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NEW INCURSIONS UNDER ERISA: TAGALONGS TO SECURITIES CLASS ACTIONS AND CASH BALANCE PLAN DISCRIMINATION CLAIMS

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

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Ever creative and resourceful in looking for new ways to secure fee awards, the plaintiff bar has developed two new models for asserting class claims under ERISA: tagalong lawsuits to securities litigation and discrimination claims attacking cash balance pension plans. For both models, the law is not fully developed and potential exposure to companies and their directors and officers is unsettled but could be enormous. Consequently, the new claims present sizable risk to fiduciary program insurers as well.

I. <u>SECURITIES TAGALONGS: USING ERISA TO BROADEN SECURITIES</u> EXPOSURE

A new type of class action lawsuit is being filed with growing frequency against directors and officers when the market price of stock in their company drops significantly following the disclosure of surprising adverse information about the company. Historically, such a stock drop would often result in class actions filed on behalf of purchasers of the company's securities for some defined time period prior to the surprising disclosure. Those class actions would allege that the company and its directors and officers named as defendants failed to disclose the adverse information sooner, thereby resulting in the artificial inflation of the market price for the company's securities during the alleged class period. The actions would allege that those who purchased securities at artificially inflated prices suffered damages and are entitled to recover the difference between what they actually paid for the securities and what the market price would have been if full and accurate information had been timely disclosed.

Securities class actions will be filed following a company's surprising announcement of adverse information, particularly when (i) the immediate stock drop following the disclosure of adverse information constitutes more than a 10% decline in the market price of the securities, (ii) the adverse information being disclosed is especially egregious or presumably was known or should have been known by insiders well before the disclosure (e.g., restatement of financial disclosures; dramatic and sudden decline in the company's financial performance or condition; etc.), or (iii) evidence exists that the defendants had the motive and opportunity to artificially inflate the company's stock price (e.g. insider trading; use of company stock to make company acquisitions; sale of company stock in a stock offering).

Although ostensibly brought for the benefit of the injured shareholders, securities class actions frequently are instigated and prosecuted primarily by and for the benefit of the plaintiff lawyers. As a result of the Private Securities Litigation Reform Act of 1995, more and more of these securities class action lawsuits are being handled (and effectively controlled) by a small group of sophisticated and highly experienced plaintiff law firms, which are routinely retained as lead counsel by institutional investors serving as lead counsel. Plaintiff firms without institutional clients are shut out of the lucrative lead counsel role. This dynamic has caused some of those plaintiff law firms to explore alternative means to recover large settlements in some type of class action lawsuit following a significant drop in a company's stock price, and thus recover large fee awards.

A favorite new type of class action lawsuit now being filed by plaintiff law firms shut out of major securities litigation is brought under ERISA. Primarily beginning with the Enron

debacle, these class actions are brought on behalf of participants and beneficiaries of a company's retirement plans to the extent those plans own securities of the company. The complaints in these class actions contain the same factual allegations as set forth in the securities class action lawsuits (i.e., the defendants misrepresented or failed to disclose certain material information about the company or its financial performance or condition). Instead of alleging those misrepresentations or omissions constitute a violation of the securities laws, however, the new lawsuits allege the defendants breached their fiduciary duties under ERISA. As a result of the breaches, the plan participants and beneficiaries allegedly were allowed or induced to invest or maintain their plan assets in company stock at artificially high prices, or otherwise suffered loss because their plan assets were invested in overpriced or ill-advised securities.

The claims asserted in these so-called tagalong class actions are summarized as follows:

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

These ERISA tagalong class action lawsuits are sufficiently new that a meaningful body of case law is not yet developed addressing the propriety of the underlying legal theories. On their surface, however, these lawsuits, which typically name as defendants senior officers and the board of directors of the company as well as other designated plan fiduciaries, raise several concerns for the defendants. First, the definition of eligible class members in the ERISA class action is broader than the definition of class members in the securities class action. Whereas the securities class is limited to purchasers of securities during the designated class period, the ERISA class action is on behalf of all plan participants or beneficiaries who held or invested in the company's securities through their retirement plan during the class period. In other words, persons who simply held company securities in their retirement account, and who made no direct investment decision regarding those securities, may be a member of the ERISA class, but would be excluded from the securities class. Although participants and beneficiaries who purchased company securities during the class period could be a class member in both the ERISA and

securities class actions (thus rendering the ERISA class action somewhat duplicative), the ERISA class action will include a potentially large number of additional plaintiffs in its class.

Second, securities claims under Section 10(b) of the Securities Exchange Act of 1934 require plaintiffs to prove the defendants acted with scienter (i.e., with intent to deceive or reckless behavior), whereas claims for breach of fiduciary duty under ERISA may require a lower threshold similar to negligence. Pleading standards for an ERISA action may also be more relaxed. Plaintiffs may therefore be able to more easily establish liability in the ERISA class action (or survive a motion to dismiss) than in the securities class action.

Defendants in the ERISA class action do have several intriguing and potentially persuasive defenses unique to the ERISA class action claims, which have not yet been fully explored by courts in the context of an ERISA tagalong class action lawsuit.

- Who is an ERISA Fiduciary? The ERISA tagalong class actions seek to expand the definition of an ERISA fiduciary to include corporate directors and officers not otherwise responsible for the management of plan assets. Traditionally, courts have recognized a person as a fiduciary under ERISA only to the extent the person exercises discretionary authority or control in connection with managing or administering an ERISA plan, providing investment advice for the plan, or investing plan assets. In addition, such a fiduciary is generally treated as a fiduciary only to the extent of the plan function over which the person exercises authority or control. In other words, a plan trustee is not automatically liable as a fiduciary for decisions involving plan administration, absent an express designation of such authority or his exercising discretion or control over those functions. Thus, under pre-existing authority, it is doubtful that a director or officer who does not have express discretionary authority or control with respect to plan investments and does not in fact exercise such authority or control, would be treated as an ERISA fiduciary and subject to ERISA fiduciary duties. However, most ERISA tagalong class actions seek to impose such duties upon directors and officers who do not have or exercise such authority or control. In recent decisions involving Williams Co. and WorldCom, Inc., courts ruled that directors are not ERISA fiduciaries simply because they appoint fiduciaries. As a result, the courts found the directors did not have a duty to monitor the appointed fiduciaries. However, a recent decision in the Enron tag-along cases found directors to be fiduciaries and to have such a duty to monitor the appointed fiduciaries. The Department of Labor supports these rulings from the Enron case.
- <u>Does ERISA Apply to Matters Regulated by the Securities Laws</u>? For more than 70 years, the federal securities laws have regulated matters relating to the purchase and sale of securities, with the goal of assuring that all affected parties have the benefit of accurate and complete information in order to make an informed investment decision. ERISA, on the other hand, traditionally has been viewed as establishing only four general standards of conduct for fiduciaries (i.e., the duty of loyalty to act for the exclusive benefit of the plan and its participants;

the duty of prudence to act reasonably with respect to plan matters; the duty to diversify plan assets; and the duty to follow the terms of plan documents consistent with the other three duties). If the ERISA tagalong class actions are successful in imposing upon fiduciaries the duty to disclose complete and accurate information about the company's securities or to preclude participants from investing in company securities under certain circumstances, new and unprecedented duties for ERISA fiduciaries would be created. Although defendants have argued such a result is inconsistent with the long-standing securities regulation scheme, courts to date have rejected defendants' arguments.

- Are Directors and Officers Acting in a Corporate or ERISA Fiduciary Capacity? Traditionally, courts have recognized that a company and its directors and officers can take actions in the ordinary course of business which may adversely affect ERISA plans without creating liability exposure (e.g., terminate or amend plans). When directors and officers who have no fiduciary responsibility for investment of plan assets make disclosures of allegedly false or misleading information to employees, shareholders or the public, such conduct arguably is not taken in their capacity as an ERISA fiduciary, but is in their "settlor" capacity in conducting the affairs of the company. Again, if the ERISA tagalong class actions are successful in creating ERISA liability for such disclosures on behalf of the company, existing ERISA liability exposure would be significantly expanded. Courts to date appear to be endorsing that broader capacity concept.
- What are Directors and Officers Expected to do if they Discover Adverse Material Nonpublic Information? If upon learning of nonpublic adverse information directors and officers quickly disclose the information and sell the company stock held in the plans, the company's stock price would undoubtedly drop significantly given the large number of company shares usually held in plan accounts. Such a dramatic collapse in the stock price would likely constitute an overreaction to the adverse information and thus unnecessarily penalize plan participants and other shareholders. In addition, if the directors and officers "quietly" begin divesting company stock held in plan accounts without publicly disclosing the adverse information, they would be trading while in possession of material nonpublic information and thus would likely violate the insider trading laws. Stated differently, the underlying premise of the ERISA tagalong class actions, if supported by courts, would place directors and officers in an impossible dilemma that could result in excessive and unnecessary losses to plan participants and beneficiaries. Notwithstanding these defense arguments, courts to date have required such disclosure of nonpublic information by ERISA fiduciaries and have ignored the practical and securities laws implications from such disclosure.

In summary, the ERISA tagalong class actions present difficult issues for courts to analyze. It will likely be a number of years before a sufficient body of case law definitively addresses these various issues, although plaintiffs are frequently prevailing in the initial decisions being rendered. Depending upon how courts ultimately resolve those issues, directors

and officers may now be facing yet another potentially catastrophic exposure when companies disclose surprising adverse information.

While the courts decide the legal viability of the ERISA tagalong claims, the financial exposure to directors and officers remains very real. As with securities class actions, companies and their directors and officers often prefer to settle rather than risk a potentially debilitating judgment. Although often smaller than the settlement in the related securities litigations (possibly because of insurance limits), settlements of ERISA tagalong actions have been substantial:

•	Enron	\$85 million
•	Global Crossing	\$79 million
•	Lucent	\$69 million
•	WorldCom	\$51 million
•	Dynegy	\$30.8 million

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

A. Loss Prevention

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

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

difficulty proving all of these requirements were met. For example, in the Enron ERISA tagalong litigation, the court found that Enron's plan failed to satisfy <u>any</u> of these four requirements.

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

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

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

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

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

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

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

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

Frequently, ERISA tagalong claims name as defendants not only the plan's named fiduciaries, but also other directors, officers and human resources personnel of the plan sponsor, as well as investment and administrative committee members. To avoid individuals being inadvertently subjected to ERISA fiduciary duties, the company and the plan should tightly control the number of people who become

involved in plan matters, and the responsibilities for each such person should be well defined and understood. In addition, the plan sponsor should not be a named fiduciary, or if it is a named fiduciary, the board of directors should expressly delegate the company's fiduciary responsibility to an individual or group of individuals. Otherwise, the directors may be liable for improperly discharging the company's ERISA fiduciary duties.

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

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

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

7. Encourage Diversification of Investments. Consistent with sound investment concepts, company management and plan fiduciaries should encourage participants to diversify their investments and not include within their investment portfolio an unreasonably large percentage of company stock. An excessive concentration of an employee's investment portfolio in company stock can not only create unnecessary investment risk and engender tagalong claims, but may motivate employees to act inappropriately in order to artificially maintain or increase the company's stock price.

8. <u>Eliminate Company Stock in Plan</u>. There are clearly benefits to employees owning stock in the company, thereby aligning their interests with outside investors. However, as demonstrated by the recent waive of ERISA tagalong claims, such a practice creates inherent and potentially large litigation risks. As a result, some companies are eliminating company stock as an authorized investment option and as the employer's matching contribution under plans. This is unquestionably the safest strategy from a risk management perspective.

B. Insurance Issues

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

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

limits endorsement is not required by the insurer, a potentially difficult allocation of loss between the two types of policies will likely be required if defense costs or any settlement amount are covered in part under both policies.

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

C. <u>Indemnification</u>

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

As a general rule, a sponsoring company may indemnify its ERISA fiduciaries in most instances. However, under federal and state law, the availability of that indemnification is less predictable than the indemnification of directors and officers for non-ERISA matters. As a result, it appears unlikely fiduciary coverage for only non-indemnifiable loss will be as widely

available as D&O Side-A only coverage. The following summarizes many of the indemnification issues unique to ERISA fiduciaries.

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

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

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

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

Another district court questioned the ability of an ESOP sponsor to indemnify the ESOP's fiduciaries under any circumstances, reasoning that such indemnification by the company was to the detriment of the company's owner, the ESOP.

<u>Donovan v. Cunningham</u>, 541 F. Supp. 276, 289 (S.D. Tex. 1982), <u>aff'd in part and rev'd in part on other grounds</u>, 716 F.2d 1455 (5th Cir. 1983), <u>cert. denied</u>,

467 U.S. 1251 (1984). <u>See</u> Horahan and Hennessy, 365-2nd T.M., <u>ERISA</u> – <u>Fiduciary Responsibility and Prohibited Transactions</u> at A-67 - 68.

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

2. <u>State Indemnification Provisions</u>. A sponsor company's indemnification of plan fiduciaries is also subject to the indemnification statute in the state in which the company is incorporated.

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

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

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

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

- of the corporation¹). In addition, indemnification will not be available if the corporation is financially unable to fund the indemnification.
- 3. <u>Indemnification Planning</u>. Based on the foregoing, corporations should examine the following primary issues when evaluating the quality of indemnification protection for its ERISA fiduciaries:
 - a. Review the applicable state indemnification statute to determine if an ERISA fiduciary must be serving at the request of the company in order to be indemnified. If so, be sure any person intended to be protected is clearly serving at the written request of the corporation as plan fiduciaries.
 - b. Review the applicable state indemnification statute and internal indemnification provision of the corporation to confirm that the corporation is <u>obligated</u> to indemnify all of the persons intended to be protected without any material restrictions on that indemnification.
 - c. Consider whether the terms of the indemnification provisions may create public policy concerns similar to those expressed by the cases summarized above. For example, such public policy concerns are more likely to arise with respect to ESOP fiduciaries.
 - d. The internal indemnification provision should mandate indemnification "to the fullest extent permitted by law" in order to increase the possibility that indemnification will be available in suits by or on behalf of the sponsoring corporation.

II. CASH BALANCE PLAN DISCRIMINATION CLAIMS

As companies continually strain to maximize profits, opportunities to contain employee costs understandably are attractive to management. For many companies, such costs are one of the largest category of operating expenses. Any program that can successfully reduce employee costs without jeopardizing the company's ability to attract and retain quality employees will be attractive to the company.

In the last several years, companies have adopted one such program with increasing frequency: cash balance pension plans. The plans can result in enormous cost savings for the company and can also be financially beneficial to at least some employees under some circumstances. However, the plans can create potentially large D&O, employment practices and fiduciary liability exposures that are only now beginning to come into focus. The following discussion summarizes those exposures and possible insurance ramifications relating to those exposures.

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¹ In some instances, the ERISA fiduciary is required to take actions which are arguably not in the best interests of the sponsor corporation, such as collecting amounts owed by the sponsor corporation to the plan. In those instances, a question may arise whether this statutory standard of conduct was satisfied by the plan fiduciary.

Cash balance pension plans usually result from a company's conversion of its traditional defined benefit plan. Under a traditional defined benefit plan, an employee's benefits are determined, among other things, based on the employee's years of service and the employee's average compensation in his/her final years of employment. Under a cash balance plan, an employee's benefits equal a defined percentage of the employee's actual compensation for each year of service plus imputed interest.

Because traditional defined benefit plans focus primarily on the level of compensation in the years just before retirement (which frequently is relatively high compared to prior levels of compensation for the employee), the retirement benefit grows much more rapidly in the later years -- i.e., the rate of benefit growth is "back-loaded" as compared to a benefit under a cash balance plan. Consequently, when a traditional defined benefit plan is converted to a cash balance plan, an older worker will often see a lower rate of benefit growth after the conversion and will also see a lower final retirement benefit than if the plan conversion had not taken place. Some critics say the pensions of workers in their 40's, 50's or 60's could be reduced between 20% to 50% as the result of a conversion to a cash balance plan. Corporations prefer the new cash balance plans for a number of reasons. On the one hand they are more attractive to younger and more mobile employees. On the other hand, because of the reduction in benefit growth for older workers, the conversion can result in an overall cost savings to the employer which can be quite significant.

The conversion from a traditional defined benefit plan to a cash balance plan may subject companies and plan fiduciaries to potential exposure under several legal theories, including the Age Discrimination in Employment Act (ADEA) and the Employee Retirement Income Security Act (ERISA). An employer may face liability exposure under the ADEA if benefits to older workers are lower under the new plan than under the old plan. One federal circuit court has held that an inference of age bias can be inferred under the ADEA if a company's new cash balance plan provides lower benefits to older workers than the company's existing defined benefit plan. Goldman v. First National Bank of Boston, 985 F.2d 1113 (1st Cir. 1993).

Under ERISA, employees adversely affected by a conversion likely will allege that the company and other plan fiduciaries breached their fiduciary duty to the employees by reducing accrued benefits or by failing to accurately disclose the allegedly adverse impact the change would have on older workers. The mere act of converting to a cash balance plan, though, should not subject the company to exposure under the fiduciary duty provisions of ERISA since the act of amending a pension plan is a corporate act as an employer, not a fiduciary act for the benefit of plan participants. Employers are generally free to adopt, modify or terminate employee benefit plans for any reason at any time. However, ERISA liability may still exist if the conversion decreases vested accrued benefits or if disclosures relating to the conversion are inaccurate or misleading.

Two important decisions in 2003 held that cash balance plans violated ERISA. In one case involving IBM's cash balance plan, <u>Cooper v. IBM Personal Pension Plan</u>, 274 F. Supp. 2d 1010 (S.D. Ill. 2003), the U.S. District Court for the Southern District of Illinois concluded that the IBM cash balance plan violated ERISA's age discrimination prohibition. The court was

particularly critical of IBM's decision to adopt the plan even though IBM was apparently aware of the plan's ERISA deficiencies: "IBM, like many other corporate plan sponsors, proceeded with open eyes and was fully informed of the consequences of the litigation that was sure to come." The next day, the Seventh Circuit Court of Appeals ruled in <u>Berger v. Xerox Corp.</u>

Retirement Income Guaranty Plan, 338 F.3d 755 (7th Cir. 2003) that the Xerox cash balance plan also violated ERISA since the plan calculated participants' lump sum distributions in amounts less than the present value of their normal retirement benefits.

Although relatively few claims have arisen to date relating to a conversion to a cash benefit plan, it is likely more such claims will be made in the future as more companies make this conversion. Because older workers are likely to be harmed in most such conversions, it is relatively easy for a plaintiff to at least allege a persuasive and sympathetic claim for wrongdoing.

From an insurance standpoint, a claim arising out of a company's conversion to a cash balance plan can potentially implicate ERISA fiduciary coverage, employment practices coverage and D&O coverage, depending on the legal theories and defendants named in the claim. Because each of these coverages frequently have significantly different retentions, limits and exclusions, significantly different coverage exists depending on how the claimant chooses to structure the claim. For example, the fiduciary coverage contains a "benefits due" exclusion which may eliminate coverage for that portion of a settlement or judgment constituting benefits due under a plan, whereas the employment practices and D&O coverages do not contain such an exclusion. For example, the fiduciary coverage contains a "benefits due" exclusion which may eliminate coverage for that portion of a settlement or judgment constituting benefits due under a plan, whereas the D&O coverage and perhaps the EPL coverage do not contain such an exclusion. In addition, a single "cash balance" claim may implicate several types of policies, thereby creating difficult allocation issues between policies and the potential for multiple retentions and multiple limits applying.