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The Great Recession: Fiduciary Lessons Learned from the Financial Crisis

by David C. Kaleda

The second half of 2008 and 2009 were trying times for many plan fiduciaries. As a result of the worst financial recession since the Great Depression and a near collapse of the money markets and credit markets, many plan fiduciaries with responsibility for managing plan assets faced obstacles such as illiquidity and substantial investment losses. This article highlights some of the challenges fiduciaries faced during the financial crisis and uses those challenges to illustrate what fiduciary practices can minimize investment losses and mitigate fiduciary risks associated with managing plan assets.

This article provides a summary of fiduciary responsibilities with respect to investment of ERISA assets, explanations of some of the investment challenges faced by fiduciaries related to securities lending, auction rate securities, stable value funds and target-date funds, and an overview of actions a fiduciary can take to avoid or minimize fiduciary liability exposure.

Overview of Fiduciary Duties of Investment Fiduciaries

Fiduciaries with responsibilities related to the investment of ERISA plan assets include fiduciaries at the plan sponsor (*e.g.,* plan administrator, investment committee, pension committee, etc.; referred to herein as "Employer Fiduciaries") and the fiduciaries engaged by the Employer Fiduciaries to manage the plan's assets (*e.g.,* investment managers, investment advisors, etc.; referred to herein as "Third Party Fiduciaries"). The terms "Employer Fiduciaries" and "Third Party Fiduciaries" are collectively referred to in this article as "Investment Fiduciaries." Investment Fiduciaries must perform their responsibilities in accordance with the general fiduciary provisions of ERISA.

Pursuant to the duty of prudence, Investment Fiduciaries must perform their duties with respect to the investment of plan assets with the care, skill and prudence that would be applied by a prudent investor, acting in a like capacity and knowledgeable about the investment of retirement plan assets.[1] In its regulations, the Department of Labor (DOL) requires the Investment Fiduciary to give "appropriate consideration" to the facts and circumstances

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1 ERISA § 404(a)(1)(B).

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Unfortunately, just as target-date funds were becoming more popular and their validity had been confirmed by the DOL through its QDIA regulations, the equity and fixed income markets performed extremely poorly, which impacted the performance of target-date funds.

relevant to the investment of plan assets.[2] In addition to the above duty of prudence, Investment Fiduciaries must:

- Act for the exclusive purpose of providing benefits to participants and beneficiaries;
- Act pursuant to the documents that govern the plan; and
- Take steps to diversify plan assets in order to minimize large losses.[3]

Furthermore, Investment Fiduciaries must make sure that they do not cause an ERISA plan or account to engage in non-exempt party in interest prohibited transactions or non-exempt self-dealing prohibited transactions.[4]

In order to meet their fiduciary obligations, Investment Fiduciaries should select plan investments in a methodical manner considering how each investment will fit into the plan's investment portfolio. Furthermore, if an Investment Fiduciary wishes to take advantage of the fiduciary protection afforded to defined contribution plans that offer participant self-directed investments, Investment Fiduciaries need to make sure that the plan also complies with Section 404(c) of ERISA. After the initial investment selections are made, Investment Fiduciaries must periodically monitor plan investments and dispose of investments that are no longer appropriate under ERISA.[5] Importantly, however, ERISA does not require that every fiduciary decision be correct, but rather it requires procedural prudence whereby the fiduciary demonstrates that it followed a deliberative process in taking action as a fiduciary.[6]

Issues Arising During the Financial Crisis

As the financial crisis unfolded, Investment Fiduciaries began to consider what action was necessary under ERISA in order to reduce investment losses, protect plan assets and minimize exposure to fiduciary liability. The following are examples of issues arising out of the financial crisis that Investment Fiduciaries encountered. This list is by no means all-inclusive. However, the following issues commonly arose in ERISA practice, gained a lot of media or political attention and were the subject of litigation or regulatory review. They also are useful in demonstrating what Investment Fiduciaries can learn from the financial crisis in order to be better ERISA fiduciaries and minimize risk.[7]

Securities Lending

Investment managers and custodians often engage in a practice called securities lending in order to make additional income from the assets they manage. Securities lending is a transaction between the investment fund and a borrower (the "Borrower"), usually a bank or other financial institution, whereby the fund "lends" securities to the Borrower. The Borrower will often pay a fee to the fund for use of the securities. In addition, the Borrower is required to give the fund collateral, which is typically cash or cash-like securities (*e.g.,* US Treasuries), with a market value of 100 percent or more of the fair market value of the securities loaned. Such assets are held for investment in a sub-account, often called a "collateral pool." The Borrower typically has a right to return the securities to the fund, at which time the collateral (or equivalent assets) must be returned. A financial intermediary, such as an investment manager or custodian (or both), enables the transaction between the fund and the Borrower. Furthermore, such manager or custodian may invest the assets held in the collateral pool until the collateral must be returned.[8]

During the financial crisis, securities lending became the focus of high profile ERISA law suits.[9] In those suits, the plaintiffs, who were Employer Fiduciaries that made the decision to invest in collective trusts that included securities lending, sued the custodian of the funds and affiliated investment managers (the "Defendants"). The claims underlying those suits stated that the Defendants imprudently invested the assets they received from the Borrowers as collateral for the lending transaction, which resulted in the funds incurring significant losses and preventing the plans from redeeming their interests in the funds without receiving a portion of fund assets, some of which were virtually worthless, in kind.

Even Investment Fiduciaries not involved in the litigation were impacted by the securities lending issues. Investment Fiduciaries that attempted to redeem a plan's interest in one of the aforementioned funds or another fund or separate account in which securities lending occurred, were prevented from redeeming such interests or such redemption could not occur without receipt of some assets in kind. Furthermore, even in the absence of a redemption, such funds or accounts

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2 *See* DOL Reg. § 2550.404a-1(b).
3 ERISA § 404(a)(1).
4 ERISA § 406(a) & (b).
5 *See* Hunt v. Magnell, 758 F. Supp. 1292 (D. Minn. 1991).
6 *See* Donovan v. Cunningham, 716 F. 2d 1455, 1467 (5th Cir. 1983).
7 Note that this article does not address some of the unique fiduciary issues that arise in the investment of employer securities.
8 This description is of a common and basic securities lending transaction, which can be much more complex in structure. *See* Mark C. Faulkner, *An Introduction to Securities Lending*, (3d Ed. 2006).
9 FedEx Corp. v. Northern Trust Co., No. 08-2827 (W.D. Tenn. December 1, 2008); BP North America Inc. Sav. Plan Inv. Oversight Comm. v. The Northern Trust Company, No 08-6029 (N.D. Ill. October 21, 2008).

incurred significant losses through the investment of assets underlying the securities lending transaction.

Auction Rate Securities

Auction rate securities (ARS) were a type of bond issued by a governmental or corporate entity. ARS typically had maturities ranging from five to 30 years. The interest paid by ARS issuers was based upon rates that were regularly set and reset through a Dutch auction process held at periodic intervals.[10] Through the Dutch auction, participants submitted offers to purchase, also called bids, a specified number of ARS and the minimum interest rate they were willing to accept from the issuer. Once offers to purchase all of the ARS were received, the highest interest rate submitted was the rate that applied to every ARS sold in the auction. In the event not enough offers to purchase were submitted so that not all of the ARS were sold, an auction failure occurred. Current owners could not sell the ARS and default, often unfavorable, interest provisions applied. Prior to the financial crisis, if an auction failure was expected to occur because bids were inadequate to sell all of the ARS, dealers would step in and purchase the outstanding ARS, thus assuring current ARS holders that the ARS in which they invested were liquid and could be sold at the next auction.

As a result of the financial crisis, the Dutch auction process failed. Unlike prior to the crisis, investors (including the dealers) were not willing to assume the risk that the issuers of the underlying debt would continue to be in a position to make the interest payments at the rate determined by the last auction. Thus, all of the ARS in multiple auctions were not purchased. This lack of confidence was largely brought on by the significant increase of defaults in the sub-prime mortgage market. Furthermore, investors began to realize that the insurers, who in some cases were supporting the payment of the interest through insurance wrappers, were no longer in a position to guarantee the debt payments. After numerous auction failures occurred, the Securities and Exchange Commission (SEC) brought enforcement actions against several dealers that ended in settlement agreements. The SEC alleged that the dealers misled investors into believing that ARS were as liquid as cash and never fully informed them of the risk of auction failures, even when clear evidence was available to the dealers that the auction failures were imminent.[11]

Due to the collapse of the auction system, ARS held by investors, including ERISA plans and funds or accounts that held ERISA plan assets, became illiquid. Valuation of these assets became very difficult. Furthermore, in many cases, ARS issuers were now required to pay to investors very high interest rates, thus presenting a high default risk, or very low interest rates, which were much lower than the rate that would have been paid had the auctions not failed (or the rate on a comparable bond that is not an ARS). Investment Fiduciaries who managed ERISA plan accounts that held ARS found themselves in a position where they could not sell the ARS or accurately value them.

Stable Value Fund Performance and Liquidity Issues

The financial crisis showed Investment Fiduciaries that investing in stable value funds and similar investments had different implications than they originally thought. Many Investment Fiduciaries viewed these funds as comparable to money market mutual funds or other cash-like investments that would maintain their one dollar par value per share while allowing for immediate liquidity. As such, principal would be protected against loss. However, the financial crisis demonstrated that stable value products were much more sophisticated investments and were not liquid like money market funds or other cash-like investments.

Unlike money market funds, stable value funds, in order to generate higher returns than money market funds, do not simply invest in cash-like instruments such as commercial paper, short-term government securities, repurchase agreements, certificates of deposit, bankers' acceptances and similar securities. Rather, in order to generate higher returns than money market funds, stable value funds invest in a broader array of securities including corporate bonds, municipal bonds, derivatives, asset backed securities, mortgage backed securities, guaranteed investment contracts and other securities. These securities are not as liquid and are more subject to market volatility and investment losses. Furthermore, stable value products often include insurance "wrappers," which are designed to help maintain, but not guarantee,

10 California Debt and Investment Advisory Commission, *Issue Brief: Auction Rate Securities* (August 2004); *See also FINRA Investor Alert: Auction Rate Securities: What Happens When Auctions Fail*, available at www.finra.org/Investors/ProtectYourself/InvestorAlerts/Bonds/P038207.

11 *See, e.g.,* SEC v. Citigroup Global Mkts, Inc. (S.D. NY, Oct. 13, 2008); SEC v. UBS Secs. LLC (S.D. NY, Oct. 31, 2008).

a par value of one dollar per share or unit in the investment fund.

As a result of the virtual paralysis of the credit and money markets and the collapse of certain insurers and the downgrading of others with respect to their credit quality, several issues related to stable value funds arose. For example, stable value managers needed to invoke provisions under investment management agreements that allow up to 12 months to liquidate a plan's position in the fund, require a significant market value adjustment or require "in kind" transfers to plans. Furthermore, the collapse of certain insurance companies and the downgrading of others threatened the ability to maintain the one dollar par value of units in stable value funds. Although such par value is not guaranteed, many Investment Fiduciaries and participants had come to expect that the value of the shares would not go below one dollar per share or unit.

Target-Date and Life Cycle Fund Investment Performance

In October of 2007, about one year before the financial crisis, the DOL implemented final regulations establishing the qualified default investment alternative (QDIA) so that if the regulatory requirements were met, the plan fiduciaries would not be held liable for the default investment of participants' accounts in the QDIA pursuant to Section 404(c)(5) of ERISA. One of the approved QDIAs included funds designed to provide varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures based on the participant's age, target retirement date or life expectancy, which include life cycle funds and target-date funds.[12]

With the issuance of the final regulations, the DOL affirmed the validity of target-date and life cycle funds as default investments, which had already been gaining popularity in 2007 and prior years.[13] Unfortunately, just as target-date funds were becoming more popular and their validity had been confirmed by the DOL through its QDIA regulations, the equity and fixed income markets performed extremely poorly, which impacted the performance of target-date funds. Target-date funds came under scrutiny. The financial crisis brought several issues into focus, including:

- Not all target-date funds are the same;
- A target-date fund may have significant holdings in stocks even if a participant is at or over the fund's stated target age; and
- Significant investment losses, at least in the short term, can be incurred through investments in the target-date funds.

Fiduciary Lessons Learned

All of the issues that arose during the financial crisis and are described above (as well as many others encountered during the crisis) serve as an excellent framework for a discussion of how the investment fiduciary provisions summarized previously can be met. Summarized below are several lessons Investment Fiduciaries can learn from the crisis, including:

- Delegating investment authority and hiring experts;
- Engaging in procedural prudence and allocating fiduciary responsibilities;
- Reviewing written materials describing investments;
- Reviewing investment-related contracts;
- Considering divestiture of assets;
- Considering whether legal action is necessary; and
- Purchasing fiduciary liability insurance.

Delegating Investment Authority and Hiring Experts

Investment Fiduciaries must carefully review proposed ERISA plan or account investments prior to the purchase of such investments and must review such investment decisions regularly, particularly in abnormal economic times such as the financial crisis. Such review is necessary to demonstrate compliance with ERISA's fiduciary duty provisions.

While Third Party Fiduciaries are trained as investment managers and are often well-equipped to perform such evaluations, many Employer Fiduciaries are not. As such, the Employer Fiduciaries should consider that Section 402(c)(3) of ERISA permits a plan's "named fiduciary" to delegate the responsibility to invest plan assets to a qualified investment manager if the named fiduciary prudently selects the investment manager and monitors his or her results. Under ERISA, to the extent the plan fiduciaries prudently select an investment manager, prudently establish investment guidelines for the manager and prudently

12 *See* DOL Reg. § 2550.404c-5(e)(4).

13 Dallas Salisbury, President and CEO, Employee Benefit Research Institute, Written Statement for the United States Senate Special Committee on Aging, *"Boomer Bust?" Securing Retirement in a Volatile Economy*, Feb. 25, 2009.

monitor the performance of the manager, the plan fiduciaries are generally not liable for any investment losses.

Even if the plan fiduciary responsible for making investment decisions does not delegate this responsibility to an investment manager, which is not possible in every case, the plan fiduciary can hire an expert, such as an investment advisor, to help it select the investments appropriate for the plan. In fact, if the fiduciary does not have the expertise to make investment-related decisions, it may have a duty under ERISA to hire an expert. At a minimum, Employer Fiduciaries, such as the plan's investment committee, should include persons who have some level of sophistication in investing.

Engaging in Procedural Prudence and Allocating Fiduciary Responsibilities

As discussed previously under the overview of fiduciary responsibilities, the focus of ERISA is not on whether an Investment Fiduciary makes the right investment decisions, but rather whether the Investment Fiduciary gave "appropriate consideration" to the facts and circumstances in determining whether the decision to purchase or retain an investment was prudent and was otherwise in accordance with the general fiduciary provisions. In effect, the Investment Fiduciary must demonstrate procedural prudence.

Furthermore, ERISA provides that fiduciary responsibilities can be allocated among multiple fiduciaries so that fiduciaries are only held liable under ERISA with respect to the responsibilities specifically delegated to them.[14] As such, through implementing procedures designed to ensure that the general fiduciary requirements are met and by allocating fiduciary responsibilities among different fiduciaries, exposure to fiduciary liability can be minimized.

The importance of being able to demonstrate procedural prudence and the effective allocation of fiduciary responsibility among fiduciaries became very apparent during the financial crisis. As plan investments decreased in value or became illiquid, fiduciaries scrambled to review their initial investment decisions to determine if there was any fiduciary liability exposure and to determine if action was necessary in light of current economic conditions. In many cases, Investment Fiduciaries did not entirely understand the nature of the plan investments or plan investment strategies used, such as liquidation restrictions on stable value products and the use of securities lending. Moreover, they had no written record establishing the basis for making certain investment decisions, so they had no evidence showing that the initial investment decisions met ERISA's requirements. Finally, there were many questions about who was the fiduciary making the investment decisions and there was very little understanding that, by allocating fiduciary responsibilities appropriately, some plan fiduciaries can be insulated from liability exposure faced by other fiduciaries.

Reviewing Written Materials Describing the Investments

Investment Fiduciaries need to read and understand the materials related to the plan's investments (*e.g.*, prospectuses, offering memoranda, collective trust agreements, etc.). The use of securities lending in a fund and the restrictions on liquidating a stable value fund are disclosed in such materials. However, many Investment Fiduciaries were surprised by the existence of these provisions during the crisis. In practice, based upon their review of these materials, Investment Fiduciaries should ask questions of managers and factor the answers into the investment decisions. Failure to do otherwise raises serious questions regarding whether the Investment Fiduciaries acted prudently including their "appropriate consideration" of the underlying facts and circumstances.

Reviewing Investment Management and Investment Advisory Contracts

Investment Fiduciaries should review investment management and investment advisory contracts carefully to determine whether the documents adequately set forth the rights and responsibilities of the respective parties. For example, Investment Fiduciaries should verify that:

- The manager or advisor specifically agrees to its appointment as a fiduciary to the plan (if such fiduciary relationship is intended);
- The agreement includes appropriate protective language, such as indemnification or cross-indemnification language, and excessive exculpatory language on behalf of the other party to the agreement is limited;
- The agreement adequately sets forth the parties' representations and warranties; and
- The manager or advisor agrees to perform its duties pursuant to ERISA including compliance with applicable prohibited transaction class exemptions.

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14 ERISA § 405(c)(1).

Investment Fiduciaries should review investment management and investment advisory contracts carefully to determine whether the documents adequately set forth the rights and responsibilities of the respective parties.

Investment Fiduciaries have a duty to assure that ERISA assets are adequately protected, which can in part be accomplished by assuring investment-related agreements are well-drafted. The provisions of these agreements became much more important during the financial crisis.

Considering Divestiture of Assets

If investment performance drops significantly and the likelihood of recovery is unlikely or the retention of certain ERISA plan assets cannot otherwise be justified under ERISA's general fiduciary provisions, Investment Fiduciaries need to consider the possibility of divesting ERISA assets. However, in so doing, the Investment Fiduciary must take care to prevent an ERISA violation, including causing prohibited transactions, in attempting to resolve the problem.

During the financial crisis, many Investment Fiduciaries, for a variety of reasons, were willing to purchase troubled assets (*e.g.,* ARS) from ERISA plans and accounts, or transfer those assets from one ERISA account to another. However, in the absence of an exemption, this would cause the Investment Fiduciaries to engage in prohibited transactions under ERISA section 406. In order to avoid prohibited transactions, Investment Fiduciaries sought individual prohibited transaction exemptions in many cases, particularly in transactions involving ARS.[15] In the alternative, fiduciaries considered taking advantage of the DOL's Voluntary Fiduciary Correction Program (VFCP), which addresses correcting the sale of certain plan assets to a party in interest.[16]

Investment Fiduciaries should also try to work with investment managers to achieve a divestiture where it otherwise does not appear possible. For example, in the case of stable value funds, managers were willing to establish a blended fixed income fund that consisted of both the stable value fund and a money market fund through which an orderly and more rapid liquidation of the stable fund assets could occur. Fund managers involved in securities lending set up programs whereby a plan could liquidate its position in the fund over time in order to avoid in kind distributions. In other words, if an Investment Fiduciary believes that ERISA requires action should be taken, it should try to work with the other party to reach the desired goal.

Reviewing Participant Communications

Investment Fiduciaries should continually review their written plan communications to assure that the nature of the plans' investments are clearly communicated to plan participants and that they are delivered in a manner that complies with DOL requirements. The importance of clear communication materials became evident as target-date funds incurred significant losses and as stable value funds faced performance and liquidity problems.

One of the key requirements for QDIA protection is that the plan administrator communicates multiple aspects of the QDIA, including investment risks, in the form of a written notice. Such notice must be delivered at the time of initial eligibility (or immediately before) and on an annual basis. During the financial crisis, questions arose whether QDIA notices adequately disclose investment risk and whether those notices were being "delivered" in a manner permitted under the regulations (*e.g.,* electronically).

In the context of stable value funds, as insurers went into receivership or received downgraded credit ratings, serious questions were raised whether the one dollar par value in a stable value fund could be maintained and whether communication materials were clear that such value was not guaranteed. By clearly drafting and properly delivering communication materials, Investment Fiduciaries can help protect themselves against successful benefit claims and ERISA suits by allowing the fiduciary to take advantage of certain investment safe harbors (*e.g.,* QDIAs) and by presenting materials that do not arguably mislead participants.

Considering Whether Legal Action is Necessary

In extreme circumstances, Investment Fiduciaries may have to take legal action in order to protect plan assets and the interests of plan participants. As examples of such circumstances, investment committees of plans sponsored by two Fortune 500 companies sued a custodian and investment manager for breach of ERISA's fiduciary duties

15 *See, e.g.,* DOL IPTE 2010-5 & DOL IPTE 2009-06.
16 71 FR 20262, 20278.

in challenging securities lending practices. These suits are still pending, so the substantive merits of the cases are yet to be determined by a court. However, these cases demonstrate that, when things go awry with respect to plan investments, Investment Fiduciaries should take the time to review plan assets and determine whether compensation should be sought on behalf of the plan or other action is necessary in order for Investment Fiduciaries to meet their ERISA obligations.

Protecting Investment Fiduciaries through Insurance or Otherwise

As the financial crisis unfolded and ERISA plans began experiencing significant losses, Investment Fiduciaries became much more aware of the total dollar exposure to which they might be personally liable in the event an ERISA fiduciary breach occurred. The crisis prompted many Investment Fiduciaries to consider to what extent, if at all, they were protected from such liability. ERISA allows an employer to purchase fiduciary liability insurance on behalf of its employees who act as Investment Fiduciaries.[17] However, many fiduciaries did not understand that an ERISA bond designed to comply with Section 412 of ERISA does not, in general, provide fiduciary liability protection. Rather, such bonds are designed to protect ERISA plans and accounts by requiring payment of losses to the plan or account when such losses are incurred by handling plan assets in a manner comparable to civil or criminal fraud. For that reason, most fiduciaries that breach ERISA's fiduciary responsibility provisions in making investment decisions are not covered by such a bond.

Furthermore, the governing plan documents did not offer adequate indemnification of employee Investment Fiduciaries by the sponsoring employer or fiduciary liability coverage was inadequate or nonexistent *(e.g.,* the policy did not cover the indemnifying fiduciary). The financial crisis refocused Investment Fiduciaries' attention on the need for adequate indemnification provisions and the need for fiduciary liability insurance coverage, at least in some circumstances.[18]

Conclusion

The last several years have been trying times for Investment Fiduciaries. By looking at the issues that arose with regard to securities lending, ARS, target-date funds and stable value funds, we can better see what steps Investment Fiduciaries should take to meet their fiduciary obligations. Importantly, Investment Fiduciaries should be reminded that although the global economic crisis that began in 2007 and still exists today was unprecedented, the responsibilities and challenges of being an ERISA fiduciary are not. In other words, the crisis simply highlighted that fiduciary risk associated with managing plan assets is very real and that certain steps can and, in some cases, must be taken by Investment Fiduciaries to protect plan assets from loss and to protect Investment Fiduciaries against liability under ERISA. Many of the prophylactic and remedial actions highlighted and recommended in this article are not new, but their relevance and importance were brought into focus by the financial crisis and should be carefully considered by all Investment Fiduciaries.

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17 ERISA § 410(b).

18 Note that the enforceability of indemnification clauses has been called into question when the plan sponsor offers an indemnification to a Third Party Fiduciary, but the indemnification provision, if enforced on behalf of the Third Party Fiduciary, would have a negative effect on the plan. In two cases involving ESOPs, the courts concluded that such indemnification provisions were invalid under ERISA § 410(a) because the enforcement of the clause would have a negative effect on the employer plan sponsor, drive down the stock price and thus reduce the value of the employer stock held in the ESOP. *See* Fernandez v. K-M Industries Holding Co., Inc., 646 F. Supp. 2d (N.D. Cal. 2009); Johnson v. Couturier, 572 F.3d 1067 (9th Cir.2009). Thus, indemnification provisions should be reviewed carefully and other alternatives, such as the purchase of insurance, should be considered as needed.