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The dilemma of the small plan fiduciary under ERISA

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One of the dramatic changes in the area of employee benefit plans created by the passage of the federal Employee Retirement Income Security Act of 19741 was the imposition of express statutory standards especially governing the conduct of employee benefit plan "fiduciaries."2 It has been widely assumed that these new standards represent a strict departure from the traditional, common law rules governing trust fiduciaries. Moreover, publicity has increased the awareness of these standards by potential litigants. As a result, fiduciaries would be wise to reexamine their conduct in light of the increased liability risks.

The basic statutory rules of conduct for plan fiduciaries are stated only in the most general terms in section 404(a) of the Act.3 Unfortunately, in the more than five years that have elapsed since the passage of ERISA, despite much unofficial speculation, little official direction has emerged to clarify those standards. Neither judicial rulings,4 nor regulations from the United States Department of Labor,5 which is charged with the responsibility of administering the fiduciary standards of ERISA,6 have allayed the fiduciaries' concerns.

The problem is particularly acute with respect to the small, single-

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2. The standards are found in 29 U.S.C. § 1104(a) (1976). "Fiduciaries," under the Act, is a category generally including all individuals responsible for the administration of benefit plans and the disposition of plan funds. Id. § 1002(21)(A).

3. Section 404(a) of ERISA provides in pertinent part:

a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and—

(B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudential 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.

Id. § 1104(a)(1) (emphasis added).

4. See text accompanying notes 75-78 infra.

5. The most recent regulations attempting to clarify the standards became effective July 23, 1979. See 29 C.F.R. § 2550.404a-1 to .414c-4 (1979).

employer retirement plan fiduciary, who typically has neither the resources nor the experience normally associated with the institutional or professional plan trustee or administrator. Consider the example of a single-employer defined contribution (individual account) retirement plan, such as a small profit-sharing plan. Here, typically, administrators and/or trustees of such plans are drawn from the executives and/or owners of the employer sponsoring the plan. Such a single-employer, defined contribution plan fiduciary charged with the responsibility of managing plan assets is likely to have the greatest potential risk exposure. The benefits to be derived by the participants are not determined by a pre-set formula where the employer makes contributions according to periodic, actuarial determinations. Rather, benefits are solely dependent upon the size of the participants' individual accounts. Because individual plan participants or beneficiaries may exercise their right under ERISA to bring a federal lawsuit to enforce the fiduciary standards or the terms of the plan, enjoin violations thereof, or obtain other relief, the risk that dwindling account balances or less than satisfactory account growth experience could trigger litigation by disgruntled participants is readily apparent. Such litigation could result in personal liability for the fiduciary, and exculpatory provisions in plan documents are deemed void.

This article will analyze the basic standards of fiduciary duty under ERISA and discuss the few guidelines which have emerged to interpret the statute. In addition, some possible solutions suited to the needs of fiduciaries of small retirement plans will be suggested, particu-

7. The term "individual account plan" or "defined contribution plan" means a pension plan which provides for an individual account for each participant and for benefits based solely upon the amount contributed to the participant's account, and any income, expenses, gains, and losses, and any forfeitures of accounts of other participants which may be allocated to such participant's account. 29 U.S.C. § 1321 (1976).
8. 29 U.S.C. § 1132 (1976). The Secretary of Labor may bring suit as well. Id.
9. Section 409(a) of ERISA provides, in pertinent part:
   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, and to restore to such plan any profits of such fiduciary which have been made through use of assets of the plan by the fiduciary, and shall be subject to such other equitable or remedial relief as the court may deem appropriate, including removal of such fiduciary.
10. Section 410(a) of ERISA provides:
   Except as provided in sections 405(b)(1) and 405(d) [relating to specific allocation or delegation of fiduciary duties], any provision in an agreement or instrument which purports to relieve a fiduciary from responsibility or liability for any responsibility, obligation, or duty under this part shall be void as against public policy.
   Id. § 1110(a).
larly those designed to invest in employer stock.11

THE "SOLE INTEREST" TEST

The "sole interest" requirement under ERISA mandates that a fiduciary discharge his duties solely in the interest of the participants and beneficiaries.12 While the provision appears straightforward, applied literally, the section poses problems for the plan fiduciary.

For example, consider the trustee or administrator who wears "two hats"—simultaneously serving as a fiduciary and a full-time officer, director, or other agent of the employer who sponsors the plan.13 The same may be true where the status as plan fiduciary is less formal, such as where the administrator is subject to the direction of the employer, officers, and/or directors.

It is well-established that corporate directors stand in a fiduciary relationship to the corporation and its shareholders.14 Moreover, where an eligible individual account plan is itself a major shareholder of the employer, the plan itself, as shareholder, and those who administer it may be considered to bear a fiduciary duty towards the corpora-

11. The leading appellate case to date applying ERISA’s fiduciary rules involved a small plan designed to hold employer securities. See Eaves v. Penn, 587 F.2d 453 (10th Cir. 1978), discussed in text accompanying notes 75-78 infra. See also Marshall v. Kelly, 465 F. Supp. 341 (W.D. Okla. 1978) (also involved a small plan and claims of naked self-dealing by the employer).

12. 29 U.S.C. § 1104(a)(1) (1976). It should be noted that the “sole interest” test applies independently of the prudence requirement which is discussed in the text accompanying notes 29-60 infra. See Hutchinson, Prudent Pension Investments Evaluated by "Whole Portfolio," NAT’L L.J. 23, 29 (June 26, 1979) [hereinafter referred to as Hutchinson].

We do not discuss herein the ramifications of the "exclusive purpose" or "exclusive benefit" test, which appears to have been fairly narrowly defined, especially as it pertains to those plans which are designed to invest primarily in employer securities. See S. Rep. No. 1090, 93d Cong., 2d Sess. 302 (1974) [hereinafter referred to as Report] which states that satisfaction of the ERISA prudence requirement will satisfy the pre-existing, exclusive-benefit rules of the Internal Revenue Service; Foley & Sussman, The Tax Aspects of Employee Stock Ownership Plans: The Internal Revenue Service’s Proposed Regulations, 26 AM. U.L. REV. 593, 597 (1977) [hereinafter referred to as Symposium]; Little & Thrallkill, Fiduciaries Under ERISA: A Narrow Path to Tread, 30 VAND. L. REV. 1, 11-12 (1977) [hereinafter referred to as Little & Thrallkill]; Note, Fiduciary Standards and the Prudent Man Rule Under the Employment [sic] Retirement Income Security Act of 1974, 88 HARV. L. REV. 960, 966 (1975) [hereinafter referred to as Note].

13. Section 408(c)(3) of ERISA exempts such dual role functions from the “prohibited transaction” provisions of section 406 of ERISA. 29 U.S.C. § 1108(c)(3) (1976). Persons who receive full-time pay from the sponsoring employer may be paid no compensation but only expenses by the plan. Id. § 1108(c)(2). “For example, the plan could provide that the investment committee is to consist of the persons who serve as the president, vice-president for finance, and comptroller of the employer.” Report, supra note 12, at 298. See also Curren v. Freitag, 432 F. Supp. 668 (S.D. Ill. 1977), where the court held that a fund trustee could simultaneously serve as employer’s director of labor relations and could counsel employer in pension matters.

tion and the shareholders. The following not uncommon situation will serve to illustrate a series of potential conflicts.

Assume that a small corporate employer maintains an eligible individual account retirement plan. The plan, like most small profit-sharing plans, is administered by a small committee designated by the employer's board of directors. The plan assets are held in trust by a bank as trustee, pursuant to a trust agreement. The trustee is subject to the direction of the administrator, and either or both of these fiduciaries are subject to the investment direction of the board of directors who, more often than not, are the individuals in the corporation with the most expertise in investment and fiscal policymaking. Assume also that the plan, an eligible individual account plan, is the largest shareholder of the employer.

Consider the consequences for the plan fiduciaries when an outside corporation attempts a take-over. Each member of the board of directors of the corporation to be acquired has responsibilities in several potentially different directions. If, for example, the take-over bid presents an opportunity for the then current shareholders to profit substantially from the sale of their stock, and the directors resist the bid, all the shareholders, including the plan and its participants, could maintain that the directors acted wrongly, out of self-interest, for their own survival, or in some other way, and thus failed in their duty to the shareholders. On the other hand, if the acquiring corporation had indicated its intention to drastically restructure the to-be-acquired cor-

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16. Section 403(a) of ERISA generally requires plan assets to be held in formal trust, with a few exceptions. 29 U.S.C. § 1103(a) (1976).
17. Section 407(a) of ERISA generally prohibits plans from holding or acquiring employer securities or real property to the extent that the aggregate fair market value thereof exceeds ten percent of the fair market value of the plan's assets. The prohibition is subject to delayed effective dates to allow gradual divestiture down to the limit by pre-existing plans. 29 U.S.C. § 1107(a) (1976). Section 407(b), however, has the effect of exempting "eligible individual account plans" from the ten percent limitation, and section 408(e) exempts such acquisitions for such plans from the "prohibited transaction" rules of sections 406 and 407 provided that certain conditions are met. Id. §§ 1107(b), 1108(e). Section 407(d)(3)(A) defines "eligible individual account plan" to include profit-sharing, stock bonus, thrift, or savings plans, ESOPs and money purchase plans in existence when ERISA became law (Sept. 2, 1974), and which on said date invested "primarily" in qualifying employer securities. Id. § 1107(d)(3)(A). Section 407(d)(3)(B), however, requires that such plans must "explicitly" provide for acquisition and holding of qualifying employer securities or real property to qualify for the exemption. Id. § 1107(d)(3)(B).
18. Depending upon the circumstances, the directors may also have to consider securities law or antitrust implications. See, e.g., Graham v. Allis-Chalmers Mfg. Co., 41 Del. Ch. 78, 188 A.2d 125 (1963).
19. Conversely, acceptance of such a bid under highly suspicious and/or inadequately investigated circumstances—as amid indications of a "looting" attempt—could result in similar liability. See, e.g., Insuranshares Corp. v. Northern Fiscal Corp., 35 F. Supp. 22 (E.D. Pa. 1940).
portion once it obtained control, resulting in substantial permanent layoffs of employees, and/or to discontinue the retirement plan, to accept the take-over bid could breach the duty owed to the plan's participant-employees by the directors as plan fiduciaries. And, this duty, it could be argued, includes assuring, so far as feasible, the indefinite continued existence and viability of the plan and its source of funding so as to enable it to fulfill its function of providing financially secure retirement benefits for the participants and avoiding unnecessary forfeitures. It could also be argued that by accepting such a bid, or directing the administrators or trustees to accept such a bid, the directors might be violating another ERISA section which prohibits plan fiduciaries from acting "on behalf of a party," such as other shareholders or the second corporation, "whose interests are adverse to the interests of the plan or the interests of its participants. . . ."21

A literal application of the sole interest test would leave the plan fiduciaries in a take-over situation with unpalatable alternatives. They could either ignore their sole interest duties with respect to the plan or ignore their common law duties as corporate or shareholder fiduciaries, and assume the risk of resulting violations, viewing and acting upon the matter solely from the point of view of the plan participants—to the possible damage of other shareholders. Clearly, this anomalous approach cannot be condoned since one law should not be applied so as to require an individual to break another law.

It must also be noted that the fiduciary in this situation does not even have the option of resigning or refusing to act in either his capacity as plan fiduciary or of corporate director in order to avoid the dilemma.22 Even if this were a feasible option, an "omission to act" such as a resignation is, nevertheless, a decision with real, foreseeable conse-
quences. Moreover, to require such a decision could intensify rather than ease the problem, for it could deprive one or more parties owed a fiduciary duty of irreplaceable usable knowledge and expertise despite the express congressional "two-hat loophole" contained in section 408(c)(3) of ERISA.23 Even the common law recognized that in the absence of bad faith or unreasonable conduct for personal gain, a trustee could hold, in trust, shares of a corporation of which he served as officer or director.24

The above example serves to demonstrate that even in the absence of willful violations, there are instances in which the sole interest test cannot or should not be literally applied for sound policy reasons. In a small plan, there likely will be cases in which it may be relatively clear what an action "solely in the interest of the participants" would be, but in which that action might conflict with or violate another legal or equitable duty owed by the same individuals, and so cannot or should not be required.

The logical and practical conclusion to be reached is that in applying even so seemingly clear a standard as the sole interest test, the courts and agencies charged with the responsibility of interpreting, applying and enforcing ERISA must engage in a balancing approach in cases where the fiduciary owes a duty to competing interests.

In fact, the courts have used an analogous approach in applying the common law pertaining to the conventional trustee who has had to balance the competing interests of the remainderman and income beneficiary. There, the trustee must "make such investments, and only such investments, as a prudent man would make of his own property having in view the preservation of the estate and the amount and regularity of the income to be derived."25 The absence of these particular competing interests simplifies and eases the application of the ERISA rule in assessing the prudence of investments, since there is no longer an urgent need to judge "an investment alone, without regard to its role in the total portfolio."26 However, other competing interests still do exist, and, in the absence of clearer official direction, plan fiduciaries must be

26. Address by Ian D. Lanoff, Administrator of Pension and Welfare Benefit Program, United States Department of Labor, American Bar Association annual meeting, Aug. 10, 1977, printed in (CCH) Pension Plan Guide ¶ 25,177 at 27,342. See also Note, supra note 12, which argues persuasively for the "whole portfolio" approach to the prudent man rule in light of modern investment theory and practice. This approach was later adopted by the United States Department of Labor.
permitted to resolve those interests on an equitable basis; the judiciary and responsible officials should soundly exercise their discretion.

One commentator, mindful of the potential conflict in fiduciary behavior where employee plans hold employer stock, has gone so far as to suggest that the ERISA "prudent man" rule should be modified so as to be applied as follows in the case of an ESOP: "Whatever would be deemed applicable to a regular stockholder under similar circumstances, by direct comparison or analogy." While some may argue that this suggestion goes too far, a case-by-case evolutionary process should allow for similar exceptions. Ultimately, it may be determined that the fiduciary duty under ERISA wholly supplants other competing legal or equitable duties. But corporate vitality and the availability of capital investors serve as the ultimate fountainhead and financial base of the private employee benefit system regulated by ERISA. Thus, the wisdom of a policy selection disfavoring said base is open to question.

It is more sensible to define prospectively the parameters of the sole interest and similar ERISA standards clearly enough to minimize the risk that well-meaning, qualified individuals serving in congressionally-approved dual roles will be penalized retroactively for failure to select properly between competing valid interests. The statute refers only to duties "with respect to a plan." Official interpreters of the statute must recognize that individuals who serve as fiduciaries often necessarily have duties to others as well.

THE "PRUDENT MAN" RULE

Under section 404(a)(1)(B) of ERISA, the "prudent man" rule provides as follows:

A fiduciary shall discharge his duties 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 matters would use in the conduct of an enterprise of a like character and with like aims.

Although the "prudent man" rule can be read to impose a stricter standard of prudence than that required of common law trustees, we suggest that this interpretation is neither required nor itself prudent.

29. Id. § 1104(a)(1)(B).
30. See The Federal Prudent Man Rule Under ERISA, Address by James D. Hutchinson, then Administrator of Pension and Welfare Benefit Program, United States Department of Labor, before the Real Property, Probate and Trust Law Section of the American Bar Association Meet-
The ERISA formulation is not intended to deviate markedly from the accepted common law standard, and at least one commentator has suggested that the courts may in fact justifiably so rule.\textsuperscript{31} As stated by the House and Senate conferees in the Joint Explanatory Statement of the Committee of Conference, the fiduciary standards contained in title I of ERISA "apply rules and remedies similar to those under traditional trust law to govern the conduct of fiduciaries."\textsuperscript{32} Moreover, it is clear from the legislative history that the House and Senate conferees did not intend the "prudent man" standard under ERISA to be any stricter than the common law rules governing trust fiduciaries. Rather, as stated in the joint explanatory statement, "[t]he conferees expect that the courts will interpret this prudent man rule (and the other fiduciary standards) bearing in mind the special nature and purpose of employee benefit plans."\textsuperscript{33}

It must be recognized that this "special nature and purpose" refers to at least two types of employee benefit plans—retirement plans generally and individual kinds of retirement plans. The investment goals and strategies perforce vary with the type of plan involved. Typically, however, fiduciaries responsible for the investment of defined benefit plan assets have tended to a more conservative, fixed-income approach than those responsible for defined contribution plans, in view of the fixed-benefit funding requirements applicable to the former type of plan.\textsuperscript{34}

For a discussion of the common law fiduciary standard of prudence, see the Restatement (Second) of Trusts \textsuperscript{\textsection} 227 (1959); Harvard College v. Amory, 26 Mass. (9 Pick.) 446 (1830) ("All that can be required of a trustee to invest, is, that he shall conduct himself faithfully and exercise a sound discretion. He 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." \textit{Id} at 461); King v. Talbot, 40 N.Y. 76 (1869) ("[T]he just and true rule is, that the trustee is bound to employ such diligence and such prudence in the care and management, as in general, prudent men of discretion and intelligence in such matters, employ in their own like affairs." \textit{Id} at 85-86 (emphasis added)).

\begin{itemize}
  \item \textsuperscript{31} See Note, \textit{supra} note 12, at 966.
  \item \textsuperscript{32} See Report, \textit{supra} note 12, at 295.
  \item \textsuperscript{33} \textit{Id} at 302 (emphasis added). See also Little & Thrailkill, \textit{supra} note 12, at 12-13 which found a dual standard for small and large plans in the legislative history, \textit{citing} Klevan, Fiduciary Responsibility Under ERISA's Prudent Man Rule: What are the Guideposts?, 44 \textit{J. Tax.} 152 (1976) [hereinafter referred to as Klevan], which contains an excellent summary of the "prudent expert" debate.
  \item \textsuperscript{34} 29 U.S.C. \textsection 1082 (1976). A "defined benefit" plan is typically one wherein a formula or level of benefits is clearly stated and the employer is responsible for contributing those sums which have been actuarially determined to provide sufficient funds to pay said benefits when such become payable, with due regard for amortization of unfunded past service liability and experience losses. \textit{See id.} \textsection 1002(35) (1976).
Recently issued final regulations of the United States Department of Labor appear to be broadly designed to take account of the considerations affecting fiduciary investment duties. The regulations purport to provide a "safe harbor" investment approach for fiduciaries to follow, although this is not meant to be an exclusive path to prudence. In adopting the regulations, the Department of Labor rejected suggestions that interpretation be left entirely to the courts, or that interpretation by regulation was impractical. The new regulations encourage a "portfolio-wide" approach to assessing the prudence of plan investments, and are designed, in part, to avoid complete discouragement of investments in small or new companies by permitting risk distribution. The regulations emphasize that the prudence requirement is met with respect to an investment or investment course of action if:

[T]he fiduciary . . . 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 the 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 . . . has acted accordingly.

Additionally, the following observations made by the Department of Labor in the preamble to the regulations could be of special importance to fiduciaries of small plans that hold employer stock:

1. The preamble states that the regulations "[do] not purport to impose any additional requirements or constraints upon plan

35. 44 Fed. Reg. 37,221-37,225 (1979) (to be codified in 29 C.F.R. § 2550.404a-1 (1979)).
36. 44 Fed. Reg. at 37,222; Hutchinson, supra note 12, at 23.
37. 44 Fed. Reg. at 37,222.
38. Id.
39. See 44 Fed. Reg. at 37,222 (1979). Such concerns could be crucial to the accumulation of capital for such companies, given the large portion of available capital that institutional investors control.
40. 29 C.F.R. § 2520.404a-1(b)(1) (1979). The regulations further provide:

For purposes of paragraph (1) of this subsection, 'appropriate consideration' shall include, but is not necessarily limited to, (A) a determination by the fiduciary that the particular investment or investment course of action is reasonably designed, as part of the portfolio (or, where applicable, that portion of the plan portfolio with respect to which the fiduciary has investment duties), to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain (or other return) associated with the investment or investment course of action, and (B) consideration of the following factors as they relate to such portion of the portfolio:

(i) The composition of the portfolio with regard to diversification;
(ii) the liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan; and
(iii) the projected return of the portfolio relative to the funding objectives of the plan.

Id. § 2520.404a-1(b)(2).
fiduciaries."41 Rather, they provide only "a manner of satisfying the requirements of the 'prudence' rule."42 Thus, it would appear that the regulations are to be flexibly applied in order to accommodate the exigencies of smaller plans.

2. Although "all" relevant facts and circumstances must be considered, the regulations provide that a fiduciary need not "expend unreasonable efforts"43 or "consider matters outside the scope of [his] duties,"44 as where investment responsibilities are divided, delegated or allocated. Here again it would appear that there is to be an accommodation for the inherent limitations of small plan fiduciaries.

3. The regulations "[do] not provide . . . that the assets of a pooled investment fund may be invested . . . without . . . consideration"45 of "the particular needs of any individual plan that has an interest in the fund."46 However, the regulations further specify that the investments in index funds, if in accordance with general plan objectives and if properly screened, generally will be deemed "prudent."47

4. Previous consideration of relevant factors will not necessarily "immunize" subsequent investment decisions.48 Concern over the prudence of investments, therefore, must be a continuing process.

5. "Diversification," according to the regulations, means "a mechanism for reducing the risk of large losses."49 The Department of Labor, however, expressly declined to clarify or define "diversification" any further.50

6. While the characteristics of individual investments must be considered, the regulations specify that an isolated high-risk investment is not necessarily imprudent if it is part of a complying portfolio.51

7. Such factors as the risk to be assumed and the services to be provided under a contract issued by an insurance company are "pertinent to any investment decision involving such contract."52

41. 44 Fed. Reg. at 37,222.
42. Id.
43. Id. at 37,223.
44. Id.
45. Id. (emphasis added).
46. Id.
47. Id. at 37,224. The legislative history makes it clear that the diversification rule may be satisfied by investment in a pooled fund which is itself properly diversified. Report, supra note 12, at 305.
48. 44 Fed. Reg. at 37,223.
49. Id.
50. Id. at 37,224.
51. Id.
52. Id.
8. In response to fears that small plan fiduciaries might be required to invest in expensive investment services, the preamble to the regulations states that "it would not seem necessary for a fiduciary of a plan with assets of $50,000 to employ, in all respects, the same investment management techniques as would a fiduciary of a plan with assets of $50,000,000."\(^\text{53}\)

9. Finally, in a departure from the common law, the regulations make it clear that the ERISA "prudent man" rule "does not require that every plan investment produce current income under all circumstances."\(^\text{54}\) Presumably, therefore, holding employer stock paying no dividends or lesser dividends than other investments is not necessarily imprudent.

As the evolutionary history of the common law of trusts suggests, it would be unreasonable to expect, and probably unwise to design in advance, a regulatory definition of the ERISA "prudent man" rule to answer most questions and conflicts fiduciaries may encounter. Thus, no matter how assiduously fiduciaries document their apparent compliance with the new regulations, open questions of liability persist because a number of potential problem areas of special concern to the small, employer-stock-holding plan fiduciary remain unaddressed.\(^\text{55}\) The courts will eventually face these situations as cases arise, but guidelines can be used to suit the special needs of smaller eligible individual account plans.

One potential problem involves the benchmark against which the conduct of small plan fiduciaries is to be judged. Clearly, if the "prudent expert" standard is to be rejected, as it should be, it makes sense to utilize a general, comparative standard applied as of the time the investment decisions are made and under "circumstances then prevailing."\(^\text{56}\) It must be noted, however, that a general comparative standard could well result in a virtual "prudent expert" effect upon the small plan fiduciary. For example, if the small plan fiduciary is irreplaceable

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53. *Id.* (emphasis added).
54. *Id.* at 37,225 (emphasis added). The common law generally required the sale of unproductive or under-productive property where there was an income beneficiary. See generally *Restatement (Second) of Trusts* § 240 (1959).
55. Nevertheless, it is still advisable for fiduciaries to document their adherence to the regulatory standards, as by minutes of all action taken during policy-decision meetings of the fiduciaries. *See* Question FR 10, ERISA Interpretive Bulletin 75-5 PENS. PLAN GUIDE (CCH) ¶ 23,855A (1978).
56. As one commentator has noted: "Courts should look to the efficiency ratios commonly achieved in the investment community as the principal reference in determining how close an approximation of the theoretical optimum should be required of fiduciaries." *Note, supra* note 12, at 976-77 (footnote omitted).
or possesses less than optimum resources or experience, a comparative standard of performance could require financially self-defeating expenditures for professional investment advice or management. Moreover, the comparative standard could require similarly self-defeating over-reliance upon a provision in ERISA which, in effect, permits plan sponsors to avoid fiduciary risks by allowing individual plan participants to exercise control over the assets in their respective individual accounts.\(^5\) As noted previously,\(^5\) there is an indication that the Department of Labor now officially recognizes at least a portion of the potential problem.\(^5\)

A fair reading of the ERISA “prudent man” rule would be to apply the rule in light of the size and type of plan involved, \(i.e.,\) “an enterprise of like character.” Thus, when the courts and government enforcement attorneys assess the prudence of investments by a small-plan fiduciary, the benchmark should not be the investment community at large. Rather, the benchmark should be what the prototypical small-plan fiduciary (\(i.e.,\) “a prudent man acting in a like capacity”) would have done at the time of the decision in question. Clearly, this involves subjective judgments and some degree of speculation. However, any comparative standard involves such factors, and the special standard suggested may be necessary to avoid the potential destruction of the small independent plan in favor of an evergrowing mass institutional investor bloc.\(^6\)

**Diversification**

Another similar potential problem area involves ERISA’s “diversification” requirement contained in section 404(a)(1)(C).\(^6\) The legislative history makes it clear that there is a rebuttable presumption in

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57. 29 U.S.C. § 1104(c)(2) (1976). Excessive use of such provisions could deprive plan participants, who are typically unsophisticated in money management matters, of the benefits to be derived from having their retirement funds invested at the direction of individuals who, while not necessarily professional money managers themselves, nevertheless offer considerably more sophistication and skill than rank-and-file employee-participants.

58. See text accompanying notes 43, 44, and 53 supra.

59. See Hutchinson supra note 30 (A plan sponsor/trustee managing a small plan with limited assets, should not be held to the same standard of care as a trust company.).

One gray area that may be the subject of court interpretation is the degree of expertise required under the Act to be able to discern if and when the services of a professional money manager are required. The general guidepost, however, should be whether the plan is of a size and nature that a prudent man would realize that professional help is both needed and can be afforded. See Klevan, supra note 33, at 154.

60. Experience indicates that, given sufficient investment latitude, a small, independently invested plan may equal or exceed the performance of larger plans.

favor of diversification; in an action for breach of the requirement, after it is initially demonstrated that there has been a failure to diversify, the legislative history notes that the defendant must demonstrate that the failure was prudent and not "clearly prudent."\(^6\)

In the case of truly small plans, enforcement of the diversification rule would seem to require one of two possible conclusions; either small plans will be forced to invest in pooled diversified investment funds,\(^6\) or the prospective defendant-fiduciary's burden will have to be liberally construed in his favor. In order to minimize the impact of investment transaction costs, depending upon the nature of the investment, the small plan investor must invest larger percentage blocs of the plan's assets, and/or at less frequent intervals, than in the case of larger plans.

In some small plans, such as a target-benefit\(^6\) or defined benefit plan,\(^6\) an abundance of caution may dictate the acquisition of relatively risk-free, stable fixed-income investments in blocs high enough to generate reasonable interest rates. While the investment principal may be subject to constant erosion by inflation, such a course of action avoids the risks of massive sudden loss and serious underfunding attendant upon other, more inflation-responsive, growth-oriented investments. In such a case, it is inequitable for small plan fiduciaries to be required to diversify to the extent deemed prudent for larger plans to guard against losses due both to market fluctuation or economic or industry conditions and to inflation. Indeed, such a diversification requirement for small plan fiduciaries would require speculation inimical to the plan's—and ERISA's—objectives.

Conversely, unless the small profit-sharing plan is to become little more than a group form of the Individual Retirement Account,\(^6\) and if real growth potential is to be permitted such plans, it would seem that less diversification, and perhaps greater risk, should be permitted than in the case of larger plans. In fact, these standards derive from the

62. Report, supra note 12, at 304. The report also states: "It is not intended that a more stringent standard of prudence be established with the use of the term ‘clearly prudent.’" Id.
63. Id. at 305.
64. The term "target benefit" plan commonly refers to a plan (typically adopted prior to the advent of ERISA) which defines both the amount to be contributed to the plan and the level of benefits (the "target") to be achieved. Such plans were frequently encountered in collective bargaining situations; unions typically sought statement of the benefit level, whereas employers typically sought statement of the contribution level so as to limit their future liability for contributions.
65. See note 34 supra.
66. The Individual Retirement Account is commonly referred to as IRA and is defined in 26 U.S.C. § 408(a) (1976).
literal wording of the statute wherein it is stated that diversification is required only "to minimize the risk of large losses." \(^{67}\) The liability for failure to diversify should not be imposed, therefore, where diversification (even when "prudent") is not absolutely necessary. It also would be consistent with the House and Senate Conference Committee's softened interpretation of the statutory language to interpret the small plan proviso to section 404(a)(1)(C), in the case of small plans, as requiring diversification "unless under the circumstances it is 'not clearly prudent' to do so." \(^{68}\)

**Plans Holding Employer Stock**

There is another especially difficult problem under the ERISA "prudent man" rule for the fiduciary of an eligible individual account plan which holds significant shares of the employer's stock. While it is true that the statute exempts such plans from the diversification requirement, at least to the extent of such employer stock holdings, \(^{69}\) it explicitly does not exempt such holdings from the rest of the prudence requirement. \(^{70}\) How the courts choose to treat this seeming anomaly may well determine whether plans continue to hold employer stock. \(^{71}\) The fiduciaries of eligible individual account plans may have impossible choices to make unless the courts go further than even the broad interpretations that Congress appears to have intended.

The range of alternatives open to the individual account plan fiduciary may depend upon the precise language contained in the plan provisions authorizing employer stock holdings. \(^{72}\) Plan language merely providing for the acquisition and holding of employer stock leaves more discretion to, and creates greater risk for, the fiduciary than plan language which requires the acquisition and holding of employer stock with lower and upper limits for such holdings. Therefore, the employer-plan sponsor may be able to draft out wholesale chunks of fiduciary liability without ever resorting to the type of exculpatory language now made void by section 410(a) of ERISA. Indeed, plan provi-

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\(^{68}\) The common law was not entirely clear as to diversification. *See generally RESTATEMENT (SECOND) OF TRUSTS § 228 (1959); A. SCOTT, SCOTT ON TRUSTS §§ 228, 230.3 (3d ed. 1967).*


\(^{70}\) *Id. See also Eaves v. Penn, 587 F.2d 453, 459-60 (10th Cir. 1978).*

\(^{71}\) *Hutchinson, When Employee Benefit Plans Invest Assets in the Employer's Stock, NAT'L L.J. 30-31 (Nov. 13, 1978).*

sions can be designed to limit or mandate generally the fiduciary's range of investment options as well as to limit specifically his ability to dispose of employer stock. In fact, under common law, trust settlors had broad drafting power to either limit or expand both the trustees' powers and their exposure to liability.73

This approach would seem to draw support from the statutory requirement that a fiduciary discharge his duties "in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this subchapter."74 This clause may, however, cut two ways. The unanswered question is whether a plan document, drafted as described above, is consistent with ERISA or in contravention of it. There is clear indication in a case decided by the United States Court of Appeals for the Tenth Circuit that the latter may be so. In *Eaves v. Penn*,75 the defendant, Penn, converted a profit-sharing plan into an ESOP and used the ESOP as a vehicle to finance his purchase of control of the employer-sponsor. The Tenth Circuit held that in recommending, designing, and implementing amendment of the plan, given the "unique circumstances" of the case, Penn had acted as a fiduciary under section 404(a) of ERISA.76 The court cited specific legislative history in concluding that such employer-financing schemes violate ERISA's "exclusive benefit requirement."77

The court's statement that the circumstances in *Eaves* were "unique" should prevent the wholesale extension of the doctrine therein stated where such financing schemes are not involved, as would be true in the case of the typical "eligible" profit-sharing plan. Moreover, it must be noted that the law already contains adequate prohibitions against employer stock transactions for inadequate consideration.78 Finally, although ERISA does not require an employer to establish a benefit plan for its employees, it is urged that

73. It was common for pre-ERISA pension and profit-sharing trusts to take advantage of the common law rule that, by trust provision, a trustor could relieve trustees of liability for breach of trust (other than due to bad faith, intentional breaches, and the like). See *Restatement (Second) of Trusts* § 222 (1959). Similarly, of course, trustees could be endowed with powers beyond normal legal limits, or with powers less broad than the law normally permitted.

74. 29 U.S.C. § 1104(a)(1)(D) (1976). This section is enforceable under section 502 of ERISA. *Id.* § 1132.

75. 587 F.2d 453 (10th Cir. 1978).


77. *See* 587 F.2d at 459-60.

78. Such prohibitions include section 408(e) of ERISA, 29 U.S.C. § 1108(e) (1976), and the Internal Revenue Service's exclusive benefit rule. *See Symposium, supra* note 12, at 597.
where an employer does establish a plan, only statutory restrictions clearly stated in advance should be permitted to alter the employer-trustor's intent.

However, what if an employer is either unable or unwilling to tie his plan's fiduciary's (or his own) hands through strict draftmanship in advance or by subsequent plan amendment which would be subject to IRS approval? Then, under what circumstances is it prudent for an eligible individual account plan to hold or acquire qualifying employer securities, where the plan has been designed, at least in part, to confer an ownership interest in the employer upon the participants?

It has been aptly noted that in the case of ESOPs, which may even be a somewhat less difficult situation than an eligible profit-sharing plan, that:

[a] dilemma arises if the qualifying employer securities begin to appear to be a poor investment. The fiduciaries are responsible for a plan specifically established to invest primarily in stocks that are now an unsound investment. The question is whether they must liquidate the plan's holdings of employer securities: how poor an investment must an employer's stock become before the fiduciaries would be required to dispose of it?79

There is a similar dilemma presented by the take-over bid example stated earlier with reference to the sole interest test.80 In that instance, the unanswered question is whether the fiduciary is required to sell employer stock because an unusual opportunity for the plan to profit thereon is presented.

In the future, there may be an alleviation of this dilemma by congressional action which may occur, if not in the case of profit-sharing plans, at least as to ESOPs,81 or even by expansion of current prudent man regulations. Presently, however, the Department of Labor, if not the Congress, appears reluctant to resolve the problem. Until a resolution is forthcoming, the answer would appear to lie in a particularly restrained application of the "prudent man" rule in cases involving the retention or disposition of employer stock.82 It is, of course, technically

79. Symposium, supra note 12, at 547. The article also reports the introduction of H.R. 5577, 94th Cong., 1st Sess. (1975), which would have provided for conclusively presumptive satisfaction of the fiduciary requirements where an ESOP acquires or holds employer stock. As the symposium notes: "the major purposes of the Act are antithetical to many of the operating concepts of ESOPs."

80. See text accompanying notes 16-21 supra.

81. Symposium, supra note 12, at 551-52.

82. Although ERISA makes no such specific provision, we presume that, as would have been the case at common law, ERISA fiduciaries will be permitted to resort to the courts for direction.
impossible to ignore Congress' express provision that the general prudence requirements apply to employer stock.\textsuperscript{83} However, since both the legislative history and the statutory scheme indicate a congressional intent to preserve employer-stock-holding plans, it seems reasonable to conclude that a particularly limited application of the prudence requirements must be made. It is only by providing such plans the necessary "breathing room," and by allowing their design to be fully honored, that they can be expected to continue to exist.

The disposition of employer stock by eligible individual account plans that meet the other non-prudence ERISA requirements should be required, as a matter of prudence, only where it seems likely that retention would destroy the plan, defeat the purpose of the plan’s employer-stockholding design, or impede full payment of benefits to participants. This would include situations where the employer is on the verge of collapse and the fiduciary's action is therefore necessary in order to help preserve both the funding source of the plan and the employment source of the employee-participants, or where absolutely required by the liquidity needs of the plan for benefit payments.\textsuperscript{84} Failure to recognize the inherently limited nature of the prudent man rule as applied to employer stock held by eligible individual account plans could well sound the death-knell for such plans. The rule, therefore, should be applied to force the fiduciary's hand only where the plan or the employer's death-knell would sound in any event, and where the commands of the plan's terms would otherwise cease to be effective through self-destruction.

**Conclusion**

We have not intended to exhaust herein the range of special problems facing fiduciaries of small and/or eligible individual account plans. Rather, our goal has been to highlight several such potential problems which we have seen and to suggest possible ways of stemming the tide of resulting confusion which appears to have affected both employer clients and government regulatory agencies. ERISA continues where there is a reasonable doubt as to the appropriate course of action to follow. See 3 A. Scott, Scott on Trusts § 259 (3d ed. 1967). Even if such suits may be entertained, the rapidity of market fluctuations and the expense of federal litigation may prohibit such resort, especially in the case of smaller plans.


\textsuperscript{84} The same rationale could apply to permit the acquisition of low-rated employer securities. See Withers v. Teachers' Retirement System, 447 F. Supp. 1248 (S.D.N.Y. 1978), aff'd, 595 F.2d 210 (2d Cir. 1979).
to visit growing pains upon those to whom it applies. However, a creative application will engender more growth than pain, consonant with the goal of regulating, rather than defeating, the growth of American private employee benefit plans.