole to ERISA's prohibited transaction section. This loophole permits an ERISA plan trustee to invest in "employer securities up to ten percent of the fair market value of the assets in the plan."⁵⁰ Section 408(e)(1) supplements this proviso by exempting employer securities, if acquired for adequate consideration, from sections 406 and 407.⁵¹ Thus, section 408(e)(1) acts as an exemption to the 406 prohibited transaction rule. It is not surprising that this limited exception is an attractive lure to an officer/trustee facing potential conflicts of interest. Along with the latent interpretational problems presented to the officer/trustee in section 404's prudence standards, this adequate consideration exception adds to the possibility that a trustee will act as an officer to acquire corporate securities, while using the trust corpus to track an imprudent venture in violation of his fiduciary obligation to plan participants.

IV. Common Conflict of Interests Facing Officer/Trustees

A. Breach of Fiduciary Duty: Officer/Trustee's Use of Plan Funds to Purchase Corporation.

In *Eaves v. Penn*,⁵² an officer/trustee acquired employer stock using a mix of his personal and ERISA plan pension capital. The purchase enabled him to establish majority shareholder control.⁵³ The

vides an "unlimited" exception to § 1106's prohibited transaction standards. *Bierwith*, 680 F.2d at 271.

50. ERISA § 407(a)(2), 29 U.S.C. § 1107(a)(2) (1982).

51. ERISA § 408(e)(1), 29 U.S.C. § 1108(e)(1) (1982) provides that:

(e) Sections 1106 and 1107 of this title shall not apply to the acquisition or sale by a plan or qualifying employer securities (as defined in § 1107(d)(5) of this title) or acquisition, sale or lease by a plan of qualifying employer real property (as defined in § 1107(d)(4) of this title)—

(1) if such acquisition, sale, or lease is for *adequate consideration* (or in the case of a marketable obligation, at a price not less favorable to the plan than the price determined under § 1107(e)(1) of this title), (emphasis added).

Id.

52. 426 F. Supp. 830 (W.D. Okla. 1976), *modified*, (rem. on attorneys' fees issue) 587 F.2d 453 (10th Cir. 1978).

53. *Eaves*, 587 F.2d at 453, 455.

court examined the propriety of a purchase agreement entered into by the trustee (Penn) of the employee stock ownership plan, and the current majority shareholders (Eaves). As trustee of the pension plan, Penn caused the transfer of \$1,013,134.01 to the Eaveses for 6,807 shares of stock,⁵⁴ to be held by the substituted employee stock ownership plan (ESOP).⁵⁵ Penn used his own capital to purchase the remainder of the majority shares from the Eaveses.⁵⁶ Penn compensated the Eaveses for their stock holdings, and, through an amendment to the company's original profit sharing plan that created an employee stock ownership plan,⁵⁷ he transferred company assets into the new ESOP.⁵⁸ This transfer occurred in the form of an advance payment from the company's assets into the newly formed ESOP.⁵⁹ By virtue of this elaborate transfer, Penn gained control over a majority amount of company shares and designated himself a board member, vice-president and treasurer of the target company, Glenss, Inc.⁶⁰

Before the transfer and purchase, Glenss, Inc. maintained a strong financial condition relative to its market place.⁶¹ However, after Penn's acquisition, leveraged by funds drawn from the ESOP,⁶² the value of Glenss, Inc. shares experienced a decline by approximately \$500,000.⁶³ As a result of Penn's actions stockholder's equity declined from a pre-acquisition value of \$746,711 to a value of \$76,000.⁶⁴ The Tenth Circuit held that the officer/trustee's elaborate buyout scheme, fueled by the amendment to the company's profit sharing plan, constituted a section 404 breach of his fiduciary duties⁶⁵ owed to that company's plan participants and their beneficiaries.⁶⁶

54. *Id.* at 455.

55. *Id.*

56. *Id.* at 456.

57. *Id.*

58. *Id.*

59. *Id.*

60. *Id.*

61. *Id.*

62. *Id.*

63. *Id.*

64. *Id.*

65. Neither the District Court nor the Court of Appeals label Penn's transaction with the substituted ESOP as a "prohibited transaction." Thus, the outgoing directors were not treated as parties-in-interest with the substituted ESOP.

66. *Id.* at 454.

1. *Does ERISA Hold the Officer/Trustee to Unrealistic Expectations, If Not Inequitable Standards?*

Penn contended on appeal that, as a trustee, his fiduciary duty bound him to the terms of the amended profit sharing plan, the ESOP, and ERISA to "invest the Plan's fund in Employer's securities, unless compliance was impossible, illegal or directly inconsistent with a specific prohibition of ERISA."⁶⁷ The court believed that this attempt to define Penn's fiduciary role to the plan participants was putting the cart before the horse. The court stated: "the premise for such a contention is based on the adoption of a uniform exemption for violations of §1104 fiduciary standards in cases involving the discretionary activities of an ESOP trustee."⁶⁸ Instead, this is really an instance where Penn interpreted the breadth of the section 408(e) prohibited transaction exception to stand as a vanguard over section 404's fiduciary standard section. It is established authority that section 408(e)'s limited exception should act as supplementary capacity in deference to section 404's prudence and diversification requirements.⁶⁹ The court adopted this viewpoint and stated that, "[w]hile an ESOP trustee may be released from certain per se violations . . ., the structure of the Act itself requires that an ESOP fiduciary . . . is governed by the 'solely in the interest' and prudence tests of §§ 404(a)(1)(A) and (B)."⁷⁰

Although the Tenth Circuit found that Penn's capital acquisition strategy violated ERISA's fiduciary standards section, his actions were not uncommon when weighed against liberal principles of corporate finance.⁷¹ Arguably, if Penn had transferred capital from the amended profit sharing plan into the ESOP and successfully gained control of the company, this lawsuit may not have ensued. Although the courts

67. *Id.* at 458.

68. *Id.* at 459. ESOP refers to an employee stock ownership plan. *See*, I.R.C. § 4975(e)(7) (1984).

69. *Eaves*, 587 F.2d at 459, (quoting H.R. Rep. No. 93-1280, 93d Cong., 1st Sess., reprinted in 1974 U.S. CODE CONG. & AD. NEWS, at 5038:

Thus, while a plan may be able to acquire employers securities or real property under the employers security rules, the acquisition must be for the *exclusive benefit of participants and beneficiaries*. Consequently, if the real property is acquired *primarily to finance the employer*, this would not meet the exclusive benefit requirement.

Id. (Emphasis supplied).

70. *Id.*

71. *See generally* Brecher, Lazarus III, & Gray, *The Function of Employee Retirement Plans as an Impediment to Takeovers*, 38 BUS. LAW 503 (1983).

warn that a fiduciary's practices will be judged prospectively,⁷² rather than retrospectively, it is doubtful that a member of a successfully run ESOP⁷³ would sue the trustee of the plan and allege that that trustee gained control of the company in an imprudent fashion.⁷⁴ Thus, it is likely that, had Penn's buyout inured to the benefit of plan participants in the form of enhanced shareholder equity, Penn would still be the vice-president, treasurer and board member of Glenn's, Inc.⁷⁵

Under slightly different circumstances, it is conceivable that an officer/trustee might sidestep a section 404 challenge to his disputed capital transfer by means of better corporate and managerial skills. Favorable financial results, measured by an increase in shareholder's equity, would appease the plan participants. When viewed retrospectively, such a purchase plan might prove "solely to benefit plan participants" thereby satisfying the section 404 fiduciary standards.⁷⁶ Given this hypothetical result, inequity in prosecutorial standards is likely to occur.⁷⁷ As long as corporate officers can act as plan trustees, there will be circumstances when an officer/trustee may be tempted to manipulate the assets of the employee pension plan to suit his own business interests. The trustee will do this with the belief that a somewhat imprudent strategy might result in enhanced wealth for the company shareholders (who are also plan members) as well as advanced personal power, wealth, and prestige for himself.

72. *Withers*, 47 F. Supp. at 1255.

73. The growth in an ESOP can be measured by the rate of return its investments experienced during a given time period.

74. *But see Leigh v. Engle*, 535 F. Supp. 418 (N.D. Ill. 1982), *vacated rem*, 727 F.2d 113 (7th Cir. 1984). In that case, members of a corporate profit sharing plan brought suit for fiduciary breach by the trustees. The trust investments experienced an "extraordinary" return, however, the participants' plan payments were deferred by the trustees.

75. This conclusion is further buttressed by evidence of the District Court's finding of facts. *See Eaves*, 426 F. Supp. at 830, 832-36.

76. Despite the court's holding in *Leigh*, 535 F. Supp. at 418, this author argues that no cause of action would have been filed by the plan participants in the *Eaves* action had: (1) Penn successfully managed the Glens, Inc. and (2) all payments to retired or withdrawn members were not deferred.

77. Specifically, imprudent uses of ESOP assets resulting in successful ventures could not be prosecuted, while unsuccessful investments would instigate actions for fiduciary breach.

B. An Officer/Trustee's Investment Decisions Track Independent Investment Group's Acquisition Plans.

In *Leigh v. Engle*,⁷⁸ the Seventh Circuit Court of Appeals held that two officer/trustees' actions in three separate investment acquisition plans violated the fiduciary standards section of ERISA.⁷⁹ The disputed transactions involved investment decisions that were made by trustees of the Reliance Manufacturing Corporation's Employees Profit Sharing Trust.⁸⁰ The officer/trustees, who were also members of an acquisition group, directed trust capital to finance the acquisition aspirations of the group.⁸¹ Each investment by the trust precluded an attempt by the group to purchase large blocks of that company's stock.⁸² Thus, despite an extraordinary return on investment, the trustees' use of trust capital to track the group's acquisition attempts violated their fiduciary responsibilities pursuant to section 404.⁸³

The investment group consisted of various individuals representing three different corporations: Libco Corporation, GSC Corporation, and Reliable Manufacturing.⁸⁴ The head of the group, a financier, and CEO of Libco and GSC, did not act alone. He received assistance from the chief counsel for Libco, who was the administrator of the Reliable Trust (Employee pension plan), the president of Reliable Manufacturing, who was also co-administrator of the trust, and an investment analyst hired by Libco.⁸⁵ This group centered its acquisition attempts on the three companies: Berkeley Bio Medical, Outdoor Sports Industries, and the Hickory Furniture Company.⁸⁶

As a white knight,⁸⁷ the financier purchased approximately 60,000

78. *Leigh*, 535 F. Supp. at 418.

79. *Leigh*, 727 F.2d at 116.

80. *Id.*

81. *Id.* at 117.

82. *Id.* at 118.

83. *Id.* at 128.

84. *Id.* at 116.

85. *Id.* at 117.

86. *Id.* at 116.

87. White knight is the colloquialism for a third, independent company that is solicited by the firm whose stock is being pursued by the acquiring firm. Usually, the third firm (the white knight) enters into an agreement with the firm that is being pursued. Often the pursued firm negotiates an exchange of its stock for the efforts of the third party to buy a large number of shares and thereby defeat the acquiring firm's attempt at gaining control of the pursued company. *See American General Ins. Co. v. Equitable General Corp.*, 493 F. Supp. 721, 732 n.19 (E.D. Va. 1980).

shares of Berkeley stock prior to the investment group meeting in an attempt to prevent a hostile tender offer⁸⁸ by Cooper Industries, the firm intending to takeover control of Berkely.⁸⁹ Following a meeting of the investment group, the Reliable trust purchased 15,000 shares of Berkeley stock.⁹⁰ After the pension plan's purchase, the financier sent correspondence to other Berkeley block shareholders, in an attempt to solicit either their interests in the stock or their proxy in upcoming Berkeley board meetings.⁹¹ This attempt was the result of opposition to the ongoing talks between Berkeley and Cooper Industries, the company that had set forth its initial tender offer.⁹² Eventually, the financier withdrew his complaint, negotiated the tender of its holdings to Cooper, and realized a "substantial profit for its Berkeley stock interests."⁹³

The group's investment in the OSI Corporation assumed a pattern similar to the Berkeley coup.⁹⁴ Again, the trust administrators tracked the investment group's acquisition plans by purchasing 12,400 shares of OSI stock.⁹⁵ Subsequent to this purchase, the investment group, headed by its financier, battled the present OSI management for managerial control.⁹⁶ The tender fight ended when a white knight sided with OSI management and offered fifteen dollars per share to the investment group for their OSI stock holdings.⁹⁷ The group responded by selling its shares to the white knight at a one hundred forty-one percent profit.⁹⁸ The investment group was less successful in their acquisition of Hickory Furniture. Following the investment group's purchase of 51,400

88. See A. Fleischer, Jr., *Tender Offers: Defenses, Responses and Planning* 99 (1978):

A tender or exchange offer is aimed directly at the shareholders of the target. The bidder may make an offer irrespective of director opposition if it complies with all the legal standards., Unlike the situation in a merger or sale of assets transaction, in which the board of directors must approve and recommend the transaction, the shareholders can respond directly to the offer.

89. *Id.* 727 F.2d at 119.

90. *Id.*

91. *Id.* at 121.

92. *Id.* at 120.

93. *Id.*

94. *Id.*

95. *Id.*

96. *Id.* at 121.

97. *Id.*

98. *Id.*

shares, the Reliable trustees bought 8,000 shares of Hickory stock.⁹⁹ After the trust's purchase, the investment group became members of the Hickory Board of Directors, and the trust then sold its shares at a four percent profit.¹⁰⁰

1. *Should a Trustee Refuse to Act Upon Inside Information Made Available to Him Vis-A-Vis His Corporate Position As An Officer?*

The Seventh Circuit in *Leigh* found that ERISA is not concerned with the success of a trust's investment.¹⁰¹ This finding is consistent with the Congressional intent to preserve the trust corpus through common-law trust principles.¹⁰² Indeed, the *Leigh* court found that Reliable trustees' activities were "self dealing" and lacked prudence as required by ERISA's fiduciary standards.¹⁰³ Thus, the investment group's successful investments, resulting in an increase in shareholder equity for plan participants, are suspect to ERISA's prohibited transaction section, as well as to the Act's fiduciary standards.¹⁰⁴ Because the investments were not "made with an 'eye single' to the interests of the Plan participants, they lacked the necessary objectivity and prudence prescribed by ERISA."¹⁰⁵ By labeling the trustees' actions "self-dealing," the court chooses to apply a broad interpretation to "section 406's restriction on officer/trustees of either the 'target' or 'raider' (corporation) who have a significant interest of their own in the outcome of the contests."¹⁰⁶

The *Leigh* court suggested that, the Reliable trustees may have avoided violating ERISA's fiduciary standards if the trustees had consulted with independent counsel, instead of an interested party.¹⁰⁷ Juxtaposed against other case precedent, this suggestion provides little hint of a touchstone by which the officer/trustee may measure future invest-

99. *Id.*

100. *Id.*

101. *Id.*

102. *Id.* at 122, n.17, 123. S. REP. NO. 93-127, 93d Cong., 2d Sess. 3, *reprinted* in 1974 U.S. CODE CONG. & AD. NEWS 4639, 5186 (Statement of Sen. Harrison Williams).

103. *Id.* at 132.

104. *Id.* at 132-134.

105. *Id.* at 129.

106. *See generally Id.* at 132-36.

107. *Id.* at 132.

ment decisions. Additionally, one authority on the law of trusts observed that:

In reaching his conclusion [the trustee] may take into consideration advice given to him by attorneys, bankers, brokers, and others whom prudent men in the community regard as qualified to give advice. He is not justified, however, in relying wholly upon the advice of others, since it is his duty to exercise his own judgment in the light of the information and advice which he receives.¹⁰⁸

In *Leigh*, the investment group relied solely on the advice solicited from the investment advisor.¹⁰⁹ The court found that this advice came from an interested party and lacked the prudence required by ERISA.¹¹⁰ The *Leigh* decision revitalizes the catch-22 atmosphere surrounding the officer/trustee. Specifically, that atmosphere consists of an improper mix of goal oriented expectations; in one corner stands the profit maximizing employee, while on the other side is the prudent trustee.

The *Leigh* court adopts the Department of Labor suggestion that trustees in this situation should abdicate their roles as trustees and "turn over the administration of the plan to another who can set forth a prudent investment course independent of that trustee's *other* interests."¹¹¹ The Department of Labor's suggestion is theoretically sound, but based on the premise that an officer/trustee will always recognize a situation that constitutes ERISA's fiduciary self-dealing.¹¹² When it is proven that the officer/trustee will ignore standards and use pension funds to self-deal, it follows that logic will not dictate that the same officer/trustee resign his position¹¹³ for the sake of prudence.¹¹⁴ In *Don-*

108. A. SCOTT, *supra* note 33.

109. *Leigh*, 727 F.2d at 132-35.

110. *Id.* at 132.

111. *Id.*

112. Semantic problems arise when the courts struggle to consider whether an action is "self-dealing." Is this an unfair label to affix upon the officer/trustee acting upon confidential information? Had Goldman, Sachs & Company circulated a "buy" opinion sheet to its investing customers suggesting that Berkeley appeared to be an attractive purchase, would the Reliable trustee's purchase be prudent? Here, ERISA and the courts shed little light on the way in which an officer/trustee may ever insulate himself from charges of fiduciary breach, while making an attractive investment for the trust plan.

113. *See Leigh*, 727 F.2d at 132.

114. Congress assesses penalties against breaching fiduciaries by: (1) awarding

ovan v. Cunningham,¹¹⁵ the court adopts section 408(e)'s adequate consideration requirement¹¹⁶ as the test for an officer/trustee's prudence over his investment decisions. The *Cunningham* court held that "ESOP fiduciaries will carry their burden to prove . . . [the payment of] . . . adequate consideration . . . [established by] . . . prudent investigation in the prevailing circumstances"¹¹⁷ However, this interpretation unearths little knowledge, because the standard of prudence expected of the officer/trustee is left as an undefined principle. It follows that the adoption of an adequate consideration standard fails to extricate the officer/trustee from the catch-22 situation encountered by the trustees in the *Leigh* case.

C. Fiduciary Breach By an Officer/Trustee in the Midst of a Corporate Tender Offer.

ERISA's fiduciary standards section plays an important role in judging the actions of an officer/trustee's investment decision to tender, or refuse to tender, corporate securities held by the employee stock ownership plan. In *Donovan v. Bierwirth*,¹¹⁸ the court evaluated the prudence of the trustee who refused to tender corporate securities and instead, decided to buy company securities in an attempt to ward off the bid of an acquiring firm.¹¹⁹

Board members of the Grumman Corporation voted to prevent a tender offer by the LTV Corp.¹²⁰ Following this board meeting, all ESOP participants received a memorandum informing them that their

compensatory damages pursuant to ERISA § 1109, *infra* note 158; and (2) assessing tax penalties against "disqualified" persons, I.R.C. § 4975, *supra* n. 45. As these provisions failed to deter the trustees in *Eaves* and *Leigh* from breaching their fiduciary duty to plan participants, it would seem that these provisions are not realistic. Further, these penalties may fail to compensate plan participants in the event that the breaching fiduciary is insolvent. *See, infra* notes 160-2 and accompanying text.

115. *Donovan v. Cunningham*, 541 F. Supp. 276 (S.D. Tex. 1982), *aff'd in part, vacated in part, rev. in part*, 716 F.2d 1455 (5th Cir. 1983), *cert. den.*, ___ U.S. ___, 104 S. Ct. 3533 (1984).

116. *Cunningham*, 716 F.2d at 1465.

117. *Id.* at 1467-68.

118. *Donovan v. Bierwirth*, 538 F. Supp. 463 (E.D.N.Y. 1981), 680 F.2d 263 (2d. Cir. 1982), *cert. den.* 459 U.S. 1069 (1982).

119. *Id.* at 466. "In this lawsuit, the ESOP officer/trustee's decision to retain Grumman stock while purchasing additional stock on the open market, did not constitute a prohibited transaction."

120. *Id.*

plan held one third of Grumman outstanding stock. The memorandum provided that "these plans are managed by Grummanites who will look long and hard at how well their fellow members would be served by selling off Grumman stock."¹²¹ One month later, Grumman trustees decided to refuse the tender offer for any of the shares held by the pension plan.¹²² Instead, the trustees voted to purchase an additional 1,275,000 shares of Grumman stock in an attempt to maintain control and defeat LTV's acquisition attempt.¹²³ The trustees based this purchase decision on an investment outlook report by Dillon, Read & Company, an investment banking concern retained by Grumman.¹²⁴ The District Court viewed the recommendation of Dillon, Read & Company as constituting "no real inquiry into the dangers presented to the Pension plan in the event of a takeover. . . [instead]. . . the trustee's imprudence formed a policy of 'conscious avoidance' to any positive effects that the LTV tender offer could enhance shareholder wealth."¹²⁵ The court ruled that "the trustees were not justified in relying upon the advice of Dillon, Read & Co. since that company had provided investment banking services to Grumman in the past, including acting as a manager of an offering of its convertible subordinated debentures in April, 1980."¹²⁶ In support of its finding that Dillon, Read & Company had an "obvious interest in Grumman's continuing independence,"¹²⁷ the court stated that:

In relying upon the advice of another, he [the trustee] should consider whether the person giving the advice is disinterested. Thus, it has been held that in purchasing securities for the trust he is not justified in relying solely on the advice of a broker interested in the sale of the securities."¹²⁸

Accordingly, the Grumman trustees' decision to retain company securities and purchase additional stock, combined with their failure to seek impartial investment advice and constituted a breach of section 404.¹²⁹

121. *Id.*

122. *Id.*

123. *Id.*

124. *Id.* at 472.

125. *Id.* at 474 (emphasis added).

126. *Id.*

127. *Id.*

128. *Id.*

129. *Id.* at 475 (emphasis added).

On appeal to the Second Circuit Court of Appeals, the Grumman trustees argued that their actions did not arise under §1106's prohibited transactions self-dealing provision.¹³⁰ In support of this argument, the trustees quoted a 1973 statement by the Department of Labor before the Senate Finance Committee.¹³¹ In pertinent part, this statement provided that:

Since such an employer will often be an administrator of his plan, or will function as a trustee or in some other fiduciary capacity, this provision [§1107(a)(3)] creates a limited exception to the listed proscription against self-dealing. The exception is made in recognition of *the symbiotic relationship* existing between the employer and the plan covering his employees.¹³²

Accordingly, the Second Circuit held that the Grumman trustees did not violate the prohibited transaction section of ERISA by following a course of action which "benefits the corporation as well as the beneficiaries."¹³³ However, the Second Circuit did find that the trustees' actions were not made at all times with "an *eye single* to the interests of the plan participants and their beneficiaries," which constituted a breach of §1404's fiduciary standards.¹³⁴

In retrospect, the Grumman officer/trustees' predicament is understandable in light of practical business considerations minimized by the Second Circuit. Realistically, Bierwirth and the other trustees acted in their official capacity as corporate officers when they decided to defeat the LTV tender offer. According to testimony in the district court, this decision is consistent with management's stated belief that LTV, pursuant to a successful tender offer, would replace existing Grumman management with LTV designees.¹³⁵ Under this assumption, Grumman trustees believed that any new management implemented by LTV would create a negative impact on shareholder equity, thereby posing a threat to the Employee Benefit Plan holdings.¹³⁶ The Second Circuit

130. *Bierwirth*, 680 F.2d at 271.

131. *See id.* at 271 (quoting Private Pension Reform: Hearings Before the Subcomm. on Private Pension Plans of the Senate Comm. on Finance, 93 Cong., 1st Sess. 446 (1973) (statement of Department of Labor)).

132. *Donovan v. Bierwirth*, 680 F.2d at 271.

133. *Id.* at 271-72.

134. *Id.*

135. *Id.* at 275.

136. Even though LTV did not announce that Grumman's executives would be displaced upon the success of its tender offer, a majority of hostile takeovers end with

empathized with this concern in light of a debt ridden LTV.¹³⁷ Nevertheless, the Second Circuit focused its attention on the Grumman trustees' decision to purchase additional Grumman stock and cautioned that they:

should have realized that their judgment . . . would be biased and accordingly they should take . . . every feasible precaution to free themselves . . . from any taint of the quick negative reaction characteristic of targets of hostile tender offers . . . (and) consider the huge risks attendant with purchasing additional Grumman shares at a price substantially elevated by the tender offer.¹³⁸

In other words, the Grumman trustees should have insulated themselves from any reaction that might be aligned with the normal reaction of a corporate decision maker.

1. *Bendix-Martin Marietta: A Solution to the Dual Loyalty Problem?*

Another conflict arose when Bendix made a hostile tender offer to acquire outstanding stock in the Martin Marietta corporation.¹³⁹ Thereafter, Martin Marietta counter-offered for Bendix' outstanding stock.¹⁴⁰ During this tender battle, Bendix plan trustees held eleven percent of outstanding Bendix stock, in the Bendix Salaried Employees Savings and Stock Ownership Plan (BSESSOP). The plan trustees sold four million five hundred thousand shares to Martin Marietta, at tender price, thereby "carry[ing] out its fiduciary responsibility by preserving 'all options' for the plan and its participants."¹⁴¹ Citibank of New York acted as the independent manager to Bendix' employee

the acquiring company substituting its chosen officials in place of the acquired company's executives. Note, *The Duties of Employee Benefit Plan Trustee under ERISA in Hostile Tender Offers*, 82 COLUM. L. REV. 1692, 1703 (1982).

137. *Bierwith*, 680 F.2d at 276.

138. *Id.*

139. See *Martin Marietta Corp. v. The Bendix Corp.*, No. 82-7669 (2d Cir., September 21, 1982)). *Wall Street Journal*, Sept. 14, 1982, at 4, col.1; Sept. 17, 1982, at 2, col.2; Sept. 20, 1982, at 2, col.2; Sept. 21, 1982, at 2, col.2.

140. *Wall Street Journal*, Sept. 21, 1982 at 2, col.2. See also *Martin Marietta Corp. v. The Bendix Corp.*, *supra* note 139.

141. *Wall Street Journal*, Sept. 21, 1982, at 2, col.2. See also *New York Times*, Sept. 24, 1982, at D1, col.5.

stock ownership plan.¹⁴² To challenge the independent trustee's decision to tender, Bendix filed for a temporary restraining order in federal district court.¹⁴³ The district court did not issue the temporary restraining order against the Citibank asset plan manager. To the contrary, the district court judge ordered the plan manager to carry out his original decision to tender Bendix stock to Martin Marietta.¹⁴⁴ On a motion for rehearing and modification, Bendix argued that ninety-four percent of the shareholders instructed the Citibank manager to withdraw the tender.¹⁴⁵ The court, however, refused to modify its original order.¹⁴⁶

One could argue that a tender offer made solely in the interest of the plan participants would never have occurred had a Bendix officer/trustee managed the Plan.¹⁴⁷ Instead, an independent qualified asset plan manager accepted the tender, satisfying his fiduciary responsibility to the members of the plan without any outside conflict of loyalties impacting upon that decision. This is the ultimate goal of the fiduciary policy guidelines set forth in ERISA.

V. Judicial Standard of Review that Gauges a Trustee's Prudence in Administering Plan Assets

Federal courts have firmly established that the actions of a trustee over the management of an ERISA Plan are to be analyzed on the basis of "whether those actions were arbitrary and capricious in light of the trustees' responsibility to all potential beneficiaries."¹⁴⁸ In *Fine v. Semet*,¹⁴⁹ for example, a district court held that the actions of the

142. Wall Street Journal, Sept. 21, 1982, at 2, col.2.

143. *Id.*

144. *Id.*

145. *Id.*

146. *Id.*

147. Accordingly, the court in *Leigh* observed that:

Otherwise, the risk is too great that the trustee will come to a crossroads where the interests of the plan and the party-in-interest diverge. For example, while the *party-in-interest may be seeking to accumulate as many shares as possible in order to maintain or acquire control, a plan's interest in maximizing its investment return may require it to tender its shares to a competing bidder for shares.*

Leigh, 727 F.2d at 132 (emphasis added).

148. *Rueda v. Seafarers Union*, 576 F.2d 939, 942 (1st Cir. 1978).

149. *Fine v. Semet*, 514 F. Supp. 34 (S.D. Fla. 1981), *aff'd*, 699 F.2d 1091 (11th Cir. 1983).

trustees are consistent with their fiduciary duties under ERISA.¹⁵⁰ In support of this finding, the court noted that the partner/trustee's concern about the impact of an immediate lump-sum payment to a departing law firm partner was well founded and rested on the consideration "that a sudden loss of some fourteen percent of the Plan's assets, combined with the significant potential for additional requests for immediate payments could not be acts of an arbitrary or capricious nature."¹⁵¹

150. *Id.* at 42-43. The District Court considered the decision of the profit sharing trustee not to allow a departing partner to withdraw his lump-sum benefit from plan assets. The plan documents provided that:

Upon termination of a Participant's employment prior to attaining Normal Retirement Age (for any reason other than death or disability), a Participant may elect, upon the consent of the Advisory Committee, to direct the Trustee to commence payment to the Participant of his Nonforfeitable Accrued Benefit prior to the Participant's attaining Normal Retirement Age. The Advisory Committee must give its direction to the Trustee on or before the last day of the Plan Year in which the Participant first incurs a Break in Service as a result of the termination of his employment. . . . If the terminating Participant is one hundred percent (100%) vested in his Accrued Benefit by the close of the Plan Year in which his employment terminates, the Advisory Committee, in its sole discretion, may direct the Trustee to commence payment to the Participant of his Accrued Benefit within sixty (60) days after the close of the Plan Year in which the Participant's employment terminates without regard to the Participant's incurring a Break in Service. . . .

If the Advisory Committee does not give the Trustee a direction to commence payment, the Trustee shall continue to hold the Participant's Accrued Benefit in trust until the close of the Plan Year in which the Participant attains Normal Retirement Age. At that time, the Trustee shall commence payment of the Participant's Nonforfeitable Accrued Benefit in accord with the provisions of Article VI. . . .

If the Participant terminates employment prior to attaining Normal Retirement Age because of death or disability, the Advisory Committee shall direct the Trustee to commence payment of the Participant's Accrued Benefit to him (or to his Beneficiary if the Participant is deceased), in accord with the provisions of Section 6.02, within sixty (60) days after the close of the Plan Year in which the Participant's employment terminates. [Deleted portions relate to date payment is to be made if directed by Advisory Committee, calculation of benefits at the close of a plan year, and alternative provisions for payment of benefits in case of death or disability].

Fine v. Semet, 514 F. Supp. at 37-38 (emphasis supplied). After it conducted a fair reading of the plan documents, the court determined that the trustee's actions were not "arbitrary or capricious."

151. *Id.*

The fourteen percent reduction that would result from the partner's withdrawal augmented the trustee's concern over assessing future investment goals and over potential financial loss to remaining plan participants.¹⁵² Thus, the retention of the departing employee's funds created a very realistic concern to the maintenance of the trust corpus.

The court reasoned that an act can be "arbitrary and capricious" if "invalid preferences" are proven to exist.¹⁵³ Such preferences are established "not merely on a showing of dissimilar treatment, but on dissimilar treatment based on 'improper purpose' or irrational effect."¹⁵⁴ Because the trustees' acts had a valid purpose, grounded in the rational effect that benefitted remaining plan members, they did not act in an arbitrary or capricious nature.¹⁵⁵

The *Fine* court's application of an arbitrary or capricious test in connection with "invalid preferences" or "irrational effects" should provide the judiciary with a uniform test to interpret the actions of an officer/trustee. Although the ERISA fiduciary responsibility section does not expressly mention the arbitrary or capricious standard, the federal judiciary should adopt this standard in conflict of interest cases. Such a uniform standard is clearly lacking in cases like *Donovan v. Bierwirth*,¹⁵⁶ *Eaves v. Penn*,¹⁵⁷ and *Leigh v. Engle*.¹⁵⁸ The arbitrary or capricious standard, however, is only a post facto solution because it fails to curb an officer/trustee's fiduciary breach at its genesis — conflict of interest. Therefore, Congress must adopt a uniform policy that will rid ERISA pension plans of the conflicts that inevitably result when a trustee acts in dual capacities for the plan and in the management of the corporation. This proposed Congressional policy will save company plan assets from the dissipation that results due to an officer/trustee's dual loyalties that eventually lead to fiduciary breach.

VI. ERISA's Provision for Relief from Fiduciary Breach Fails to Protect Plan Participants From Loss

If an officer/trustee's actions are clearly in violation of ERISA's

152. *Id.*

153. *Id.* at 44.

154. *Id.*

155. *Id.*

156. *See Bierwirth*, 538 F. Supp. at 463.

157. *See Eaves*, 426 F. Supp. at 830.

158. *See Leigh*, 535 F. Supp. at 418.

fiduciary standards, it is likely that adequate redress will not be available to plan participants and their beneficiaries. Section 409(a) of ERISA provides in pertinent part 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 to the plan resulting from each such breach".¹⁵⁹

In *Freund v. Marshall & Ilsley Bank*,¹⁶⁰ pension trustees breached their fiduciary duties, and the court ordered that they be jointly and severally liable to restore to the plan \$464,925.95, the amount adjudged to constitute damages of their breach.¹⁶¹ Plan participants' beneficiaries might survive dissipation if the trustees can satisfy the court's judgment. On the average, officer/trustees who are guilty of a breach involving millions of lost plan dollars surely cannot restore such amounts to the plan. The corporation need not indemnify "bad faith" fiduciaries in such cases.¹⁶² Thus plan participants are exposed to catos-

159. ERISA § 409(a), 29 U.S.C.A. § 1109(a) (1982).

160. *Freund*, 485 F. Supp. at 636.

161. *Id.* at 633-35.

162. However, some state corporation acts provide for the indemnification of officers, directors, employees, and agents. Fla. Stat. § 607.014(1)(1984), provides:

607.014 Indemnification. of officers, directors, employees, and agents. -

(1) A corporation shall have power to indemnify any person who was or is a party, or is threatened to be made a party, to any threatened, pending, or completed action, suit, or proceeding, whether civil, criminal, administrative, or investigative (other than an action by, or in the right of, the corporation), by reason of the fact that he is or was a director, officer, employee, or agent of the corporation or is or was serving at the request of the corporation as a director, officer, employee, or agent of another corporation, partnership, joint venture, trust, or other enterprise against expenses (including attorneys' fees), judgments, fines, and amounts paid in settlement actually and reasonably incurred by him in connection with such action, suit, or proceeding, including any appeal thereof, *if he acted in good faith and in a manner he reasonably believed to be in, or not opposed to, the best interests of the corporation* and, with respect to any criminal action or proceeding, had no reasonable cause to believe his conduct was unlawful. The termination of any action, suit, or proceeding by judgment, order, settlement, or conviction or upon a plea of nolo contendere or its equivalent shall not, of itself, create a presumption that the person did not act in good faith and in a manner which he reasonably believed to be in, or not opposed to, the best interests of the corporation or, with respect to any criminal action or proceeding, had reasonable cause to believe that his conduct was unlawful.

trophic losses if the officer/trustee cannot satisfy a court order that he compensate the plan for his fiduciary breach.

VII. Conclusion

In a statement before the Subcommittee on Labor, United States Representative John Erlenborn of Illinois referred to ERISA as "the subject of derision, inasmuch as the acronym has come to stand for 'Every Ridiculous Idea Since Adam.'"¹⁶³ It is apparent that Section 408(c)(3)'s provision that allows an officer of a corporation to act as a trustee over that company's pension plan adds impetus to Representative Erlenborn's statement.¹⁶⁴ As the cases reviewed in this note demonstrate, it is often impractical to allow an officer with loyalties divided between the goals of his corporation and the interests of the plan participants open access to a highly liquid source of capital. Specifically, section 404 requires that an officer/trustee set aside his daily corporate obligations (that often include his own job security)¹⁶⁵ and abide by common-law trust prudence standards.¹⁶⁶

Additionally, the trustee cannot gauge his investment decisions with only one uniform standard of conduct. As the "adequate consideration" standard is based upon prudence,¹⁶⁷ it fails to provide one consistent regulatory standard to measure the trustee's investment decisions. Confronted with case precedent and the Department of Labor's diversification standards, the officer/trustee is left with a mass of conflicting standards.

The Department of Labor proposes that a officer/trustee resign his administration upon discovery of possible "self-dealing" circum-

Id. (emphasis added).

Thus, in Florida, if the officer/trustee acts in "good faith" by administering the plan in the "best interests" of the corporation, he may be indemnified for the resultant loss to plan participants. However, the Florida Act has no provision for the corporate indemnification of officer/trustee's "bad faith" breach.

163. Retirement Income Incentives Act of 1981: Hearings on S. 1541 Before the Senate Sub. Comm. on Labor of the Sen. Comm. on Human Resources, 97 Cong., 1 Sess. 846-54 (1982)(statement by U.S. Representative John Erlenborn).

164. Section 1108(c)(3) adds impetus to Representative Erlenborn's statement, as it allows an officer/trustee access to a position where he will surely encounter conflicts of interest that could threaten plan asset security.

165. See *supra* note 136.

166. See ERISA § 404, 29 U.S.C. § 1104 (1982).

167. Compare § 1104 with § 1108(e).

stances.¹⁶⁸ Though this suggestion might avoid fiduciary breach, it is based on the unrealistic supposition that an officer/trustee can recognize situations constituting conflicts of interest. While the judiciary can adopt a uniform "arbitrary and capricious" standard of review to determine whether an officer/trustee actually breached his fiduciary duties, it is a post facto solution.

The best solution available to Congress is to repeal section 408(c)(3) and disallow an officer of the corporation from acting in a dual capacity as an ERISA trustee. In its place, Congress should enact a substitute section that provides for a two-tiered investment counseling requirement. All ERISA plans with assets over \$2,550,000 must employ the services of an ERISA investment manager,¹⁶⁹ while those plans with assets below this mark need not abide by this requirement. As in *Bendix v. Martin Marietta*,¹⁷⁰ such a plan manager will be able to administer plan assets independent of ongoing corporate activity, thereby eliminating the difficulties inherent in allowing an officer access over the administration of an ERISA pension plan. Nevertheless an

168. See *Leigh*, 727 F.2d at 132.

169. This \$2,550,000 allowance is determined by: \$17,000 [I.R.S. Employer/Employee Joint Contribution Allowance to Individual Retirement Account] x 150 employees (average number of employees based upon U.S. Census Report on Employer Benefits in Medium and Large Firms). See I.R.C. §§ 219(a), (b)(1) and (b)(2); 1371(a)(3) (1985). STATISTICAL ABSTRACT OF THE UNITED STATES, 437, (104th ed. 1984). ERISA defines an investment manager as:

any fiduciary (other than a trustee or named fiduciary, as defined in § 1102(a)(2) of this title) —

(A) who has the power to manage, acquire, or dispose of any asset of a plan;

(B) who is (i) registered as an investment adviser under the Investment Advisers Act of 1940; (ii) is a bank, as defined in that Act; or (iii) is an insurance company qualified to perform services described in subparagraph (A) under the laws of more than one State; and

(C) has acknowledged in writing that he is a fiduciary with respect to the plan.

ERISA § 3(38), 29 U.S.C. § 1002(38) (1982). See also Shilling, *The CFO's Potential Fiduciary Liability under ERISA*, CFO., March 1985, at 65-6. A CFO (Chief Financial Officer) who names an ERISA investment manager to administer plan assets may be liable to plan participants or their beneficiaries for fiduciary breach if: "(1) the CFO participates in or conceals a breach of fiduciary duty; (2) the CFO knows of a breach but does nothing to remedy it; or (3) the CFO's failure to carry out his other duties [i.e. failure to choose the investment manager prudently] made the breach possible." *Id.*

170. See *Wall Street Journal*, Sept. 21, 1982, at 2, col.2.

officer may act as a trustee to plans with assets under \$2,550,000. This allowance is contingent on the stringent requirement that the officer/trustee, upon discovery of a "questionable transaction,"¹⁷¹ seek the advice of an ERISA investment manager. The incentive for this response is a clear exemption from any resultant fiduciary breach or imprudent action that might arise out of the "questionable transaction."

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171. In light of the potential for conflict of interest, this author would define a "questionable transaction" as one that is clearly violative of accepted corporate investment practice; according to Markowitz's portfolio theory, such an investment clearly upsets the balance of risk already maintained in the plan's portfolio. *See generally* Markowitz, *supra* note 7, at 77-91.