Employer Stock in Your Plan

A post-Dudenhoeffer approach to fiduciary responsibility.

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PSCA Foreword

In mid-2015, PSCA's leadership rejuvenated its Investment Committee. This committee is currently led by David Booth and Tim Kohn of Diversified Investment Advisors.

The committee includes plan sponsor representatives from Microsoft, International Paper, Nestle, Bierlein Companies, Rooms To Go, National Grid, and FMC Corporation, as well as subject matter experts from Portfolio Evaluations Inc., Mercer, Marquette & Associates, Greenspring, and Stratford Advisors.

The Investment Committee is currently working on several projects that are valued by PSCA's members, including best practice guidance and decision support tools related to company stock. The present article is the product of a collaboration between: Michael Olah, Michael J Olah & Associates; Karen Brodbeck, CFA, Nestle USA; Brandon Diersch, Microsoft; and Carol Sung, International Paper.

Ever since the Supreme Court of the United States announced its decision in *Fifth Third Bancorp v. Dudenhoeffer*[1], numerous articles have appeared discussing the major tenets of the decision and its impact on the future of employer stock funds in retirement plans. Analysis of the opinion has been extensive, but in light of the Court's overturning the so-called "Moench presumption," practical guidance for plan sponsors is inadequate. This paper is a preliminary attempt by PSCA's Investment Committee to examine issues related to creating, maintaining, and dismantling employer stock funds in qualified retirement plans, and to provide guidance to the plan sponsor community on approaches to complying with ERISA's fiduciary mandates in doing so.

Background — How We Got to the "Moench Presumption"

The Supreme Court's ruling in the Dudenhoeffer case dealt specifically with the issue of what responsibilities ERISA imposes on plan fiduciaries when dealing with an undiversified employer stock funds in an Employee Stock Ownership Plan (ESOP). Clearly, through various pieces of legislation including the Employee Retirement Income Security Act (ERISA) of 1974[2] and certain provisions of the Internal Revenue Code ("Code"), Congress expressed a preference for employee ownership of the companies they work for. ERISA imposes essentially four obligations[3] on plan sponsors: 1) the obligation of loyalty (sometimes called the "exclusive purpose rule"); 2) the obligation of acting with the care, skill and prudence of one familiar with the issues involved in managing plans (the "prudent expert rule"); 3) the obligation to diversify plan assets to avoid the risk of large losses; and 4) the obligation to abide by the terms of the plan unless to do so would violate one of the other three fiduciary obligations.

As most professionals managing ESOPs are aware, laws governing ESOPs exempt fiduciaries from the requirement of diversifying plan assets. More, the Code and ERISA allows "disqualified persons"[4] or "parties in interest"[5] to engage in financing transactions for the purchase of employer stock in an ESOP, which would otherwise be considered a "prohibited transaction."[6] Both ERISA and the Code provide a variety of other incentives meant to encourage employers to establish ESOPs and employer stock funds in qualified retirement plans.

While these provisions seem to encourage employer stock funds in plans, the statutory scheme has also created a dichotomy of rules that at times conflict and require plan fiduciaries to seemingly wear two "hats" simultaneously — that of a pure plan fiduciary charged with duties of prudence, loyalty, and adherence to plan documents (unless it would be imprudent to do so), and that of an employer charged with protecting the entity, all of its shareholders (including those not participating in the plan) and to manage its affairs in a business-like manner. When the duties inherent in wearing each of those hats collide, litigation usually results; there have been numerous recent cases involving losses suffered by participants invested in

employer stock funds (the oft-named "stock drop cases").

Moench v. Robertson, a court decision reached in 1995 by the Third Circuit Court of Appeals, is a case which provided plan fiduciaries some assurances that investment in employer stock was not *per se* a breach of fiduciary duties. In that case, Moench, a participant in his employer's ESOP plan suffered a loss when one of two banks owned by the bank holding company sponsoring the plan failed. The company's stock had depreciated considerably over a few years, and even though members of the plan committee — charged with being fiduciaries over plan management and investments — were well aware of the deteriorating financial condition of the company they continued to invest contributions to the plan in employer stock. Indeed, the committee, at one time, even approached company management to change the terms of the plan to allow it to invest in other funds and to diversify the assets of the plan away from employer stock. Management refused, and the Court recognized that the company, as "settlor" of the trust and plan, could have legitimate, non-fiduciary reasons for creating and maintaining an ESOP.

In the trial court, Moench argued that the plan committee and its members were "investment fiduciaries." While the committee acquiesced on that issue, it countered by arguing that it did not breach any fiduciary duty by continuing to invest as the plan document directed it to (caveat being it had limited discretion to invest in other vehicles, such as cash equivalents, for purposes of operating the plan efficiently). The trial court agreed with the committee, and Moench appealed. The appellate court spent considerable time discussing the "standard" that should be applied to the committee before determining if a breach of a fiduciary duty occurred. The court concluded that (a) the standard to apply is whether or not the committee "abused their discretion" in continuing to invest in company stock, and (b) that abuse can only be shown if continued investment in company stock would defeat the purpose for which the plan was established.

In *Moench,* given that the plan was established to give employees "ownership" in their employer, it was reasonable to infer that continuing to invest in company stock would only be an abuse of discretion if employee ownership was imperiled through impending bankruptcy or severe insolvency. The court ruled that investing in employer stock was consistent with the intent of the employer in establishing the plan and *was presumed to be consistent with their fiduciary duties under ERISA unless the very existence of the company was in jeopardy.*

If the company were on the brink of insolvency, continuing to invest in employer stock would do nothing to facilitate employee ownership in the company and would be imprudent. That presumption has become known as the "Moench presumption" and it effectively means that plaintiffs challenging fiduciary decisions to continue to invest in employer stock must prove the fiduciaries are violating the original intent of the employer/settlor — a high burden considering the intent of employers in establishing ESOPs, and employer stock funds in other plans, is to give employees "skin in the game."

Subsequently, five other Circuit Courts of Appeal adopted the "Moench presumption" in various forms, including the Sixth Circuit Court of Appeals (Michigan, Ohio, Kentucky, and Tennessee) which gave rise to the *Dudenhoeffer* case. Most of those Circuit Courts held that, absent a showing of "dire straits" for the continued existence of the plan sponsor, the goal of employee ownership would be satisfied regardless of the current financial situation of the employer, or the price of the employer stock, and as such fiduciaries have some level of protection in continuing to invest in employer stock.

The Supreme Court Takes on the Moench Presumption

In *Dudenhoeffer,* the Supreme Court focused on the Moench presumption's validity as abrogating the responsibility of plan fiduciaries to act "prudently" with loyalty to participants. In that case, the plaintiffs, participants in the Fifth Third ESOP plan, argued the plan fiduciaries knew of both public and non-public information that would have led a prudent fiduciary to believe the stock was overvalued, and as a prudent fiduciary should have (a) sold the stock in the plan, (b) stopped purchasing additional (overpriced) shares within the plan, or (c) disclosed the non-public information to allow the market to correct the price prior to subsequent purchases. The fiduciaries countered that under the Moench presumption, absent an abuse of discretion (which was never alleged), continued purchases of employer stock and maintaining the employer stock fund was given a *fiduciary pass.*

The Court unanimously held that no presumption exists that relieves plan fiduciaries from any fiduciary obligation other than the obligations specifically curtailed by the terms of the statutes involved. The Court pointed out that laws governing ESOPs only curtail the obligation to "diversify plan assets," and the requirement to act "prudently" only extends as far as it would be prudent to diversify plan assets. All of the other fiduciary requirements remain obligations of ESOP fiduciaries (and, of course, fiduciaries of other plans holding employer stock).

The Court explained that an "ordinary" (non-ESOP) plan had the goals of (a) maximizing retirement benefits for participants while (b) avoiding excessive risk in that endeavor. According to the Court, the laws that govern ESOPs add a third goal of promoting employee ownership of the business, but ruled that additional goal did not eliminate or supersede the other two goals that apply to plans. The third goal

is equal to the first two, and fiduciaries must strive to give effect to all of the goals in managing the plan and investing plan assets. ESOP plan fiduciaries must strive to achieve each of the three goals and do so as a prudent fiduciary would without favoring one goal over the others, as the courts adhering to the Moench presumption rules. Prudence is to be considered in light of the circumstance, and the obligation of loyalty (sometimes called the "exclusive purpose" rule) requires fiduciaries to consider participant impact — the effect of achieving, or not, the goals of maximizing retirement benefits and excessive risk avoidance — in all their decisions.

The Court did caveat its opinion by clearly pointing out that nothing in ERISA requires plan fiduciaries to violate any other law in carrying out their ERISA duties, and hinted that disclosing non-public information or even acting on non-public information may violate securities laws. Prudence may also dictate that the plan fiduciaries consider the effects of selling stock, which might have the undesirable effect of further depressing a stock's price by signaling to the market that material, non-public information was being acted on by plan fiduciaries.

So, What Does This Mean to Plan Sponsors?

Simply put, the *Dudenhoeffer* decision means plan fiduciaries are plan fiduciaries with respect to employer stock held in ESOPs and other plans, and must manage company stock in a manner consistent with all of the goals of a retirement plan (maximizing retirement benefits, avoiding excessive risk, and facilitating employee ownership), except that they need not diversify the employer stock fund while doing so. Duties of loyalty, prudence (except as it relates to employer stock diversification), and adhering to the plan documents (unless clearly not prudent to do so) are all obligations that remain, even with respect to employer stock as an investment in the plan. Since the Dudenhoeffer decision, the role an employer stock investment plays in maximizing retirement benefits and avoiding excessive risk must be considered in making fiduciary decisions concerning that investment.

How does a plan sponsor comply with these obligations, work towards maximizing retirement benefits, and avoid excessive risk all while complying with the terms of a plan that provides — if not mandates — investment in employer stock?

As with all fiduciary functions, the key is to develop a prudent process and adhere to it unless, or until, it becomes imprudent to continue to do so (and then, modify it so that once again it becomes a "prudent process"). Fiduciaries have long developed processes for managing adherence to their fiduciary responsibilities while managing the risks inherent in being a fiduciary. Dealing with employer stock should, now that the Supreme Court has affirmed that the ERISA fiduciary obligations haven't been superseded by statutory preferences for employee ownership, be no different from any other investment decision or plan management issue.

The challenge is that, while we have many years of experience in structuring fiduciary decision making processes with respect to "normal" investments within a plan, the typical methods of making fiduciary investment decisions do not apply to employer stock investments. Investment Policy Statements (IPS), which frequently provide for a comparative analysis of mutual funds or other collective investment vehicles against peer groups and hypothetical benchmarks or indices, do not work as easily for stock options and objective quantitative factors (e.g., fees, expenses, and relative performance) and qualitative factors (e.g., "style drift" and manager tenure) that are likely to be used by fiduciaries to scrutinize other investments do not apply.

Employer stocks typically lack comparable peers and are consequently difficult to benchmark. They are not managed, so there is no such thing as style consistency or manager tenure to assist fiduciaries in their evaluation of the fund. And fees are almost a non-issue for employer stock investments (which usually have nominal custody expenses and possibly trading costs). As such, fiduciary processes need not be mathematical, and nothing beats solid fiduciary judgements in making decisions.

The preliminary findings of this committee suggest that the key to establishing reasonable (prudent) criteria for evaluation of an employer stock investment is for the sponsor to begin with the outcome. For example, fiduciaries should ask: how will (or can) employer stock maximize retirement benefits for participants, and how can excessive risk be avoided (or managed)? Answers to such questions will vary among plan sponsors, but will also begin providing a framework for an employer stock policy.

How Can Fiduciaries Become Better Fiduciaries with Employer Stock?

Unfortunately, determining what is "good" fiduciary practice usually means looking at what others have done wrong. Since the Dudenhoeffer decision, a handful of cases have made it through litigation that provide some guidance, but — because most cases involving "bad" fiduciary practices get settled before a court can provide an opinion — often settlements are confidential and defendants neither admit nor deny wrong doing. Thus, the substance of the matter is left to speculation and press releases by the prevailing party touting the size of the settlement. Nonetheless, doing nothing or awaiting further guidance from the courts is imprudent. Being a "good" fiduciary means addressing the situation at hand and making sound judgements.

Contemplating broad general steps as part of an ongoing investment management process is a good first step.

First, determine the purpose of the employer stock in the plan. Of course, inclusion of employer stock in a plan is fundamentally a management decision — a settlor function — and not a fiduciary function. However, most plan sponsors seldom consider the reasons it should be (or was) included in the plan. Absent a reason that can be articulated, it probably should be there. Having a clear objective for the fund helps the fiduciaries balance their obligations (employee ownership vs. maximizing benefits vs. avoiding excessive risk). Having the rationale for employer stock in the plan gives some guidance for determining what it means to maximize retirement benefits and helps determine what excessive risk is worthy of avoidance. Those are relative concepts that can be weighed against the value of employee ownership.

ESOPs may have more easily identified reasons for their existence: corporate financing, owner succession issues, tax planning (both for the owner and the entity), and the like. Non-ESOP employer stock funds may be more difficult to peg the corporate reason, but an effort should be made so competing interests can be evaluated. Consider the value of: (a) added loyalty through ownership (e.g., increased motivation, esprit de corps, employee longevity); (b) reinforcing employee "line of sight" (e.g., reminding employees of their individual impact on the company's future); (c) tax advantages of dividend pass-through options; and (d) keeping ownership in the hands of "friendlies."

Second, establish criteria for managing the "investment." Common in IPS language is an indication of when a plan investment will be further scrutinized (placed on a "watch" list) or removed from the plan. Employer stock is harder to evaluate, but providing general guidelines for determining the continued appropriateness of the investment creates a prudent approach to adhering to fiduciary obligations. Quarterly performance of employer stock (gains, losses, dividends) is a difficult criterion to apply, as the volatility of an undiversified fund renders the measurements meaningless, so contemplating a longer horizon (total return over a long time frame) in conjunction with management expectations (readily available for public companies, but difficult or impossible to obtain for privately held concerns) could be a better measure. Also, consider events that might make continued investments in employer stock imprudent. Significant, ongoing, or long-term financial difficulties, prolonged layoffs, financing covenant breaches and restrictions, material litigation, adverse regulatory action, and other events that would have a potentially significant effect on ongoing company and stock performance might trigger the equivalent of a "watch" status, a suspension of new investments, or liquidation of existing investments.

Third, determine if restrictions on participant direction of investments into employer stock are prudent. Managing excessive risk (for plans that are not ESOPs) might entail capping investment in employer stock to some predetermined limit (usually expressed as a percentage of the employees total account balance) so that no new employee-directed investments can be made into employer stock once that limit is reached. The established limit can be a fiduciary decision in its own right, so care must be taken to provide a prudent rationale for that decision. For example, setting a low limit might be interpreted that the plan sponsor or fiduciaries believe the investment is too risky, and maybe should not even be part of the plan. Setting a high limit might defeat the purpose of the limit and be construed as the company's endorsement of that level of investment in employer stock.

Cautionary Note: limits might create operational issues. For example, not all recordkeepers are able to suspend investments into employer stock when the value of the investment meets or exceeds the limit. More, if the value of the investment in employer stock drops below the limit, the recordkeeper must have the ability to resume or restore investments in the fund. Another example is employee education and communications. These are critical ingredients to helping employees understand limits. Information must be readily available should conditions cause rapid movements in the value of employer stock resulting in the limit being crossed.

Fourth, ensure appropriate educational materials exist for the employer stock investment. Most mutual funds and other collective investments include a plethora of educational materials explaining the focus of the fund, past performance, top holdings, expense ratios, etc. Rarely does the same scope and breadth of information concerning employer stock exist, let alone is it readily available for cost-effective distribution to potential investors. Plan sponsors should develop appropriate information that can help participants understand the reason employer stock exists in the plan, and the risks of investing in an undiversified employer stock fund. Challenges related to conflicts of interest, degree of effort, scope of communication, and inherent risks to the employer and plan (e.g., risk of miscommunication and uninformed investment in the employer stock fund) should be weighed by the Investment Committee.

Finally, consider alternatives to employee ownership outside the plan. While bundling investments in employer stock within a plan offers many advantages, offering ownership outside a qualified plan may be a preferred alternative. Employee stock purchase plans, stock option plans, and phantom stock ("appreciation") plans are not covered under ERISA, so the same fiduciary obligations do not apply. Such alternatives may prove better for companies where managing the fiduciary risks of having an employer

stock investment in an ERISA plan is too burdensome or worrisome.

Where We Go From Here

As part of the PSCA's ongoing commitment to providing valuable information to plan sponsors, the task force empaneled to consider employer stock issues in plans will be producing a variety of other materials, including webinars, white-papers, position statements, and other materials to educate and facilitate further discussion on the topic. We actively are seeking input on what matters to plan sponsors who have employer stock, and will be reaching out to the membership directly to solicit input for further study by the team.

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[1] 134 S. Ct. 2459 (2014)

[2] 29 U.S.C. ch. 18

[3] 29 US Code § 1104

[4] 26 US Code § 4975

[5] 29 U.S. Code § 1106

[6] See e.g., 29 CFR 2550.408b-3

2016: A Lot To Be Excited About

PSCA is excited to announce its 2016 Calendar of Events, and we hope you choose to become a very active and engaged participant.

In addition to hosting its **69th Annual National Conference in Nashville on May 3 – 4,** PSCA's members will host fifteen half-day City Event Symposiums and a large number of 90-minute lunch roundtables in cities across the country.

The purpose of these events is to bring plan sponsors together for education, networking, feedback, and engagement, on topics related to participant-directed, retirement-related benefit plans.

These events are:

- Financially-sponsored by respected national providers, such as SageView Advisory Group, Dimensional Fund Advisors, and Vanguard, and by reputable local providers.
- Hosted by members at their business locations

Examples of members that have volunteered to host events include Gallup, UPS, National Grid, Enterprise Holdings, Microsoft, Gallagher, SageView Advisory Group, Dimensional Fund Advisors, and Custom Air Products.

Following is a list of the City Events and 2016 dates:

Omaha, Nebraska 15-Mar
Phoenix/Scottsdale, Arizona 22-Mar
Denver, Colorado 24-Mar
Atlanta, Georgia 24-Mar
Boston, Massachusetts 5-Apr
New York City, New York 7-Apr
Tampa Bay, Florida 14-Apr
St. Louis, Missouri 21-Apr
Los Angeles, California 26-May
Chicago, Illinois 14-Sep
Seattle, Washington 22-Sep
Austin, Texas 27-Sep
Houston, Texas 29-Sep
San Francisco, California 20-Oct
Kansas City, Kansas 10-Nov

PSCA appreciates the contributions of every member that is helping conduct these events, and hopes everyone will attend (and bring a few friends).

For more information and to register, please call PSCA at 312.419.1863 or visit our website.