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DIRECTORS' FIDUCIARY DUTIES

Just Say No: Why Directors Should Avoid Duties That Will Subject Them to ERISA

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Pension plans are still a big part of the business of U.S. corporations. According to the Federal Reserve Board, as of June 31, 2014, U.S. companies had more than $3.1 trillion in pension liabilities on their books and had set aside approximately $3 trillion in assets to fund these obligations. Add to that the more than $5.2 trillion in assets in traditional 401(k) and other defined contribution plans, a portion of which is invested in company stock funds, and companies end up with a pretty sizable pool of money to invest and a significant corporate liability to be controlled and monitored.[1]

Success in managing a company's retirement plans impacts the retirement security of the company's workforce and the annual pension expense recognized by the company for financial accounting purposes. Poor management of these plans can pose significant risks to a company's business, and underfunded plans (e.g., witness plans in portions of the industrial sector in the last decade) can materially impact a company's financial performance.

For these and other reasons, boards of directors of U.S. corporations with large pension plans typically retain some oversight responsibilities for these plans and the investment of their assets. This responsibility can fall upon the compensation committee or other standing committee of the board. And while it is almost self-evident that effective board oversight is a good idea, in the context of retirement plans, such oversight should be exercised in a way that does not cause board members to be subject to ERISA's fiduciary standards.[2] ERISA imposes standards of conduct on fiduciaries that are more restrictive than those imposed on directors generally, and complying with these standards can lead to potential conflicts with a director's overall responsibility to the corporation and its shareholders.

State Law Standards

There is a stark contrast between the standards of conduct applicable to directors under state law and those set by ERISA. State law standards of conduct for directors have evolved in a manner that both gives directors wide latitude to judge what is right for the business and broadly protects directors in the exercise of their business judgment. State corporate law subjects directors to a duty of care that requires them to make decisions on an informed basis, but gives them considerable latitude on how to comply with the standard. Under Delaware law, for example, directors will generally not be found liable for breaching their duty of care unless their conduct amounts to gross negligence. Moreover, under Delaware law, a corporation may indemnify a director from liability resulting from a breach of the director's duty of care, and a corporation's constituent

[1] Federal Reserve Board, *Flow of Funds Accounts of the United States*, Table L.117, December 11, 2014.

[2] The Employee Retirement Income Security Act of 1974 (commonly referred to as ERISA) is the federal law that regulates the conduct of persons that exercise discretion in the administration of benefit plans and manage the assets of those plans.

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documents may exculpate directors entirely from such liability.

State law applicable to director conduct also typically imposes a duty of loyalty upon directors and a companion duty to act in good faith when engaging in the oversight of the business. Here, too, state law has set the bar fairly high on those trying to show that directors have breached their duty of loyalty to the business. Under Delaware law, directors may be found to have breached this duty when they put their own interests ahead of the corporation. Directors act in bad faith when they engage in activity that is intentionally designed to harm the business or is unlawful. Although Delaware law does not permit exculpation or indemnification for liability resulting from breaches of loyalty or bad faith conduct, case law holds that a breach of duty of care is not, *per se*, a breach of the duty of loyalty or an act of bad faith by the director.

Under state law, directors also benefit from a presumption—the so-called ''business judgment rule''—that gives them the benefit of the doubt for their acts and omissions as directors and requires those challenging a board decision in court to show that the standard of care has not been met. Taken as a whole, these state law standards of conduct give board members wide latitude to decide what is right for the business and set reasonably tough hurdles for those challenging their actions. At the same time, directors are held accountable for actions that, in hindsight, may have proved less than optimal for the business.

ERISA Standards

ERISA's standards are a pronounced contrast to state law. Persons who are plan fiduciaries must comply with ERISA's so-called ''prudent expert'' and ''exclusive benefit'' rules and are also subject to ERISA's prohibited transaction restrictions, which broadly prohibit a wide range of transactions with the plan's corporate sponsor or with other persons providing services to the plan. Further, ERISA is derived from the law of trusts, which means that ERISA fiduciaries cannot assert an attorney-client privilege for legal advice related to the performance of their duties.

ERISA's standard of care for fiduciaries is known as the prudent expert rule. ERISA requires that fiduciaries act ''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.'' As with the state law duty of care applicable to directors, compliance with ERISA's prudent expert standard often turns on the process by which decisions are made. But under ERISA there is no presumption that a fiduciary has acted prudently, and the fiduciary's actions are measured against how a theoretical prudent expert would have acted in like circumstances. Unlike under state law, mere negligence, rather than gross negligence, is the minimum threshold for liability under ERISA.

Similarly, ERISA's exclusive benefit rule is more restrictive than the state law duty of loyalty applicable to directors. The exclusive benefit rule compels fiduciaries to consider only the best interests of the plan and its participants when making decisions affecting the plan. An immediate and practical implication of this standard is that directors, when acting as plan fiduciaries, cannot take into account the interests of the corporation when exercising their duties to the plan.

The limitations flowing from ERISA's duty of loyalty standards are illustrated when selecting plan vendors. Most major U.S. corporations have lending, underwriting and investment banking relationships with banks and other financial institutions. An ERISA fiduciary charged with retaining a financial institution to be custodian of a company's benefit plans cannot base the custodial hiring decision on the impact that the decision might have on the company's other relationships with the bank. The ERISA standard is more limiting than the duty of loyalty standard under state law, as it would arguably be a violation of the ERISA standard to confer a benefit on the company that sponsors the plan when acting for the plan, even though there may be no actual harm to the plan.

As if the ERISA general fiduciary standards were not sufficiently limiting, ERISA's prohibited transaction rules further confine the conduct of fiduciaries and set the stage for potential conflicts for a director serving as a fiduciary. The prohibited transaction rules are sweeping in what they prohibit and on the limits they place on transactions with the plan's sponsor or with service providers to the plan. For example, one of the principal ERISA restrictions on fiduciaries states that a ''fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he knows or should know that such transaction constitutes a direct or indirect . . . transfer to, or use by or for the benefit of a party in interest, of any assets of the plan.'' ''Parties in interest'' are broadly defined to include the company sponsoring the plan, and the litany of transactions prohibited by ERISA would include any indirect benefit flowing to the sponsor of the plan as a result of a board member's or other fiduciary's action on behalf of the plan.

Structuring Effective Oversight

Avoiding ERISA's fiduciary standards does not mean abandoning the board's oversight of a corporation's benefit plans. Rather, the goal is to structure board level oversight of pension and other benefit plans without subjecting directors to ERISA's fiduciary standards. And this can usually be accomplished by careful planning and committee charter drafting and attention to the manner in which the applicable committee of the board engages in plan oversight.

Unfortunately, it is all too easy (intentionally or not) to cause directors to become ERISA fiduciaries. Directors will be ERISA fiduciaries where they have the authority to appoint or approve the appointment of other ERISA fiduciaries. In practice, this typically arises when a committee of the board has the authority to approve the appointment of the officers serving on the company's ERISA investment or benefits committee. It can also arise for large pension plans when a committee of the board has the authority to set the investment policy for the plan or to appoint, approve or remove one or more asset managers for the plan.

ERISA status can also arise from the improper drafting of plan documents or committee charters. For example, plans that state that the ''corporation'' is the plan administrator or that indicate that the corporation is the ''named ERISA fiduciary'' tend to sprinkle fiduciary authority diffusely within the organization and leave the board susceptible to being tagged with fidu-

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ciary status. Committee charters that give a board committee specific authority for plan administration or management of the plans assets, or the authority to appoint other plan fiduciaries, will also result in fiduciary status for members of the committee. Charters that specifically mention compliance with ERISA or limit activities to those permitted by ERISA also run the risk of creating fiduciary status for the members of the applicable committee.

Fortunately, there are ways for boards of directors and their committees to retain reasonable oversight of a company's pension and other benefit arrangements without subjecting directors to ERISA's fiduciary standards. Three steps are key to achieving this result:

First, plan documents should be precise in the allocation of responsibility for plan administration and the management and investment of plan assets. Plans should be specifically drafted to allocate fiduciary responsibility to officers and other designated employees of the corporation and not to directors. Plan documents should not list the corporation as a ''plan administrator'' or ''named fiduciary,'' or authorize directors to appoint fiduciaries.

Second, if a board level committee retains oversight for plan matters, the applicable committee charter should state that the directors are acting on behalf of the corporation and not the corporation's plans when engaging in these oversight activities. The purpose of this somewhat self-serving language is to align with the well-established legal principle that actions on behalf of an employer—so called ''settlor functions''—are not within the ambit of ERISA's fiduciary rules. Settlor functions include decisions to have or amend a plan, accounting policies related to plan liabilities and expenses, and the use of corporate assets to fund a plan over and above the minimum contributions required by law.

Lastly, actions by boards and committees overseeing plans and plan investments should be confined to those that are, in fact, settlor in nature. ERISA fiduciary status is determined on a functional basis and persons who perform the duties of an ERISA fiduciary cannot avoid that status by asserting that they are not named as fiduciaries in plan documents or committee charters. Board and committee minutes should be drafted with the necessary care to document that any oversight activity is confined in this way.

Conclusion

As noted at the outset, both the exposure of U.S. corporations to pension liabilities and the value of assets dedicated to funding those liabilities continue to be enormous. Proper board oversight of these assets and liabilities is important, particularly at a time when corporations are exploring pension de-risking, plan terminations and other ways of mitigating their exposure to retirement obligations. Boards are best able to exercise this oversight responsibility, however, when they are free to act exclusively in the interests of the corporation and its shareholders, not when they are burdened and potentially conflicted by ERISA's fiduciary standards.