NEW STANDARDS OF DIRECTOR LOYALTY AND CARE IN THE POST-ENRON ERA: ARE SOME SHAREHOLDERS MORE EQUAL THAN OTHERS?

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Introduction

In recent years, corporate scandals have attracted widespread attention from Wall Street[3] to Main Street[4] and have provided much fodder for the business press[5] as well as the tabloid press.[6] In response to the public outcry, Congress passed the Sarbanes-Oxley Act (SOX).[7] The Securities and Exchange Commission (SEC) then

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3. *See, e.g.*, John M. Berry, *Greenspan Says Economic Recovery on Track*, WASH. POST, July 21, 2002, at A3 ("Greenspan blamed part of the recent plunge in stock prices on investors' reaction to a variety of corporate accounting scandals.").

4. *See, e.g.*, Andrew Countryman, *Oversight Chief Says Trust Up to Auditors*, CHI. TRIB., Feb. 26, 2004, § 3, at 1 ("Congress . . . is 'really responsive to th[e] fury at the level of the average American.'").

5. *See* Ronald Alsop, *Scandal-Filled Year Takes Toll on Companies' Good Names*, WALL ST. J., Feb. 12, 2003, at B1.

6. *See, e.g.*, *Put Corporate Crooks Behind Bars!*, THE NAT'L ENQUIRER, *at* http://www.nationalenquirer.com/stories/feature.cfm?instanceid=42899 (Aug. 1, 2002) ("Thieving corporate executives who steal wages and retirement savings from American workers must do hard jail time—no Club Fed!").

7. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 11 U.S.C., 15 U.S.C., 18 U.S.C., and other chapters (2002)).

stepped in, producing extensive regulatory guidance on SOX[8] and escalating its scrutiny of investment banks and mutual funds.[9] Through SOX and the subsequent SEC regulations, the federal government has penetrated the traditionally state-regulated field of corporate governance. This intrusion by the federal government has engendered much literature,[10] with commentators offering conflicting views on the value of the obligations that SOX and the related regulations impose upon corporate officers and directors.[11]

In this Article, we will consider at a conceptual level how formerly stable principles have been affected by the legislative activity. Prior to the recent events, state corporate governance standards and federal securities law principles were well-established. However, the collision of federal securities law, federal law regulating employee

8. See, for example, the disclosure required by sections 406 and 407 of the Sarbanes-Oxley Act. *Id*. at 789–90; *see also* Integrated Disclosure System for Small Business Issuers, 17 C.F.R. § 228 (2003); Standard Instructions for Filing Forms under Securities Act of 1933, Securities Exchange Act of 1934 and Energy Policy and Conservation Act of 1975—Regulation SK, 17 C.F.R. § 229 (2003); Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, 17 C.F.R. § 205 (2003).

9. *See, e.g.*, Rules and Regulations, Investment Company Act of 1940, 17 C.F.R. § 270 (2004); Forms Prescribed Under the Securities Act of 1933, 17 C.F.R. § 239 (2004); General Rules and Regulations, Securities Exchange Act of 1934, 17 C.F.R. § 240 (2004); Forms Prescribed Under the Investment Company Act of 1940, 17 C.F.R. § 274 (2004); Press Release 2004-102, Securites and Exchange Commission, Franklin Advisers to Pay $50 Million and Undertake Compliance Reforms to Settle Market Timing Charges, *at* http://www.sec.gov/news/press/2004-102.htm (Aug. 2, 2004); Press Release 2003-87, Securities and Exchange Commission, SEC Settles Enforcement Proceedings Against J.P. Morgan Chase and Citigroup, *at* http://www.sec.gov/news/press/2003-87.htm (July 28, 2003).

10. *See, e.g.*, John S. Baker, Jr., *Reforming Corporations Through Threats of Federal Prosecution*, 89 CORNELL L. REV. 310 (2004); John C. Coffee, *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 333–45 (2004); E. Norman Veasey, *State-Federal Tension in Corporate Governance and the Professional Responsibilities of Advisors*, 28 J. CORP. L. 441 (2002).

11. *Compare* Lisa M. Fairfax, *Form Over Substance?: Officer Certification and the Promise of Enhanced Personal Accountability Under the Sarbanes-Oxley Act*, 55 RUTGERS L. REV. 1, 3 (2002) (stating that SOX's personal certification requirement may end up being symbolic); Joseph F. Morrissey, *Catching the Culprits: Is Sarbanes-Oxley Enough?*, 2003 COLUM. BUS. L. REV. 801, 851–53 (2003) (criticizing Congress for not extending secondary actor liability as part of SOX); Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 35 (2002) (arguing SOX will impose significant costs on corporations and will not effectively prevent corporate fraud); *with* Margo Eberlein, *Recovering Retirement Security: An Analysis of the Lockdown Claims Under ERISA, as Illustrated by the Enron Litigation*, 79 CHI.-KENT L. REV. 699, 710 (2004) (noting SOX's protections in lockdown situations); Jillian M. Lutzy, *Analysis of the Proposed NYSE Corporate Governance and Audit Committee Listing Requirements*, 2 DEPAUL BUS. & COM. L.J. 99, 162–63 (2003) (commenting on "positive" changes in required audit committee composition).

stock purchase programs, and state corporate law is reshaping the traditional duties of loyalty and care owed by corporate actors to shareholders. The longstanding principle of shareholder equality has been rendered unstable, and the doctrine that allows a corporation to remain silent even in the face of direct questioning unless a specific statutory provision obligates it to disclose a particular matter, in place since the passage of the major federal securities acts in the 1930s, may be obliterated altogether.

Officers and directors have long looked to traditional principles arising from state corporate law and federal securities law to provide standards for their conduct. However, these traditional principles are now being affected by company-sponsored 401(k) plans—relatively new vehicles for share ownership that have developed over the last twenty years.[12] Where employer stock has fallen dramatically due to massive corporate fraud, the bursting of the tech bubble, or the fluctuation in the equity markets, private plaintiffs[13] and the Department of Labor (DOL)[14] have filed lawsuits against the employer, its directors, and individuals who oversee the 401(k) plans. These cases raise novel issues of fiduciary obligation, corporate disclosure, and overlapping legal frameworks. Further, they introduce ambiguity to the obligations and liabilities of high-level corporate actors who oversee incentive, savings, and pension plans (such as 401(k) plans) that utilize employer stock as an investment vehicle.

Typically, employees have sole responsibility for their own investment decision-making. The principle of employee responsibility theoretically applies whether the employee acts through a brokerage account unaffiliated with the employer, a stock purchase plan, a stock

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12. See *infra* text accompanying notes 280–93 for a discussion of 401(k) plans. A stock purchase or option plan allows an employee to purchase the employer's securities either at current market rates or at a set price (respectively), while a 401(k) plan provides for tax-favored individual accounts. Contributions to 401(k) plans may be made by employers and/or employees, and employer securities may be an investment option. Some contributions, particularly what are known as employer matching contributions, may be invested automatically in employer securities. For a discussion of these plans and defined contribution (DC) plans more generally, see Dana M. Muir, *The Dichotomy Between Investment Advice and Investment Education: Is No Advice Really the Best Advice?*, 23 BERKELEY J. EMP. & LAB. L. 1, 46 (2002).

13. *See* Jonathan D. Glater, *From Investor Fury, a Legal Bandwagon*, N.Y. TIMES, Sept. 15, 2002, § 3, at 1.

14. *See* Press Release, U.S. Dept. of Labor, Office of Public Affairs, Secretary of Labor Elaine L. Chao Announces Settlements Restoring at Least $66.5 Million to Enron Retirement Plans (May 13, 2004) ("The department sued Enron, corporate directors and the administrative committee on June 26, 2003, for violating [ERISA]."), http://benefitslinks.com/pr/detail.php?id=37974 (last visited Mar. 29, 2005).

option plan, or a company-sponsored employee investment plan[15] such as a 401(k) plan; employees are responsible whether the investment of choice is employer stock or some other investment product. Thus, it would be reasonable to expect a company's interactions with its employee shareholders to be regulated by the same conceptual legal framework that regulates the company's interaction with all of its other shareholders.

In practice, however, employees do not always act as independent, rational investment decision-makers. Research by behavioral economists and others shows that seemingly irrelevant factors affect employees' investment decision-making.[16] Employee shareholders are vulnerable to undue influence as they make investment decisions, and the law recognizes this vulnerability by instituting multiple tiers of regulation. Through the Securities Act of 1933[17] (1933 Act), and the Securities Exchange Act of 1934[18] (1934 Act), federal securities law imposes disclosure requirements on many issuers of securities and prohibits fraud in connection with the sale or purchase of any security. The Employee Retirement Income Security Act[19] (ERISA) establishes some obligations for company-sponsored employee investment plans even where investment decision-making responsibility is delegated to employees. State corporate law regulates the obligations of corporate fiduciaries vis-à-vis corporate shareholders. The cumulative effect of this regulatory framework means that, in fact, employees are often not solely responsible for their own investment decision making. Employee responsibility is particularly questionable where the investment decision relates to employer stock. Corporate officers and directors share in that decision-making responsibility—at least from a legal liability perspective—in subtle and complex ways.

This new era of complex interactions between state and federal law, as well as between federal securities law and federal law regulating company-sponsored employee investment plans, raises important questions. How is the scope of officer and director responsibility changing and developing? What distinctions are being made between shareholders who are traditional investors and those who are employees? How do the applicable legal standards overlap? Are those stan-

15. We will use this terminology throughout the Article to refer to tax-favored plans regulated by ERISA where employees have some decision-making power over their investment vehicles. For discussion of our reasons for the choice of terminology, see *infra* text accompanying notes 289–93.
16. Muir, *supra* note 12, at 11–15.
17. 15 U.S.C. §§ 77a–77aa (2000).
18. 15 U.S.C. §§ 78a–78mm (2000).
19. 29 U.S.C. §§ 1001–1461 (2000).

dards sometimes inconsistent? Can and should some of the traditional state law standards governing officer and director conduct be salvaged and imported into the federal regulatory schemes? We begin to approach these questions in Part I by analyzing the traditional obligations owed to shareholders under federal securities law. In Parts II and III we look at the state corporate law duties that corporate officers and directors owe to shareholders. In Part IV we move to an examination of the basic fiduciary obligations imposed by ERISA. In Part V we evaluate the case law emerging from recent shareholder cases, paying special attention to the litigation arising from employee investments in company stock. Finally, in Part VI, we consider the intersection of these complex legal regimes. We analyze a number of anomalous situations created by the varying standards articulated by state and federal law. We also suggest some ways in which courts and policy makers may be able to draw from traditional, well-established legal doctrine as they attempt to deal with the fallout from the recent market downturn and the numerous instances of corporate malfeasance. The traditional legal doctrines may be useful in informing and rationalizing the law of shareholder protection in the post-Enron era.

I.
Traditional Obligations Owed by Directors and Officers to Shareholders Under Federal Securities Law

The federal securities laws date back to the 1930s. They have long been the fundamental source of federal regulation of the relationship between a corporation and its shareholders. The 1933 Act and the 1934 Act govern all sales of securities. We refer to both acts together as the Federal Securities Acts or the Acts. When an employee invests in company stock, whether through a brokerage account unrelated to the company or through any form of company-sponsored program, that acquisition may be subject to some provisions of the Federal Securities Acts. Similarly, disclosures related to the securities, subsequent sales of the securities, and other actions taken vis-à-vis the securities may be regulated by the Acts.

A. The Initial Offer and Sale of Securities

The 1933 Act regulates the initial offer and sale of securities. Its primary goal is to ensure that investors receive the information they need to assess the securities.[20] At its most basic level, the 1933 Act requires the issuer of securities either to register the sale of its securities or qualify for an exemption from registration.[21]

Notably, the enactors of the 1933 Act rejected any role for federal regulators in determining the market value of publicly offered securities.[22] Federal law permits a company to offer its securities for sale even when, for example, the company's statement of its prospects is that:

> We have never achieved profitability . . . . We may not obtain a large enough customer base utilizing our mission-critical Internet solutions to generate sufficient revenue and achieve profitability. We believe that we will continue to incur losses for at least the next several years, and that our losses will increase significantly from current levels.[23]

The bottom line is that directors, officers, and other relevant actors are not liable under the 1933 Act for offering worthless securities as long as the offering documents are accurate and fully disclose the risks inherent in investing in the securities.[24]

B. Subsequent Trading, Securities Fraud, and Insider Trading

In contrast to the 1933 Act, the 1934 Act regulates the trading of securities by imposing an array of requirements that are largely market related. Regardless of whether a security is exempt from registration under the 1933 Act, the 1934 Act mandates that issuers with securities traded on a national exchange or with 500 or more shareholders and at least $10 million in assets register and comply with periodic reporting obligations.[25] Further, section 10b of the 1934 Act prohibits fraud in the purchase or sale of any security without reference to whether the securities are traded on a national exchange, its number of shareholders, or the amount of company assets.[26] In general, section 10b prohibits any material misstatement or omission made in connection with

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20. LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION § 2(B)(1) (4th ed. 2001).
21. *Id.*
22. *See id.* at § 1(D)(10).
23. IASIAWORKS INC., FORM S-1 REGISTRATION STATEMENT, *available at* http://www.sec.gov/Archives/edgar/data/1110992/0001012870-00-002246-index.html (Apr. 20, 2000).
24. This does not mean, of course, that investors who have suffered losses will not allege defects in the registration statement. *See, e.g.*, Kiyashka v. iAsiaWorks, Inc., No. C01-3224, 2002 U.S. Dist. LEXIS 9554, at *3 (N.D. Cal. May 14, 2002) (dismissing plaintiffs' claims associated with iAsiaWorks securities offering).
25. LOSS & SELIGMAN, *supra* note 20, at § 1(D)(3).
26. 15 U.S.C. § 78j(b) (2000).

the purchase or sale of securities.[27] In addition, it is the source of insider trading law, which includes a ban on tipping material, nonpublic information to others who trade on the information.[28]

Though section 10b has broad application, the Supreme Court has established significant limits on suits alleging section 10b violations. First, the statute does not allow private party claims for aiding and abetting.[29] Second, a plaintiff must prove scienter on the part of the defendant; negligence is insufficient.[30] Although the Supreme Court has not addressed whether recklessness is sufficient to establish scienter, the majority of circuits utilize a recklessness standard.[31] Third, only actual purchasers or sellers of securities may bring section 10b claims.[32] Thus, an investor who, due to fraud, does not purchase securities she otherwise would have purchased has no standing to bring a section 10b claim.

Regulation FD[33] (Reg. FD) is another important federal securities law constraint. Reg. FD prohibits senior management from selectively disclosing material, nonpublic information to specified persons listed in the rule, such as securities holders, institutional investors, and securities analysts.[34] A Reg. FD violation requires neither scienter nor breach of any fiduciary duty, but is enforceable only by the SEC. An officer is in violation of Reg. FD if she communicates information such as concerns about fraud in company financial reports to employees ahead of an announcement to the market.[35]

Both Reg. FD and section 10b are intended to reduce informational asymmetry. In another provision meant to counteract informational advantages, the 1934 Act provides that "insiders," defined to include officers, directors and ten-percent shareholders of reporting

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27. *Id.*

28. LOSS & SELIGMAN, *supra* note 20, at § 9(B)(5).

29. *See* Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 191 (1994).

30. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197–214 (1976).

31. *See* LOSS & SELIGMAN, *supra* note 20, at § 9(B)(6).

32. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

33. 17 C.F.R. § 243 (2004).

34. *Id.* It also regulates the communications of investor relations professionals and other issuer representatives who regularly interact with security holders or securities market professionals. *Id.* at § 243.100(b). Although Reg. FD is intended to permit selective communications to employees for business purposes, it is not consistent with the regulation's intent that companies could selectively communicate with employees in order to encourage the employees to buy or sell company securities. *See* Susan J. Stabile, *I Believed My Employer and Didn't Sell My Company Stock: Is There an ERISA (or 1934 Act) Remedy for Me?*, 36 CONN. L. REV. 385, 418–19 (2004).

35. 17 C.F.R. § 243.100(a) (2004).

act companies, must disgorge any profit made on purchases and sales of company securities made within a six-month period.[36]

Together, the 1933 and 1934 Acts constrain the behavior of corporate officers and directors vis-à-vis employee shareholders. As mentioned above, the 1933 Act requires issuing companies to register their securities or qualify for an exemption from registration.[37] If material misstatements or omissions are made in the registration materials, the officers and directors, as well as the issuer and other parties who took part in the offering, may be liable for those misstatements or omissions.[38] While the issuer is strictly liable, the officers and directors may assert a due diligence defense.[39]

Similarly, officers and directors must comply with the 1934 Act whenever they trade in company securities or provide information to others who may trade based on that information. In one of the foundational cases on insider trading, *In re Cady, Roberts & Co.*,[40] J. Cheever Cowdin, a director of Curtiss-Wright Corporation, telephoned Robert M. Gintel, a broker and partner of Cady, Roberts & Co., during a short break in a Curtiss-Wright board meeting. Cowdin left a message telling Gintel that the quarterly dividend had been reduced.[41] The SEC determined that the antifraud provisions of the 1934 Act prohibited Cowdin, a corporate insider, from conveying material nonpublic information to someone such as Gintel, who could use that information to benefit himself or his clients.[42] While *Cady, Roberts* remains valid law, the United States Supreme Court has repeatedly rejected SEC theories of insider trading that rely simply on the concept of informational equality and, instead, requires the existence of both a breach of duty and scienter before finding a violation.[43] Officers and directors have scienter and violate the 1934 Act's fraud provisions when they tip or trade while in possession of material, nonpublic information about their company; such actions violate the fiduciary obligation officers and directors owe to corporate shareholders.[44] Similarly, officers and directors cannot trade on or tip material, nonpublic information in breach of a fiduciary duty owed to the source

36. Securities Act of 1933, 15 U.S.C. § 78p (2000).
37. *See supra* text accompanying note 21.
38. 15 U.S.C. §§ 77k, 77l (2000).
39. *Id.* at § 77k(b)(3).
40. 40 S.E.C. 907 (1961).
41. *Id.* at 909.
42. *Id.* at 911–13.
43. *See* Dirks v. SEC, 463 U.S. 646, 654–59 (1983); Chiarella v. United States, 445 U.S. 222, 228–30 (1980).
44. *See* Loss & Seligman, *supra* note 20, at § 9(B)(6).

of the information.[45] Other than this narrow use of state law fiduciary duty, the Federal Securities Acts do not rely on or impose fiduciary duties in regulating the relationships between issuers and buyers of securities.

Together, Reg. FD and the 1934 Act's antifraud provision prevent officers and directors from selectively communicating material, nonpublic information about the company's prospects to employees that could be used to determine whether to invest in company stock. Such a targeted disclosure would violate the officer's duty to all stockholders and almost certainly would be made with scienter. As a result, the statement would violate section 10b, potentially exposing the employee who trades securities and the officer to both civil and criminal liability.

C. The Federal Securities Acts and Employee Shareholders

In this Article, we are most concerned with purchases of employer stock that are facilitated by a company-sponsored employee investment program, such as a 401(k) plan. Under ERISA, purchased stock that is an asset of the plan must be held in a trust.[46] The trust provides a buffer between the employee and the security that is not present when an individual buys a security in a normal brokerage transaction. The Federal Securities Acts, as applied to employee benefit plans, recognize the multi-layered nature of benefit plan investments and sometimes treat employee shareholders differently from non-employee shareholders. As a result, the employee's interest in a formal company-sponsored employee investment plan is itself likely to be considered a security under the definition of the Federal Securities Acts.

What constitutes a security regulated by the Federal Securities Acts? This question pervades all situations involving benefit plans and employee stock purchases. In *SEC v. W.J. Howey Co.*,[47] the Supreme Court listed several factors that determine whether any given interest is an investment contract. The factors, aggregately known as the *Howey* test, include the requirements that:

> a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are

45. *See* United States v. O'Hagan, 521 U.S. 642, 676 (1997).
46. 29 U.S.C. § 1103 (2000).
47. 328 U.S. 293 (1946).

> evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.[48]

In *International Brotherhood of Teamsters v. Daniel*,[49] the Court applied the *Howey* test to ownership interests in an employee benefit plan, and found that the employee's interest in the benefit plan did not constitute securities for purposes of the Federal Securities Acts.[50] In *Teamsters*, the interests were held by union members in a traditional form of pension plan known as a defined benefit plan.[51] The union members' participation was automatic, and they did not make contributions to the plan.[52] According to the Court, a defined benefit plan does not involve either an investment of money or an expectation of profits from a common enterprise, both of which are required under the *Howey* test for an investment contract to exist.[53] The Court decided that, to the extent an employee could be said to be exchanging labor for the employer's pension plan contribution, the contribution was a minimal and indivisible portion of the employee's total compensation.[54] Furthermore, the Court did not believe that an employee would typically exchange labor for the relatively low likelihood that he or she would be able to profit from the pension plan's investment earnings.[55] The Supreme Court buttressed its analysis by articulating its belief that "[t]he existence of this comprehensive legislation governing the use and terms of employee pension plans [referring to ERISA] severely undercuts all arguments for extending the Securities Acts to noncontributory, compulsory pension plans."[56] Thus, the Court appeared to view ERISA, and not the Federal Securities Acts, as the primary regulatory framework for traditional pension plans.

At the other end of the spectrum, when an employee invests in company stock in a way that is totally unrelated to any employer-sponsored stock purchase program, such as through a brokerage account, there is no doubt that the employee acquires a security that is subject to the Federal Securities Acts.[57] That analysis does not change simply because the employee purchases the company stock through an

48. *Id.* at 298–99.
49. 439 U.S. 551 (1979).
50. *Id.* at 558–60.
51. *Id.* at 554 n.3. Defined benefit plans do not provide for individual employee accounts and the plan sponsor assumes the investment risk. For additional discussion of defined benefit plans, see Muir, *supra* note 12, at 4–5.
52. 439 U.S. at 553.
53. *See id.* at 558–62.
54. *Id.* at 560.
55. *Id.* at 561–62.
56. *Id.* at 569–70.
57. *See* Loss & Seligman, *supra* note 20, at § 3(A)(1)(h).

employer-sponsored program; the employee still has bought a "security" as the term is defined by the Federal Securities Acts. In 1953, the Supreme Court implicitly recognized that employer stock constitutes a security when it decided *SEC v. Ralston Purina Co.*[58] Ralston Purina had offered its key employees the opportunity to purchase company stock but had not registered the offering with the SEC.[59] The company argued that an offering limited to its key employees constituted a private offering, which would not have to be registered, because the offer was made to a circumscribed population that did not require the protections of the Federal Securities Acts.[60] The Supreme Court faulted the lower courts for permitting too wide an exemption for sales of company securities to employees.[61] According to the Court, such sales are subject to the registration requirements of the 1933 Act except in the special circumstances where "executive personnel who because of their position [would] have access to the same kind of information that the [1933] act would make available in the form of a registration statement."[62]

The SEC has confirmed that the typical 401(k) plan gives rise to an employee participation interest in the plan itself that constitutes a security.[63] Unlike the defined benefit plan interests at issue in *Daniel*, 401(k) plans typically are structured to permit voluntary employee contributions to the plan. Similarly, when a plan purchases a security, the plan's purchase—just like any other purchase of a security—is subject to the requirements of and enjoys the protections of the Federal Securities Acts.[64]

This can be complicated, so consider the following example: Employee A works for Company Y and is a participant in the company's 401(k) plan. One of the investment options in the 401(k) plan is Company Y stock. Employee A directs the plan to purchase 100 shares of Company Y stock for Employee A's account. The plan itself purchases the 100 shares of Company Y stock. That purchase is a purchase of securities and is governed by the Federal Securities Acts.

58. 346 U.S. 119 (1953).
59. *Id.* at 120.
60. *See id.* at 121–22 (discussing Ralston Purina's argument).
61. *See id.* at 124–26.
62. *Id.* at 125–26.
63. Employee Benefit Plans, Securities Act Release No. 33-6281, 21 SEC DOCKET 1372, at 1372–74 (Feb. 3, 1981).
64. By way of comparison, in the absence of significant differences between a stock purchase plan and a typical brokerage transaction, an employee's participation interest in a stock purchase plan is not a security even though the underlying company stock is a security. Employee Benefit Plans, Securities Act Release No. 33-6188, 19 SEC DOCKET 465, at 483 (Feb. 19, 1980).

In addition, Employee A has an investment in the Company Y 401(k) plan. Federal securities law defines Employee A's ownership interest in the 401(k) plan to be a security and regulates the ownership interest. Finally, as we will discuss in Part IV below, Employee A's relationship with the 401(k) plan, including the purchase of Company Y stock, is governed by ERISA.

In sum, the Federal Securities Acts establish a unified framework regulating the purchase and sale of securities. That framework establishes disclosure obligations, has been interpreted to prohibit insider trading, and sets penalties for disclosures that are neither accurate nor sufficient. The extent to which employee interests in company-sponsored investment plans constitute securities subject to the Federal Securities Acts can be complex. In the typical 401(k) plan, however, both the individual securities held in employee accounts and the employees' interests in the accounts are securities.

II.
Traditional Obligations Owed by Directors and Officers to Shareholders Under State Corporate Law

The concept of fiduciary duty, as applied to corporate officers and directors, is a significant part of corporate law jurisprudence. It is well established that corporate officers and directors owe fiduciary duties to the corporation and its shareholders.[65] The most salient duties are the duties of care and loyalty,[66] set against the obligation to act in

65. *See, e.g.*, Alessi v. Beracha, 849 A.2d 939, 950 (Del. Ch. 2004) ("[F]iduciary duties are owed by the directors and officers to the corporation and its stockholders.") (quoting Arnold v. Soc'y for Sav. Bancorp., 678 A.2d 533, 539 (Del. 1996)); *see also* Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 931 (Del. 2003); Paramount Communications v. QVC Network Inc., 637 A.2d 34, 43 (Del. 1993); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 179 (Del. 1986); Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985); Chambers v. Beaver-Advance Corp., 140 A.2d 808, 811 (Pa. 1958); Dennis v. Copelin, 669 So. 2d 556, 560 (La. Ct. App. 1996); Victor Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 B. C. L. Rev. 595, 611 (1997); William E. Knepper & Dan A. Bailey, Liability of Corporate Officers and Directors §1.07 (7th ed. 2003); D. Kyle Sampson, *The Fiduciary Duties of Corporate Directors to "Phantom" Stockholders*, 62 U. Chi. L. Rev. 1275, 1276 (1995). *But see* John C. Carter, *The Fiduciary Rights of Shareholders*, 29 Wm. & Mary L. Rev. 823, 824 (1988) ("Although courts commonly speak of a fiduciary duty of directors to the corporation and its shareholders, one is hard pressed to find a case in which directors are held directly liable to shareholders, absent circumstances that create a special relationship.").

66. See *infra* Part III.A–B for a discussion of the duties of care and loyalty. One of the earliest cases discussing the duty of care in the United States is Percy v. Millaudon, 8 Mart. (n.s.) 68, 74–75 (La. 1829).

good faith.[67] A review of this body of law yields some insights that may be instructive in helping to define the contours of the liability officers and directors face in their roles as ERISA fiduciaries.

The corporate law fiduciary duties are somewhat analogous to those duties found in ERISA jurisprudence. The fiduciary duties in corporate law had their genesis in the law of trusts.[68] A fiduciary relationship exists "whenever any person acquires a power of any type on condition that he also receive with it a duty to utilize that power in the best interests of another, and the recipient of the power uses that power."[69] This relationship is found between trustees and their beneficiaries and between agents and their principals.[70] Although corporate officers and directors are not formally considered trustees of the organizations they serve,[71] corporate law implicitly analogizes the fiduciary obligations of officers and duties to that of trustees when determining the scope of corporate fiduciary duties.[72] One of the reasons why corporate law draws so heavily on trust law jurisprudence seems to be the early suspicion of the private power of corporations. With the increase of public investments in corporations, corporate scandals and fiduciary mismanagement became a matter of concern in public policy.[73] The laws generated in response focused on shareholder rights. These rights are similar to those reserved for trust beneficiaries; both aim to protect the interests of those whose money is being handled by others.[74]

Review of the early cases addressing the fiduciary obligations of corporate officers and directors reveals that the courts drew upon the law of trusts when defining these obligations. According to the Restatement of Trusts:

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67. See *infra* Part II.C for a discussion of the obligation of good faith.

68. Henry Ridgely Horsey, *The Duty of Care Component of the Delaware Business Judgment Rule*, 19 DEL. J. CORP. L. 971, 973 (1994); Edward Rock & Michael Wachter, *Dangerous Liaisons: Corporate Law, Trust Law, and Interdoctrinal Legal Transplants*, 96 NW. U. L. REV. 651, 651 (2002); L.S. Sealy, *Fiduciary Relationships*, CAMBRIDGE L.J. 69, 69–70 (1962); Joseph T. Walsh, *The Fiduciary Foundation of Corporate Law*, 27 J. CORP. L. 333, 333 (2002).

69. J.C. SHEPARD, THE LAW OF FIDUCIARIES 93 (1981).

70. *Id*. at 98.

71. *See* Sealy, *supra* note 65, at 71–72 ("The word fiduciary (which earlier had received very little judicial support) was adopted to describe these situations which fell short of the now strictly defined trust.") (footnote omitted); Walsh, *supra* note 68, at 334 (citing Guth v. Loft, Inc., 5 A.2d 503 (Del. 1939)).

72. Horsey, *supra* note 68, at 974; Walsh, *supra* note 68, at 334.

73. ARTHUR R. PINTO & DOUGLAS M. BRANSON, UNDERSTANDING CORPORATE LAW § 1.03 (2d ed. 2004).

74. *Id*.

> [a] trustee is under a duty to the beneficiary in administering the trust to exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property; and if the trustee has or procures his appointment as trustee by representing that he has greater skill than that of a man of ordinary prudence, he is under a duty to exercise such skill as he has.[75]

The Comment to this section notes:

> The standard of care and skill required of a trustee is the external standard of a man of ordinary prudence in dealing with his own property. A trustee is liable for a loss resulting from his failure to use the care and skill of a man of ordinary prudence, although he may have exercised all the care and skill of which he was capable. On the other hand, if the trustee has a greater degree of skill than that of a man of ordinary prudence, he is liable for a loss resulting from the failure to use such skill as he has.[76]

The Restatement further notes the liability that attaches for failure to adhere to this standard. Section 205 provides for the Liability in case of Breach of Trust as follows:

> If the trustee commits a breach of trust, he is chargeable with
> (a) any loss or depreciation in value of the trust estate resulting from the breach of trust; or
> (b) any profit made by him through the breach of trust; or
> (c) any profit which would have accrued to the trust estate if there had been no breach of trust.[77]

The origin of the corporate law duty of care may go back to the 1742 English case of *Charitable Corp. v. Sutton*,[78] in which the directors of a charitable organization failed to oversee loans to other directors. The court referred to the trust obligations of the directors before holding them liable for breach of duty.[79] According to the court, "[b]y accepting of a trust of this sort, a person is obliged to exercise it with fidelity and reasonable diligence . . . ."[80] Similarly, one of the early cases articulating the corporate standard of care in the United States utilized language from the law of trusts in assessing the obligations of bank directors. In *Hun v. Cary*,[81] decided in New York in 1880, the court found that by voluntarily serving as a director, the individual

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75. RESTATEMENT (SECOND) OF TRUSTS § 174 (1959).
76. *Id*. at § 174 cmt. a.
77. *Id*. at § 205.
78. 2 Atk. 400, 405, 26 Eng. Rep. 642 (Ch. 1742) (finding that board members were "most properly agents to those who employ them in this trust and superintend the affairs of the corporation"); *see also* Sealy, *supra* note 68, at 70.
79. *See* Horsey, *supra* note 68, at 973; Rock & Wachter, *supra* note 68, at 656.
80. *Sutton*, 2 Atk. at 406, 26 Eng. Rep. at 645.
81. 82 N.Y. 65 (1880).

"invites confidence in that relation,"[82] and required the directors to exercise "the same degree of care and prudence that men prompted by self-interest generally exercise in their own affairs."[83] This duty has been extended to non-banking corporations, at least as early as 1891, as articulated by the Supreme Court in *Briggs v. Spaulding*.[84] The Court defined the corporate fiduciary standard as that of "ordinarily prudent and diligent men,"[85] which reflects the standard of trust law.

The Delaware courts have followed suit in their analysis of the ambit of the corporate fiduciary standards. In *Lofland v. Cahall*,[86] the Delaware Supreme Court analogized to the law of trusts in describing directors as trustees for the shareholders.[87] In 1926, the court in *Bodell v. General Electric Corp.*,[88] noted that although directors "are not trustees in the strict sense of the term . . . [w]ith respect to unissued stock they are said to control it as trustees."[89] The court further found that "[i]t is not always necessary . . . to reap a personal profit or gain a personal advantage in order for their actions in performance of their quasi trust to be successfully questioned . . . . They owe the duty of saving their beneficiaries from loss."[90]

Thus, the corporate law standard of care has its genesis in the law of trusts, and was framed in terms of negligence as articulated by the early courts.[91] Yet, as noted some time ago by Professor Bishop, the search for cases where directors were held liable for breach of that standard is like searching for needles in a haystack.[92] Although the

82. *Id.* at 74.
83. *Id*. at 71.
84. 141 U.S. 132 (1891).
85. *Id*. at 152.
86. 118 A. 1 (Del. 1922).
87. *Id.* at 3.
88. 132 A. 442 (Del. Ch. 1926).
89. *Id.* at 446.
90. *Id*. at 447.
91. *See, e.g.*, Briggs v. Spaulding, 141 U.S. 132, 152 (1891) (stating "the degree of care to which these defendants were bound is that which ordinarily prudent and diligent men would exercise under similar circumstances"); Charitable Corp. v. Sutton 26 Eng. Rep. 642, 645 (Ch. 1742) (holding that "by accepting of a trust of this sort, a person is obliged to execute it with fidelity and reasonable diligence"); *see also* Krishnan Chittur, *The Corporate Director's Standard of Care: Past, Present and Future*, 10 DEL. J. CORP. L. 505, 507–08 (1985) ("Conceivably the rule's foundation is in tort law, in that directors' decisions were protected so long as they behaved reasonably. The rule thus incorporates the 'reasonable man' standard to determine negligence.").
92. *See* Joseph W. Bishop, Jr., *Sitting Duck and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099–1100 (1968). Bishop found only four cases in which directors of industrial corporations had been held liable under a standard of negligence. *Id.*

duty of care is described in terms of negligence,[93] the courts did not generally find liability for its breach. Instead, the standard in corporate law evolved to a standard of gross negligence, tempered by presumptions that have become known as the business judgment rule.[94] The next section analyzes current formulations of fiduciary duties in corporate law and their divergence from trust law.

III.
Modern Formulations of Fiduciary Duties in Corporate Law

The essential fiduciary duties of corporate officers and directors in corporate law are the duties of care and loyalty. Intertwined with these duties is the requirement that corporate officials act in good

93. The duty of care is defined by statute in most states. *See, e.g.*, ALASKA STAT. § 10.06.450 (Michie 2004); ARIZ. REV. STAT. ANN. § 10-830 (2004); CAL. CORP. CODE § 309 (West 2004); CONN. GEN. STAT. ANN. § 33-756 (West 2003); FLA. STAT. ANN. § 607.0830 (West 2003); GA. CODE ANN. § 14-2-830 (2003); HAW. REV. STAT. § 414-221 (2003); IOWA CODE ANN. § 490.830 (West 2003); KY. REV. STAT. ANN. § 271B.8-300 (Michie 2003); LA. REV. STAT. ANN. § 12:91 (West 2004); ME. REV. STAT. ANN. tit. 13-C § 831 (West 2005); MD. CODE ANN., CORPS. & ASS'NS § 2-405.1 (2003); MASS. GEN. LAWS ANN. ch. 156B § 65 (West 2004); MICH. COMP. LAWS ANN. § 450.1541a (West 2002); MINN. STAT. ANN. § 302A.251 (West 2004); MISS. CODE ANN. § 79-4-8.42 (2004); MONT. CODE ANN. § 35-2-441 (2003); N.H. REV. STAT. ANN. § 293-A:8.30 (2004); N.J. STAT. ANN. § 14A:6-14 (West 2003); N.M. STAT. ANN. § 53-4-18.1 (Michie 2001); N.Y. BUS. CORP. LAW §717 (McKinney 2003); N.C. GEN. STAT. ANN. § 55-8-30 (West 2000); N.D. CENT. CODE § 10-19.1-50 (2001); OHIO REV. CODE ANN. § 1701.59 (Anderson 2004); OR. REV. STAT. § 60.357 (2003); 15 PA. CONS. STAT. §1712 (2004); R.I. GEN. LAWS § 7-1.1-33 (2004); S.C. CODE ANN. § 33-8-300 (Law. Co-op.2003); TENN. CODE ANN. § 48-18-301 (2002); VA. CODE ANN. § 13.1-690 (Michie 2004); WASH. REV. CODE ANN. § 23B.08.300 (West 2004); W. VA. CODE ANN. § 31D-8-830 (Michie 2003); WYO. STAT. ANN. § 17-16-830 (Michie 2003). The duty is defined by common law in a minority of jurisdictions. For example, in Arkansas, directors are liable for failure to exercise diligence or good faith. Sternberg v. Blaine, 17 S.W.2d 286, 290 (Ark. 1929); *see also* Christy v. Cambron, 710 F.2d 669, 672 (10th Cir. 1983) (discussing the law in Colorado); Holland v. Am. Founders Life Ins. Co., 376 P.2d 162 (Colo. 1962); Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 366 (Del. 1993); Sampson v. Hunt, 665 P.2d 743, 754–55 (Kan. 1983); Speer v. Dighton Grain, Inc., 624 P.2d 952, 959 (Kan. 1981) (same); Sletteland v. Roberts, 16 P.3d 1062, 1067 (Mont. 2000); Elec. Dev. Co. v. Robson, 28 N.W.2d 130, 137–38 (Neb. 1947); Buchanan v. Henderson 131 B.R. 859, 867 (D. Nev. 1990), *rev'd on other grounds*, 985 F.2d 1021 (9th Cir. 1993); Crews v. Garber, 111 P.2d 1080, 1082 (Okla. 1941) (pertaining to bank directors in Oklahoma); Mobridge. Cmty. Indus., Inc. v. Toure, Ltd., 273 N.W.2d 128, 133 (S.D. 1978).

94. *See* Robert H. Sitkoff, *Trust Law, Corporate Law, and Capital Market Efficiency*, 28 J. CORP. L. 565, 575 (2003) (discussing insulation of managers from liability "in the absence of egregious conduct" and how fiduciary duty of care in trust law "is not similarly buffered").

faith. This section provides an overview of the modern formulation of these duties in corporate law.

A. *Duty of Care and the Business Judgment Rule*

Although there are some variations, the duty of care generally requires officers and directors to act with the care of a reasonable person acting in similar circumstances.[95] Even though the standard seems analogous to the negligence standard of tort law, courts do not find directors liable for violation of this standard of care unless the act is considered grossly negligent.[96] For example, the Delaware Supreme Court has found evidence of gross negligence where the board failed to obtain all reasonably available information before making a decision.[97] The duty of care, as it has developed in the case law, thus emphasizes decision-making processes as opposed to outcomes.[98] Furthermore, courts have employed the "business judgment rule" to protect decisions made in good faith, and in the best interest of the corporation and its shareholders.[99] If the requirements of the business judgment rule are met, courts will generally not second-guess business decisions, even if those decisions result in negative outcomes.[100]

The modern cases involving claims for breach of the duty of care can be categorized by the nature of the underlying action or inaction giving rise to plaintiffs' claim. As set forth below, the first type of claim comes up in the context of business decisions where defendants invoke the protection of the business judgment rule. Where the presumptions of the business judgment rule apply, courts do not further scrutinize the business decisions.

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95. *See* Horsey, *supra* note 68, at 978 ("[H]is judgment must have been reasonable and exercised with the care of an ordinarily prudent person."); *see also* Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1, 17–19 (1989) ("Directors are required to exercise that degree of care ordinarily prudent persons would exercise under similar circumstances."); Chittur, *supra* note 91, at 508 ("The rule thus incorporates the 'reasonable man' standard to determine negligence.").

96. *See, e.g.*, McMullin v. Beran, 765 A.2d 910, 921 (Del. 2000) ("Director liability for breaching the duty of care 'is predicated upon concepts of gross negligence.'"); Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985) ; Katz v. Chevron Corp., 27 Cal. Rptr. 2d 681, 689 (Cal. Ct. App. 1994).

97. *Van Gorkom*, 488 A.2d at 893.

98. *See* John Gibeaut, *Stock Responses*, 89 A.B.A. J. 38, 41 (2003) (comment of Chief Justice Veasey).

99. *See id.*; *see also*, Joseph Hinsey, *Business Judgment and The American Law Institute's Corporate Governance Project: The Rule, the Doctrine and the Reality*, 52 GEO. WASH. L. REV. 609, 610 (1984).

100. *See* Horsey, *supra* note 68, at 980.

The second situation concerns the directors' duties in the context of fending off a hostile takeover bid. This situation inherently involves the potential for conflicts of interest. The courts address this conflict by evaluating the reasonableness of the transaction in relation to the threat posed to the corporation.

The third category involves the claim that defendants breached their fiduciary duty by failing to oversee the activity of others. These cases, by definition, do not involve business decisions, and therefore the business judgment rule presumptions are not in play. Here the courts consider whether directors may be liable for the actions of others by considering whether they knew or should have known that the illegal behavior was likely to occur.

The analysis utilized by the courts differs depending on the nature of the underlying claims. These claims are discussed below.

1. Business Decisions

Judicial reticence towards second-guessing good faith business decisions accompanied the common law development of the corporate fiduciary duty of care. Although courts have articulated several formulations of the business judgment rule throughout the years, the rule can be summarized generally as a presumption that business decisions are made in good faith, with reasonable care, and with an absence of self-dealing.[101] If the presumption has not been rebutted, the business judgment rule forecloses further judicial scrutiny of the business decision. In situations where the presumption applies, the duty of care in the corporate arena diverges significantly from its counterpart in trust law. Innocent mistakes do not give rise to corporate law liability. The business judgment rule was described by the Delaware Supreme Court in *Aronson v. Lewis*[102] as protection available to directors who:

> have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them. Having become so informed, they must then act with requisite care in the discharge of their duties. While the Delaware cases use a variety of terms to describe the applicable standard of care, our

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101. *See* Hinsey, *supra* note 99, at 609; *see also* Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456, 465 (2004). In *Davis v. Louisville Gas & Elec. Co.*, 142 A. 654, 659 (Del. Ch. 1928), one of the early cases discussing the business judgment rule, the court found a rebuttable presumption in favor of the directors of the corporation where the decision was made in good faith and in the best interests of the corporation.

102. 473 A.3d 805 (Del. 1984).

> analysis satisfies us that under the business judgment rule director liability is predicated upon concepts of gross negligence.[103]

The American Law Institute (ALI) variation of the business judgment rule provides that:

> A director or officer who makes a business judgment in good faith fulfills the [duty of care] if the director or officer (1) is not interested in the subject of his business judgment; (2) is informed with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances; and (3) rationally believes that the business judgment is in the best interests of the corporation.[104]

Commentators have articulated a number of theories to explain why courts defer to business decisions. One theory is that managers otherwise would become too risk-averse in their decision making.[105] Another is the concern that competent people would not be willing to serve as officers and directors without protection for mistakes, particularly when it is not clear exactly what constitutes the boundaries of the duties of an officer or director.[106] Courts frequently justify the business judgment rule by stating that they are without authority to substitute their judgment for the informed business judgment of the directors.[107] Recently, when asked whether the business judgment

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103. *Id.* at 812; *see also* Rock & Wachter, *supra* note 68, at 659.

104. AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01 (1994); *see also* Douglas M. Branson, *The Rule that Isn't a Rule—The Business Judgment Rule*, 36 VAL. U. L. REV. 631, 634–35 (2002).

105. *See* Melvin A. Eisenberg, *The Duty of Care of Corporate Directors and Officers*, 51 U. PITT. L. REV. 945, 964 (1990) ("A rule that imposes liability on a director or officer for unreasonable decisions might therefore have the perverse incentive effect of discouraging bold but desirable decisions."); Resolution Trust Corp. v. Blasdell, 930 F. Supp. 417, 423 (D. Ariz. 1994) (stating that if courts did not defer to business decisions then "few directors would recommend ventures involving more than minimal risk"); Marcia M. McMurry, *An Historical Perspective on the Duty of Care, the Duty of Loyalty, and the Business Judgment Rule*, 40 VAND. L. REV. 605, 617 (1987).

106. *See* Washington Bancorp. v. Said, 812 F. Supp. 1256, 1267–68 (D. D.C. 1993); E. Norman Veasey, et al., *Responses to the D&O Insurance Crisis*, 19 SEC. & COMMODITIES REG. 263, 265 (1986) (regarding response to liability imposed by Delaware Supreme Court in *Van Gorkom*). Commentators have also noted the difficulty in providing an objective standard by which to judge corporate behavior. *See, e.g.*, Hal R. Arkes & Cindy A. Schipani, *Medical Malpractice v. the Business Judgment Rule: Differences in Hindsight Bias*, 73 OR. L. REV. 587, 624 (1994) ("There is no commonly accepted methodology as to what a business person should do when faced with every business situation."); Symposium, *The Business Judgment Rule*, 45 OHIO ST. L.J. 629, 648–49 (1984) (comments of Dean Manning).

107. *See* Helfman v. Am. Light & Traction Co., 187 A. 540, 550 (N.J. Ch. 1936); Liebman v. Auto Strop Co., 150 N.E. 505, 506 (N.Y. 1926); *see also* Sinclair Oil

rule is still the law, Chief Justice Veasey of the Delaware Supreme Court replied, "Yes it is. We will not second-guess your business judgment, but we are going to look at your process."[108]

In 1985, the Delaware Supreme Court decided the case of *Smith v. Van Gorkom*.[109] It is the first significant case in which the Delaware court found gross negligence, and therefore liability for breach of the duty of care.[110] Here, the court held that directors who approved a merger transaction were not entitled to the presumptions of the business judgment rule where they approved the transaction without meaningful financial advice or analysis.[111] The court found that the directors were grossly negligent because they did not seek all information reasonably available to them to determine the true intrinsic value of the company before voting to accept the proposal.[112] The court noted that there was no investment banking opinion, although it also pointed out that neither an investment banking opinion, nor a valuation study, are necessary to satisfy the due care requirement.[113]

The main lesson to be gleaned from *Van Gorkom* involves the significance of the due care requirement to obtain all reasonably available information before making a business decision. The Delaware Supreme Court applied the *Van Gorkom* precedent in 1993 in *Cede & Co. v. Technicolor, Inc.*,[114] where it found that the directors' failure "to inform themselves fully concerning all material information reasonably available prior to approving the merger agreement" constituted a breach of the duty of care negating the benefit of the presumptions that the business judgment rule would normally provide.[115]

Within about a year and a half of the decision in *Van Gorkom*, the Delaware legislature adopted a law to permit corporations to limit or eliminate monetary liability of directors for breach of the duty of care.[116] This law, adopted as section 102 (b)(7) of the Delaware Code, was promulgated to address the concern that potential liability

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Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) (stating board of directors enjoys presumption of sound business judgment, and court will not disturb that judgment when based on any rational business purpose).

108. Gibeaut, *supra* note 98, at 41 (comment of Chief Justice Veasey).

109. 488 A.2d 858 (Del. 1985).

110. *See* Rock & Wachter, *supra* note 68, at 651.

111. *Van Gorkom*, 488 A.2d at 888.

112. *Id.* at 874.

113. *Id.* at 876.

114. 634 A.2d 345 (Del. 1993).

115. *Id.* at 371.

116. Section 102(b)(7) of the Delaware Code provides that the articles of incorporation may include:

for breach of due care was responsible for the then-crisis in the directors' and officers' liability insurance market and was discouraging otherwise qualified individuals from serving on corporate boards. The exculpatory legislation applies only to corporate directors and is not applicable in cases which present allegations of lack of good faith, conflicts of interest, or other concerns implicating the duty of loyalty.[117]

The Delaware Chancery Court recently considered an allegation of breach of the duty of care for a business decision in *In re General Motors Class H Shareholders Litigation*.[118] In this case, the shareholders challenged the fairness of transactions that involved the spinning off of a subsidiary of General Motors (GM).[119] Plaintiffs claimed that the directors of GM violated their duty of care with regard to these transactions,[120] but the court disagreed.[121] It found that the GM directors acted with a business purpose in proposing the spin-off and that the shareholders were well informed and not coerced by management in connection with their vote. The actions of the directors were thus protected by the business judgment rule.[122]

2. *Transactions for Corporate Control*

The mid-1980s and early 1990s witnessed a plethora of cases involving changes in corporate control. *Smith v. Van Gorkom* was an unusual case for that time period because it involved a friendly transaction. In the hostile scenario, the courts found themselves further modifying the requirements of the duty of care and the business judg-

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> A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director (i) for any breach of the director's duty of loyalty to the corporation or its stockholders, (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law, (iii) under section 174 of this Title, or (iv) for any transaction from which the director derived an improper personal benefit. No such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective. All references in this paragraph to a director shall also be deemed to refer to a member of the governing body of a corporation which is not authorized to issue capital stock.

DEL. CODE ANN. tit. 8, § 102(b)(7) (2004).

117. Bradley & Schipani, *supra* note 95, at 43 (citing Synopsis, S. 533, 133rd Gen. Assembly (1986)).

118. 734 A.2d 611 (Del. Ch. 1999).

119. *Id*. at 612.

120. *Id*.

121. *Id*. at 616–19.

122. *Id*.

ment rule. These cases are more complex because they involve not only allegations of breach of due care, but also the potential for breach of loyalty. Whenever a hostile bid is made, the directors and officers are fully aware that their own positions within the corporation are in jeopardy and this conflict of interest may cloud their judgment.

For example, in *Unocal v. Mesa Petroleum Co.*,[123] the Delaware Supreme Court found that the duty of care, in the context of a transaction involving corporate control, required an analysis regarding whether the decision of the board of directors was reasonable in relation to the threat posed.[124] The court was not only scrutinizing the decision process, but also substantively evaluating the decision itself for reasonableness. Then, in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,[125] the court further found that if a corporation is for sale, or a breakup of the corporation is inevitable, the directors must act as efficient auctioneers and attempt to find the highest price for the shareholders.[126] Yet the Delaware court does not always require the board to sell the company when an offer has been made. In *Paramount Communications, Inc. v. Time Inc.*,[127] the Delaware Supreme Court upheld the decision of the Time Inc. (Time) directors to refuse a hostile takeover bid for the company.[128] Time was permitted to fight off a tender offer made by Paramount and proceed with its own long-term strategic plan with Warner, even though the Paramount bid was at a significantly higher price than the Warner alliance.[129] According to the court, the transaction with Warner did not involve a sale or breakup of the company, and Time could thus refuse to sell the company to Paramount.[130]

The Delaware Supreme Court continued to define the contours of the directors' duties in the context of a takeover battle in *Paramount Communications, Inc. v. QVC Network, Inc.*[131] In this case, QVC Network, Inc. (QVC) attempted to take control of Paramount.[132] The Paramount board adopted a number of defensive mechanisms and attempted to enter into a transaction with Viacom Inc. (Viacom).[133] The

123. 493 A.2d 946 (Del. 1985).
124. *Id.* at 958–59.
125. 506 A.2d 173 (Del. 1986).
126. *Id.* at 185.
127. 571 A.2d 1140 (Del. 1989).
128. *Id.* at 1150.
129. *Id.* at 1152.
130. *Id.* at 1151.
131. 637 A.2d 34 (Del. 1994).
132. *Id*. at 39.
133. *Id*.

Delaware Supreme Court distinguished this case from *Paramount Communications, Inc. v. Time Inc.*[134] by finding that the Paramount-Viacom transaction, unlike the Time-Warner transaction, would entail a change in control.[135] The court noted that prior to the Viacom transaction, control of Paramount was vested in a "fluid aggregation of unaffiliated stockholders,"[136] but if the transaction was permitted to proceed, public stockholders would be relegated to a minority voting position and control would vest in a single stockholder.[137] Due to this change in control, the court found it necessary to review the defensive tactics of the board with enhanced scrutiny. The court outlined the key features of the enhanced scrutiny test as:

> (a) a judicial determination regarding the adequacy of the decision-making process employed by the directors, including the information on which the directors based their decision; and (b) a judicial examination of the reasonableness of the directors' action in light of the circumstances then existing.[138]

The court ultimately found that the Paramount board's defensive tactics failed this test and that the board was required to consider the transaction that offered the best value to the shareholders.[139]

Thus, the duty of care has evolved from a standard that had been fairly lax to one where process has become important, and one that subjects the actions of boards to closer scrutiny in the case of takeover attempts. However, the scope of duty for boards of directors to monitor the actions of others remains unclear.

3. *Oversight Responsibility for Activities of Others*

Determining the contours of the duty of care of directors when the wrongdoing was committed by others in the corporation presents a significant difficulty for the courts. It has become clear that directors may not turn a blind eye toward corporate affairs and expect to avoid liability. What is less clear is how much responsibility they have for oversight.

Francis v. United Jersey Bank[140] illustrates the principle that directors must be active in corporate affairs. Here, Mrs. Pritchard, the widow of the former CEO, inherited a forty-eight percent share of the

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134. 571 A.2d. 1140 (Del. 1989).
135. *QVC Network, Inc.*, 637 A.2d at 46.
136. *Id*. at 43.
137. *Id*.
138. *Id*. at 45.
139. *Id.* at 51.
140. 432 A.2d 814 (N.J. 1981).

company and served as a director in name only.[141] Mrs. Pritchard did not attend board meetings or read financial statements, and knew essentially nothing about the business.[142] Upon her husband's death, Mrs. Pritchard's sons actively embezzled funds from the company.[143] The court found that the fraud was obvious, and if Mrs. Pritchard had merely looked at the financial statements, she should have detected it.[144] There was no allegation that Mrs. Pritchard had participated in the fraud or that she had knowledge of it, but her failure to be active in corporate affairs was no defense—she was required to have some basic knowledge of corporate workings.[145] The business judgment rule may be a defense for business decisions, but the rule was unavailable to Mrs. Pritchard because there was no business decision to defend.

In contrast, the Delaware Supreme Court did not find liability in *Graham v. Allis-Chalmers Manufacturing Co.*[146] Here, the directors of the company failed to prevent employees from violating antitrust laws.[147] Plaintiffs alleged that the directors breached their duty of care by failing to learn of and prevent antitrust activity, and by not having some system in place to detect the illegal activity.[148] The *Allis-Chalmers* court stated that "the individual director defendants are not liable as a matter of law merely because, unknown to them, some employees of Allis-Chalmers violated the anti-trust laws thus subjecting the corporation to loss."[149] The court noted that the question of liability for neglect is determined by the circumstances.[150] The court further stated that liability would attach if the directors had "recklessly reposed confidence in an obviously untrustworthy employee, ha[d] refused or neglected cavalierly to perform [their] duty as . . . director[s], or ha[d] ignored either willfully or through inattention obvious danger signs of employee wrongdoing."[151] The acts did not rise to this level of egregiousness in *Allis-Chalmers*.

More recently, the Delaware Chancery Court addressed the oversight function in *In re Caremark International Inc.*[152] The *Caremark* employees were investigated for violations of various healthcare laws

141. *Id*. at 819.
142. *Id*.
143. *Id*. at 819, 829.
144. *Id*. at 825–26.
145. *Id*. at 826.
146. 188 A.2d 125 (Del. 1963).
147. *Id*. at 130.
148. *Id*.
149. *Id*. at 131.
150. *Id*. at 130.
151. *Id*.
152. 698 A.2d 959 (Del. Ch. 1996).

involving the prohibition of kickbacks for referrals of medical supplies and equipment.[153] The Chancery Court attempted to distinguish the facts of *Allis-Chalmers* from the facts of the case before it, and articulated a duty to set up systems to attempt to insure compliance with laws by those in the field.[154] It concluded that "[a] director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that the failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards."[155] The *Caremark* court stated that, in order to show that the defendants breached their duty of care in failing in their oversight function, the plaintiffs would need to show:

> either (1) that the directors know or (2) should have known that violations of law were occurring and, in either event, (3) that the directors took no steps in a good faith effort to prevent or remedy that situation, and (4) that such failure proximately resulted in the losses complained of . . . .[156]

The court approved the settlement of the shareholder derivative litigation, and found "essentially no evidence that the director defendants were guilty of a sustained failure to exercise their oversight function."[157] However, because this case involved approval of a settlement, it does not represent a court ruling on the merits of the litigation. Instead, the court considered the oversight function in the context of determining whether the proposed settlement was fair and reasonable.[158] To do this, it weighed the strengths and weaknesses of the parties' positions, but did not make determinations of fact.[159] Yet,

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153. *Id*. at 962.

154. *Id*. at 969–70.

155. *Id*. at 970. Other courts have relied on the *Caremark* reasoning:

> Neither party presented evidence on the relevant issue under Caremark: the extent of the board's oversight of the Marvel employees. Alleging that the board should have known of the employees' actions without further proof is not enough to support plaintiffs' summary judgment motion. Similarly, showing that no company policy encouraged misrepresentations is not dispositive of whether the board fulfilled its monitoring responsibilities under Caremark. Thus, such arguments do not support defendants' motion for summary judgment. Since neither party presented the necessary evidence, the court will not grant summary judgment for either party on this issue at this time.

Cantor v. Perelman, 235 F. Supp. 2d 377, 389 (D. Del. 2002).

156. *Caremark*, 698 A.2d at 971.

157. *Id.*

158. *Id.* at 961.

159. *Id.*

although the court analyzed the *Caremark* board's oversight function in dicta, its comments on the oversight function have been noted in later cases and proved significant in the literature.[160]

For example, in *Guttman v. Huang*,[161] shareholders of NVIDIA, a technology firm, alleged that the board did nothing to prevent the accounting irregularities that eventually required the company to restate its earnings. There were also allegations of violations of laws prohibiting insider trading.[162] The plaintiffs' complaint was dismissed for lack of evidence that the board knew of the accounting irregularities and did nothing to stop them.[163] According to the court, there must be a showing that the directors knew that they were not doing their jobs before directors will be held liable for failure of oversight under *Caremark*.[164] It held that "only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability."[165]

In *Beam v. Stewart*,[166] plaintiffs claimed that the board of directors owed them a "duty to monitor the personal affairs of an officer or director," referring to a duty to monitor the personal affairs of Martha Stewart.[167] The court stated that there is no separate fiduciary duty to monitor, but rather that this duty emanates from the duties of care and loyalty.[168] The court applied the reasoning of *Graham v. Allis-Chalmers Manufacturing Co.*,[169] noting that "absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no rea-

160. *See, e.g.*, H. Lowell Brown, *The Corporate Director's Compliance Oversight Responsibility in the Post* Caremark *Era*, 26 DEL. J. CORP. L. 1, 6 (2001) (After *Caremark*, "directors would be well advised to attend to the corporation's compliance efforts, even in the absence of a definitive statement of the board's responsibility"); Gregory S. Rowland, *Earnings Management, the SEC and Corporate Governance: Director Liability Arising from the Audit Committee Report*, 102 COLUM. L. REV. 168, 198 (2002) ("Commentators have interpreted *Caremark* to stand for the proposition that 'directors should take reasonable steps to assure themselves that they are receiving information relevant to the implementation of their oversight function.'").
161. 823 A.2d 492 (Del. Ch. 2003).
162. *Id*. at 496.
163. *Id*. at 507.
164. *Id*. at 506.
165. *Id*.
166. 833 A.2d 961 (Del. Ch. 2003).
167. *Id.* at 971.
168. *Id*. at 971 n.16.
169. 188 A.2d 125 (1963).

son to suspect exists."[170] The *Beam* court then held that it was "patently unreasonable" to require the board of directors to "preemptively thwart a personal call from Stewart to her stockbroker or to fully control her handling of the media attention that followed as a result of her *personal* actions."[171]

B. Duty of Loyalty

The duty of loyalty, like the duty of care, emanates from the law of trusts.[172] According to the Restatement of Trusts, the trustee's duty of loyalty is "a duty to administer the trust solely in the interest of the beneficiaries."[173] Where there is a conflict of interest, the trustee has a duty "to deal fairly and to communicate to the beneficiary all material facts the trustee knows or should know in connection with the transaction."[174]

Meinhard v. Salmon[175] is the oft-cited case discussing the contours of the duty of loyalty in the context of a business relationship. Chief Justice Cardozo, addressing the duty of loyalty joint adventurers owe each other, called it "the duty of the finest loyalty."[176] He further stated that "[a] trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior."[177]

The duty of loyalty has found its way into corporate law jurisprudence. It requires directors and officers to act in good faith and in the honest belief that the action taken is in the best interests of the corporation. Loyalty requires avoiding conflicts of interest, and corporate officers and directors are obligated to refrain from using their corporate position of trust and confidence for their own benefit.[178] The duty

170. *Beam*, 833 A.2d at 972.

171. *Id.*

172. *See* Aronson v. Lewis, 473 A.2d 805 (Del. 1984); Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993), *modified*, 636 A.2d 956 (Del. 1994); *see also* Brudney, *supra* note 65, at 601.

173. RESTATEMENT (THIRD) OF TRUSTS § 170(1) (1992).

174. *Id*. at § 170(2).

175. 164 N.E. 545 (N.Y. 1928).

176. *Id*. at 546.

177. *Id*.

178. *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993) ("Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests." (quoting Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939)); *see also* Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1345 (Del. 1987) ("[D]irectors must eschew any conflict between duty and self-interest."); Walsh, *supra* note 68, at 334. Most states have codified the duty of loyalty. *See* ALA. CODE § 10-2B-8.30 (2004); ALASKA STAT. § 10.06.450 (Michie 2004); ARIZ. REV. STAT. ANN. § 10-830 (West 2004); CAL. CORP. CODE § 309 (West 2004);

of loyalty "requires officers and directors not profit at the expense of their corporation, whether through self-dealing contracts, usurpation of corporate opportunities or other means."[179] In *Guth v. Loft*,[180] the Delaware Supreme Court analogized to the law of trusts in finding the president and director liable for breach of the duty of loyalty for taking personal advantage of an opportunity that came to him because of his position in the corporation.[181] The court said that a director is obligated to "affirmatively . . . protect the interests of the corporation committed to his charge . . . ."[182]

1. Fairness Standard

Although the duty of loyalty requires the "punctilio of an honor the most sensitive," conflicts of interest do not automatically give rise to breach. It should be noted, however, that where a transaction gives rise to a conflict of interest between members of the board and the corporation, the business decisions of the board members are no longer afforded the presumptions of the business judgment rule. If the conflict in a transaction is disclosed and disinterested members of the board approve the transaction, there will be generally no cause for liability.[183] If a transaction is contested because the decision was not

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CONN. GEN. STAT. ANN. § 33-756 (West 2003); FLA. STAT. ANN. § 607.0830 (West 2003); GA. CODE ANN. § 14-2-830 (2003); HAW. REV. STAT. § 414-221 (2003); IOWA CODE § 490.830 (2003); KY. REV. STAT. ANN. § 271B.8-300 (Michie 2003); ME. REV. STAT. ANN. tit. 13-C, § 831 (West 2003); MD. CODE ANN., CORPS. & ASS'NS § 2-405.1 (2003); MASS. GEN. LAWS ANN. ch. 156B § 65 (West 2005); MICH. COMP. LAWS ANN. § 450.1541a (West 2004); MINN. STAT. ANN. § 302A.251 (West 2003); MISS. CODE ANN. § 79-4-8.42 (2004); MONT. CODE ANN. § 35-2-441 (2004); N.H. REV. STAT. ANN. § 293-A:8.30 (2004); N.M. STAT. ANN. § 53-4-18.1 (Michie 2004); N.C. GEN. STAT. § 55-8-30 (2004); N.D. CENT. CODE § 10-19.1-50 (2003); OHIO REV. CODE ANN. § 1701.59 (West 2004); OR. REV. STAT. § 60.357 (2003); 15 PA. CONS. STAT. ANN. § 1712 (West 2004); R.I. GEN. LAWS § 7-1.1-33 (2004); S.C. CODE ANN. § 33-8-300 (Law. Co-op. 2003); TENN. CODE ANN. § 48-18-301 (2004); VA. CODE ANN. § 13.1-690 (Michie 2004); WASH. REV. CODE ANN. § 23B.08.300 (West 2005); W. VA. CODE ANN. § 31D-8-830 (Michie 2003); WYO. STAT. ANN. § 17-16-830 (Michie 2003).

179. JOEL SELIGMAN, CORPORATIONS CASES AND MATERIALS 415 (1995).

180. 5 A.2d 503 (Del. 1939).

181. *Id.* at 510.

182. *Id.*

183. *See* Stegemeier v. Magness, 728 A.2d 557, 562 (Del. 1999) ("The absolute prohibition under common law against self-dealing by a trustee has been modified in the corporate setting to offer a safe harbor for the directors of a corporation if the transaction is approved by a majority of disinterested directors."); Schock v. Nash, 732 A.2d 217, 225 n.21 (Del. 1999) ("The statute . . . provide[s] corporate directors with a safe harbor from allegations of self-dealing if the transaction is approved by a majority of the informed and disinterested directors . . . ."); *see also* Oberly v. Kirby, 592 A.2d 445, 466 (Del. 1991) ("[S]ection 144 [of the Delaware Code] allows a com-

made by a disinterested board, a court will likely evaluate the transaction substantively for fairness.[184] The court applied this fairness standard in *Cinerama, Inc. v. Technicolor, Inc*.[185] Here the plaintiff alleged that the defendant directors violated their duty of loyalty in approving a merger. The court held that the burden of proof shifted to the directors to prove the entire fairness of the transaction because the business judgment rule had been rebutted. As the Chancery Court stated, to assess the entire fairness of a transaction, "the court must consider the process itself that the board followed, the quality of the result it achieved and the quality of the disclosures made to the shareholders to allow them to exercise such choice as the circumstances could provide."[186] The Delaware Supreme Court affirmed this reasoning, holding that its use of a disciplined balancing test in determining fairness and credibility would not be disturbed.[187]

Therefore, the level of scrutiny applied by the courts when considering claims of violations of the duty of care increases when there are concerns about loyalty. These concerns require stricter scrutiny of the substance of business decisions.

2. *Significance of Independence: Special Litigation Committees*

The directors' decision whether to proceed with or terminate shareholder derivative litigation raises concerns of conflict of interest. The courts are mindful of the potential conflict of interest presented in this decision. Before bringing a derivative claim, the shareholder plaintiff must first make a demand on the board of directors, unless

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mittee of disinterested directors to approve a transaction and bring it within the scope of the business judgment rule.").

184. *See Stegemeier*, 728 A.2d at 562 ("If . . . the transaction is not approved by the requisite number of disinterested directors, the directors must prove that the transaction was entirely fair."); Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1162 (Del. 1995) ("If the [business judgment] rule is rebutted, the burden shifts to the defendant directors, the proponents of the challenged transaction, to prove to the trier of fact the 'entire fairness' of the transaction to the shareholder plaintiff."); *Oberly*, 592 A.2d at 466 ("Where an independent committee is not available, the stockholders may either ratify the transaction or challenge its fairness in a judicial forum . . . . When a challenge to fairness is raised, the directors carry the burden of 'establishing . . . [the transaction's] entire fairness, sufficient to pass the test of careful scrutiny by the courts.' ") (citations omitted).

185. 663 A.2d 1156 (Del. 1995).

186. *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1134, 1140 (Del. Ch. 1994), *aff'd* 663 A.2d 1156 (Del. 1995).

187. *Cinerama*, 663 A.2d 1156, 1180 (Del. 1995); *see also* Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1279 (Del. 1989) ("[B]ecause the effect of the proper invocation of the business judgment rule is so powerful and the standard of entire fairness so exacting, the determination of the appropriate standard of judicial review frequently is determinative of the outcome of . . . litigation.").

demand would be futile.[188] A board may refuse to pursue the claim the shareholder demands; the board's refusal is an action that will generally be afforded the usual protections of the business judgment rule, provided that the action is taken by disinterested directors, and in good faith.[189] The presumptions of the business judgment rule in these circumstances thus operate as they would in any other situation of board action.[190]

In some situations, shareholders are not required to make a demand on the board because demand would be futile. These are often cases where it is the action of the board of directors that gave rise to the shareholder's claim. In cases where demand is excused, it is still possible for the board to terminate the litigation. If the board does decide to terminate litigation and is subsequently sued, the courts look to whether the decision to terminate was made in good faith by disinterested directors, and also apply their own business judgment to the decision at hand.[191]

Boards may appoint a special litigation committee (SLC) to make decisions regarding whether litigation should be pursued or terminated. In *Zapata Corp. v. Maldonado*,[192] the Delaware Supreme Court articulated a two-step analysis for evaluating the decision of a special litigation committee.[193] This analysis requires the court to evaluate the independence and good faith of the members of the special litigation committee, and permits the court to use its own business judgment to determine whether it is in the best interest of the corporation for the suit either to continue or to be terminated.[194]

The lynchpin of the willingness of courts to defer to an SLC is the independence of that committee. Recently, in *In re Oracle Corp. Derivative Litigation*,[195] the Delaware Chancery Court had the opportunity to consider whether the SLC members, both of whom were Stanford University faculty members and Oracle directors, were independent from the director defendants—who also had significant

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188. *See* Lewis v. Curtis, 671 F.2d 779, 787 (3d Cir. 1982).
189. *See* Aronson v. Lewis, 473 A.2d 805, 813–15 (Del. 1984); Atkins v. Hibernia Corp., 182 F.3d 320, 324 (5th Cir. 1999); Cramer v. Gen. Tel. & Elec. Corp., 582 F.2d 259, 273–75 (3d Cir. 1978).
190. *See Aronson*, 473 A.2d at 813–15.
191. *See* Zapata Corp. v. Maldonado, 430 A.2d 779, 788–89 (Del. 1981) (holding that if corporation proves independence, good faith, and reasonableness of decision to terminate the suit, the court should apply its own business judgment to determine whether to grant motion to dismiss).
192. 430 A.2d 779 (Del. 1981).
193. *Id.* at 788–89.
194. *Id.*
195. 824 A.2d 917 (Del. Ch. 2003).

ties to Stanford.[196] The court noted that independence "turns on whether a director is, *for any substantial reason*, incapable of making a decision with only the best interests of the corporation in mind."[197] The court further noted that the burden of proof rests with the SLC to establish its independence[198] and denied the SLC's motion to terminate the derivative litigation.[199] The ties among the SLC members and the defendants to Stanford University were, according to the court, so substantial that they cast doubt about the impartiality of the SLC.[200]

Independence was also a recent issue in *In re eBay Shareholders Litigation*.[201] The court was not convinced that a non-defendant director could "objectively and impartially consider a demand to bring litigation against those to whom he is beholden for his current and future position on eBay's board."[202] The court reached this conclusion after noting that the defendant directors owned enough stock to control the corporation and the election of directors. The court was also concerned that the non-defendant directors owned options that had not vested, and would not vest unless they continued to serve as directors of eBay; some of these options were worth millions of dollars. These facts led the court to conclude that demand would be futile because the non-defendant directors were not sufficiently impartial.[203]

C. Requirement of Good Faith

As mentioned above, the duty of care and its corollary, the business judgment rule, require that the actions of the officers and directors have been made in good faith. The duty of loyalty requires that corporate officers and directors place corporate interests above personal interests, implicating obligations of good faith. The good faith requirement is still developing in corporate law and today appears to be considered, at least by some commentators and courts, as a separate fiduciary duty.[204] Chief Justice Norman Veasey of the Delaware Su-

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196. *Id.* at 920.
197. *Id*. (citing Parfi Holding AB v. Mirror Image Internet, Inc., 794 A.2d 1211, 1232 (Del. Ch. 2001)).
198. *Id.* at 928.
199. *Id*. at 948.
200. *Id*. at 942.
201. No. 19988-NC, 2004 Del. Ch. LEXIS 4 (Del. Ch. Feb. 11, 2004).
202. *Id.* at *11.
203. *Id*. at *10–11.
204. *See, e.g.*, Sale, *supra* note 101, at 463 (arguing that Delaware case law "reveal[s] an emerging doctrine of good faith"). Recent cases in which the court has considered the good faith requirement include Emerald Partners v. Berlin, 787 A.2d 85, 90 (Del. 2001); McMullin v. Beran, 765 A.2d 910, 918 (Del. 2000); and Scattered Corp. v. Chi. Stock Exch., 701 A.2d 70 (Del. 1997).

preme Court has commented that, in his view, "it seems that there is a separate duty of good faith, not only arising out of our case law, but also as a matter of statutory construction."[205] Section 102(b)(7) of the Delaware Code, to which the Chief Justice alludes, permits exculpation of directors for monetary damages for due care violations, but it expressly excludes exoneration for breach of the duty of loyalty or "acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law."[206] Furthermore, according to the Chief Justice, "good faith requires an honesty of purpose and eschews a disingenuous mindset of appearing or claiming to act for the corporate good but not caring for the well-being of the constituents of the fiduciary."[207]

In May 2003, the Delaware Chancery court denied a motion to dismiss the claims against the directors of The Walt Disney Company alleging lack of good faith and breach of due care in the context of the board's approval of an employment agreement.[208] An earlier complaint was dismissed because the complaint did not allege sufficient facts to overcome the presumption of the business judgment rule.[209] The later complaint alleged that the "defendant directors consciously and intentionally disregarded their responsibilities."[210] The court let the claim stand for determination of whether the board "exercised any business judgment or made any good faith attempt to fulfill the fiduciary duties they owed to Disney and its shareholders."[211] In essence, the case involves the claim that the board of directors gave CEO Michael Eisner full authority to negotiate the employment contract for the Disney presidency with his friend, Mr. Ovitz. It was alleged that neither the full board nor the compensation committee reviewed the terms of the contract.[212] There were also issues raised concerning the later no-fault termination of the contract on terms quite favorable to Ovitz. There is no record of the full board or the compensation committee reviewing these terms.[213]

Casting this case as one involving lack of good faith has significant implications for corporate actors. As noted above, after the deci-

205. Veasey, *supra* note 10, at 447.
206. DEL. CODE ANN. tit. 8 § 102(b)(7) (2004).
207. Veasey, *supra* note 10, at 447.
208. *In re* Walt Disney Co. Derivative Litig., 825 A.2d 275, 291 (Del. Ch. 2003).
209. Brehm v. Eisner, 746 A.2d 244, 248 (Del. 2000).
210. *Walt Disney Co. Derivative Litig.*, 825 A.2d at 289 (emphasis omitted).
211. *Id*. at 287 (emphasis omitted).
212. *Id*. at 287–88.
213. *Id.* at 288.

sion of the Delaware Supreme Court in *Smith v. Van Gorkom*,[214] the Delaware legislature, as well as most other state legislatures, passed laws permitting corporations to limit or eliminate monetary liability of directors for actions involving breach of the duty of care.[215] However, statutory exculpation is not available for actions lacking good faith.[216] Thus, if failure to monitor is considered lack of good faith, directors will find no protection in the exculpatory statutes. Moreover, because these cases involve failure to act, there is no business decision for which to seek protection under the business judgment rule.

D. Distinguishing Between Officers and Directors

Interestingly, corporate law has not made significant efforts to distinguish the fiduciary duties of corporate officers from those of directors. For example, the Model Business Corporation Act (MBCA) requires officers to act:

> (1) in good faith;
> (2) with the care that a person in a like position would reasonably exercise under similar circumstances; and
> (3) in a manner the officer reasonably believes to be in the best interests of the corporation.[217]

Similarly, the MBCA provides that each member of the board of directors must act:

> (1) in good faith, and
> (2) in a manner the director reasonably believes to be in the best interests of the corporation.[218]

Directors also must "discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances."[219] Thus, according to the MBCA, both officers and directors must act in good faith, in a manner reasonably believed to be in the best interest of the corporation, and with the care of the reasonable person acting under similar circumstances. Courts

214. 488 A.2d 858 (Del. 1985).
215. *See, e.g.*, DEL. CODE ANN. tit. 8 § 102(b)(7) (2004).
216. *See* Douglas M. Branson, *Assault on Another Citadel: Attempts to Curtail the Fiduciary Standard of Loyalty Applicable to Corporate Directors*, 57 FORDHAM L. REV. 375, 382 (1988) ("[B]ecause severe forms of negligence rising to the level of conscious disregard are akin to intentional conduct, in all probability these shareholders will continue to be able to obtain damage recoveries for the corporate treasury whenever directors have been reckless.").
217. MODEL BUS. CORP. ACT § 8.42 (1984).
218. *Id*. at § 8.30(a).
219. *Id.* at § 8.30(b).

and commentators often use the phrase "officers and directors" as though the terms are inextricably linked.

Recently, commentators have criticized the lack of distinction between the fiduciary duties of corporate officers and those of directors in corporate law.[220] For example, Professor Johnson and Dean Millon note that it is more appropriate to apply agency principles to the duties of officers who manage daily corporate functions and to impose separate fiduciary duties upon outside directors who monitor corporate activities.[221] Johnson and Millon take this analysis further, noting that the standard of review for the conduct of officers might more appropriately fit a negligence standard. The presumptions of the business judgment rule would not necessarily apply.[222] Yet the more deferential standards of review of gross negligence, coupled with the presumptions of the business judgment rule, may still be appropriate for outside directors in the monitoring functions.[223] It should be noted that few cases have been brought against officers for breach of fiduciary duty as an officer.[224]

E. Levels of Scrutiny

Although the corporate law fiduciary standards originate in the law of trusts, courts and legislatures apply these standards to corporate officers and directors in various ways, depending on whether conflicts of interest are implicated. The courts are highly deferential to directors' decisions. In the absence of evidence of self-interest, courts will presume that the directors' decisions are made in good faith and in the honest belief that they further the interest of the corporation. In addition, most states have enacted legislation along the lines of section 102(b)(7) of the Delaware Code, which permits corporations to limit or eliminate the liability of directors for breach of fiduciary duty in the

220. *See* Lyman P.Q. Johnson & David Millon, *Recalling Why Corporate Officers are Fiduciaries*, Wash. & Lee Public Law & Legal Theory Research Paper Series, Working Paper No. 04-13 (June 2004), http://ssrn.com/abstract=557926 (last visited Mar. 29, 2005); *see also* Lyman Johnson & Mark A. Sides, *The Sarbanes-Oxley Act and Fiduciary Duties*, Wash. & Lee Public Law & Legal Theory Research Paper Series, Accepted Paper No. 04-04 (2004) (offering reasons for lack of attention to distinction between officer and director roles), http://ssrn.com/abstract=528523 (last visited Mar. 29, 2005).

221. Johnson & Millon, *supra* note 220, at 4–5.

222. *Id*. at 43–47.

223. *Id*. at 7, 32–39.

224. *Id*. at 39; *see also* Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859, 861 (2003) (noting that "state law has focused largely on the duties and liabilities of directors and not those of officers," but federal law has begun to fill that void).

absence of bad faith, intentional misconduct, or breach of the duty of loyalty. They are less deferential and evaluate the reasonableness in relation to the threat posed to the corporation in transactions for corporate control. These transactions, by their nature, necessarily give rise to conflict of interest concerns and require stricter scrutiny. Courts employ the highest level of scrutiny, and will evaluate the entire fairness of a transaction, where the decision-makers have an interest in the transaction.

The question of oversight raises its own set of issues. Here, the courts have not required directors to be insurers of outcomes, but according to the Delaware Chancery Court in *Caremark*, directors are obligated to insure that an adequate information and reporting system exists.[225] In this context, the courts seem willing to impose liability for failure to oversee activities that resulted in wrongdoing if the directors either knew or should have known of the propensity for the harm and did nothing to prevent it. As recently noted by Vice Chancellor Strine:

> With power comes responsibility, and being the director of a public company is an important undertaking. Most trustees are held to a simple negligence standard. Corporate directors are given far more protection. But independent directors should and will remain accountable if it can be proved that those directors consciously—i.e., *knowingly*—failed to discharge those responsibilities.[226]

Finally, the standard of good faith appears to be emerging as a fiduciary duty standard in its own right. The Delaware Chancery court in *Disney* let stand a complaint that alleged that the directors "failed to exercise *any* business judgment and failed to make *any* good faith attempt to fulfill their fiduciary duties to Disney and its stockholders."[227]

IV.
ERISA and Employee Purchases of Company Stock

We have traced the development of trust law principles in the field of corporate law. We will now show how these same principles have been used in the context of employer-sponsored stock purchase plans governed by ERISA. In the following section, we raise ques-

225. *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 970 (Del. Ch. 1996).
226. Leo E. Strine Jr., *Warning—Potential Danger Ahead! A Business Judge's Starting List of "Yellow Flags" for Conscientious Directors*, 28 Directors & Boards 25 (2004).
227. *In re* The Walt Disney Co. Derivative Litig., 825 A.2d 275, 278 (Del. Ch. 2003).

tions and concerns about the extent to which delegation should be permitted, the level of oversight the law should encourage, and the fiduciary duties owed to employees.

A. Directors and Officers as Benefit Plan Fiduciaries

Determining when directors and officers owe fiduciary obligations to employees who have purchased employer securities through company-sponsored investment plans is considerably more complex than the parallel question of fiduciary obligation to shareholders. The fiduciary obligation towards employee shareholders is further confused by the variety of benefit programs through which employees can become company shareholders.

The most compelling issues during the past few years have concerned 401(k) plans. For example, participants in the Enron 401(k) plan lost more than $2 billion, primarily because of the collapse in the value of Enron stock.[228] Plan participants brought suit against a wide variety of defendants, including certain Enron officers and directors.[229] The Department of Labor (DOL) filed suit as well,[230] and in May 2004, the DOL and private plaintiffs announced a $66.5 million settlement with some of the Enron defendants.[231] Similar issues arise under employee stock ownership plans (ESOPs),[232] stock purchase plans, and stock option plans even though, of these, only 401(k) plans and ESOPs are regulated by ERISA.[233]

Unlike its corporate law counterpart, employee benefit law departs rather significantly from trust law in determining when an individual owes fiduciary obligations and the scope of actions to which the fiduciary obligations attach. First, because fiduciary status may be predicated on formal plan terms or actual exercise of responsibility,

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228. *See* Kirstin Downey, *Restitution Sought From Enron Officials*, WASH. POST, June 27, 2003, at E1.

229. *In re* Enron Corp. Secs., Derivative & "ERISA" Litig., 284 F. Supp. 2d 511, 511 (S.D. Tex. 2003).

230. *See* Press Release, U.S. Dept. of Labor, Office of Public Affairs, Secretary of Labor Elaine L. Chao Announces Settlements Restoring at Least $66.5 Million to Enron Retirement Plans (May 13, 2004) ("The department sued Enron, corporate directors and the administrative committee on June 26, 2003, for violating [ERISA]."), http://benefitslinks.com/pr/detail.php?id=37974 (last visited Mar. 29, 2005).

231. *Id.*

232. ESOPs are ERISA-regulated plans that are designed primarily to invest in employer stock. *See* 29 U.S.C. § 1107(d)(6)(A) (2000). For additional information about ESOPs, see Brett McDonnell, *ESOPs' Failures: Fiduciary Duties When Managers of Employee-Owned Companies Vote to Entrench Themselves*, 2000 COLUM. BUS. L. REV. 199, 204–09 (2000).

233. *See infra* Part V.

more people are likely to become plan fiduciaries under employee benefit law than if traditional trust law principles governed. On the other hand, benefit plan fiduciaries owe fiduciary obligations only when undertaking specific actions. In comparison, traditional trust law and corporate law would apply fiduciary standards to all actions taken by an individual who is a fiduciary vis-à-vis the beneficiaries or shareholders.

As is true for other individuals and entities, a corporate director, officer, or other employee may become a plan fiduciary in one of two ways. First, the individual may be named a fiduciary by a benefit plan document.[234] Second, the individual may take actions that give rise to fiduciary obligations—under ERISA, a person becomes a fiduciary to the extent she exercises discretion over plan management or assets, has discretionary authority over plan administration, or provides investment advice regarding plan assets in return for a fee. In performing such functions, the individual is accorded "functional fiduciary status."[235] Thus, a person's formal title generally is irrelevant to the ERISA analysis of fiduciary standing. If the person performs fiduciary acts, that person will be an ERISA fiduciary whether her position at the company is that of officer, director, or janitor. The two routes to becoming a fiduciary are discussed in more detail below.

1. Named Fiduciaries

Disputes over fiduciary status rarely arise when an individual is named a fiduciary under plan terms. That named individual clearly is a fiduciary. The situation, however, is more difficult when the plan document names a company as the plan fiduciary. Do the individual board members, corporate officers, or other employees of the company become plan fiduciaries in such an instance?

One approach would be to find that the individual directors necessarily become plan fiduciaries regardless of their actions and involvement with the plan, by virtue of their oversight and management of the company. Such a position would be consistent with the ultimate responsibility state corporate law imposes on directors. Similarly, using basic agency theory, it would be theoretically consistent to find that any officer or other employee vested with discretion over the action in question acquires fiduciary status through receipt of that discretion. The Third Circuit, however, has decided that individual officers

234. 29 U.S.C. § 1102(a) (2000).

235. 29 U.S.C. § 1002(21)(A) (2000). A "person" for statutory purposes includes corporations and other business entities. 29 U.S.C. § 1002(9) (2000).

do not become fiduciaries simply by holding a corporate office. In *Confer v. Custom Engineering Co.*,[236] the court held that even actions by the officers who caused the corporation to breach its fiduciary obligations under the plan did not cause the officers to become fiduciaries.[237] The court appeared to find it irrelevant that the two officers also were the primary owners of the corporation and stood to personally benefit from their actions.[238]

The Third Circuit reasoned that any other interpretation would fail to defer to the statutory language, which permits a plan to provide for a named fiduciary and also permits a business entity to act as a fiduciary. In the words of the court:

> When a corporation is the "person" who performs the fiduciary functions . . . the officer who controls the corporate action is not *also* the person who performs the fiduciary function. Because a corporation always exercises discretionary authority, control, or responsibility through its employees, [the statute] must be read to impute to the corporation some decisions by its employees. Otherwise, the fictional "person" of a corporation could never be a fiduciary because a corporation could never meet the statute's requirement of "having discretion." We cannot read [the statute] in a way that abrogates a use of corporate structure clearly permitted by ERISA.[239]

Under this reasoning, directors and officers only become fiduciaries if they explicitly accept individual discretionary roles over plan management, assets, or administration.[240] For example, the corporation could formally delegate at least a portion of its fiduciary obligations to a director or officer and such a delegation would give rise to individual fiduciary status.[241] But, in the absence of a delegation, actions taken on behalf of the named fiduciary would not result in a defendant assuming fiduciary obligations. The district court in *In re Reliant Energy ERISA Litigation*[242] used similar logic to find that

236. 952 F.2d 34 (3d Cir. 1991).
237. *Id*. at 37.
238. *See id*. at 35 ("Defendants . . . own 94 per cent of Custom Engineering.").
239. *Id.* at 37.
240. *See id*. The court actually refers only to discretion over plan administration as giving rise to fiduciary status. That language is understandable due to the context of the case, but, given the relevant statutory language on functional fiduciary status, the court's reasoning would seem to extend to discretionary functions that relate to plan management or assets. It also would seem to apply to investment advice provided for a fee, though that is rarely within the scope of duties of a corporate director or officer. *See* 29 U.S.C. § 1002(21)(A) (2000).
241. *See Confer*, 952 F.2d at 37.
242. *In re* Reliant Energy ERISA Litig., 336 F. Supp. 2d 646 (S.D. Tex. 2004).

board members were not per se fiduciaries in relation to continued plan investments in company stock.[243]

Other courts have disagreed with the Third Circuit. In *Kayes v. Pacific Lumber Co.*,[244] the Ninth Circuit held that individual officers became plan fiduciaries.[245] The plan document designated the company as the plan's named fiduciary and further stated that in carrying out their duties, the company's directors and officers would be "acting on behalf of and in the name of the Company . . . and not as individual fiduciaries."[246] The Ninth Circuit explicitly disagreed with the Third Circuit's analysis and held that any person who undertakes actions covered by the statute's functional definition of fiduciary status necessarily becomes a fiduciary regardless of the person's position vis-à-vis a named fiduciary.[247] The Ninth Circuit reasoned that the statute separately defines "fiduciary" and "named fiduciary" and does not contain an exemption from fiduciary status for functional actors who perform duties as agents of a named fiduciary.[248] Furthermore, the statute forbids relieving any fiduciary from liability except through insurance.[249] The Ninth Circuit viewed the plan's provision, which stated that directors and officers did not act "as individual fiduciaries," as a prohibited attempt to relieve fiduciaries from liability.[250] Finally, the court buttressed its decision with DOL regulations recognizing that fiduciary status may be based on functional activities.[251]

The Ninth Circuit later extended its rationale in *Kayes* to the situation where a benefit plan designated a committee instead of the company as the named fiduciary.[252] According to the court, "where, as here, a committee or entity is named as the plan fiduciary, the corporate officers or trustees who carry out the fiduciary functions are themselves fiduciaries and cannot be shielded from liability by the company."[253]

The issue of fiduciary status has been important in 401(k) litigation. For example, the court in *In re Enron Corp. Securities, Deriva-*

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243. *Id.* at 658.
244. 51 F.3d 1449 (9th Cir. 1995).
245. *See id.* at 1461; *see also* Bannistor v. Ullman, 287 F.3d 394, 405 (5th Cir. 2002) (concluding that corporate officers were liable as fiduciaries).
246. *Kayes*, 51 F.3d at 1459 (referring to terminated pension plan at issue).
247. *Id*. at 1461.
248. *Id*. at 1460.
249. *Id*.
250. *Id.*
251. *Id*. at 1460–61.
252. *See* Stewart v. Thorpe Holding Co. Profit Sharing Plan, 207 F.3d 1143, 1156–57 (9th Cir. 2000).
253. *Id*. at 1156.

tive & "ERISA" Litigation followed the reasoning of the Ninth Circuit.[254] The plaintiffs alleged that officers, including Kenneth L. Lay, and directors who were members of the board's Compensation and Management Development Committee (Compensation Committee), violated their fiduciary obligations associated with Enron stock offered through the company's 401(k) plan.[255] After a discussion of the dispute among the circuits, the *Enron* court decided that the language and policy considerations of ERISA militated in favor of potential personal liability for corporate officers and directors who act as the agents of a corporation that is a named ERISA fiduciary.[256] According to the court, fiduciary status in such a situation is determined by "a functional, fact-specific inquiry to assess 'the extent of responsibility and control exercised by the individual with respect to the Plan.' "[257]

Do directors or officers become fiduciaries when they carry out discretionary functions originally assigned by a plan document to an entity (such as a corporation)? From a policy perspective, it is an interesting question. The Supreme Court has recognized Congress' expanded definition of "fiduciary" for benefit plan purposes.[258] The statutory provision that establishes personal liability for breach of fiduciary duties would most effectively incentivize careful and compliant fiduciary conduct if discretionary acts subject individual officers and directors to fiduciary status, and thus to liability. Permitting companies that sponsor benefit plans to insulate individual actors from liability by naming entities as fiduciaries would considerably undermine the incentives established in the personal liability provision.

One might further consider whether companies could insulate both themselves and their officers, directors, and employees from fiduciary liability by designating a plan committee as the named fiduciary. The rationale of the Third Circuit seems to preclude imputing the plan committee's actions to the company. Plan committees typically have no assets of their own. Thus, plaintiffs with a successful breach of fiduciary duty claim should be able to recover only up to the plan

254. *In re* Enron Corp. Secs., Derivative & "ERISA" Litig., 284 F. Supp. 2d 511, 568–69 (S.D. Tex. 2003).
255. *Id*. at 531–37.
256. *Id*. at 568–70.
257. *Id*. at 569 (quoting Bell v. Executive Comm. of United Food and Commercial Workers Pension Plan for Employees, 191 F. Supp. 2d 10, 15 (D. D.C. 2002)).
258. *See* Mertens v. Hewitt Assocs., 508 U.S. 248, 262 (1993) ("ERISA, however, defines 'fiduciary' not in terms of formal trusteeship, but in *functional* terms of control and authority over the plan, . . . thus expanding the universe of persons subject to fiduciary duties—and to damages—under § 409(a).").

committee's statutorily required surety bond. Certainly, as discussed above, the statutory definition of fiduciary can be read in a way to support the Ninth Circuit's extension of liability to individuals who act with such discretion on behalf of named fiduciaries.

On the other hand, the statutory definition of "person," which lists and includes various types of business entities, implies some recognition of the separate legal status of those entities. It follows that the statute intends to hold only the specifically listed entities liable, insulating other actors, such as shareholders, from liability. Deeming directors, officers, and others who engage in discretionary activities on behalf of a benefit plan to be fiduciaries may have an anomalous effect. Consider the situation where a plan designates the company as the named fiduciary. Under the Ninth Circuit's rationale, any director or officer who did not take any action with respect to the plan would not be considered a fiduciary and would be protected from all liability. Any director or officer, though, who acted in the role of the company's agent and exercised discretion with respect to the plan would be deemed a fiduciary and would face potential liability as a result of that exercise of discretion. In short, those individuals who ignored the need to take action as an agent on behalf of the company would be insulated from liability and would leave their fellow agents, who do take action, with the potential liability.[259]

2. *Functional Fiduciaries*

In addition to becoming a fiduciary by being named as such in the plan documents, ERISA recognizes the fiduciary status of individuals and entities that engage in particular actions vis-à-vis a plan. Thus, identifying precisely what actions give rise to functional fiduciary status can be extraordinarily important. Depending on the nature of the plan's terms and the jurisdiction's position on the agency debate, a director, officer, or other individual who undertakes the specified discretionary actions will become a plan fiduciary. Fiduciary status based on this functional definition, however, is limited "to the

259. The Third Circuit in *Confer* states that corporate actors who act improperly vis-à-vis the company's benefit plan may breach an obligation owed to the corporation under state law. *See* Confer v. Custom Eng'g Co., 952 F.2d 34, 38 (3d Cir. 1991). Similarly, one could argue that an individual who refuses to take appropriate discretionary actions with respect to a benefit plan also breaches a state law fiduciary obligation owed to the company and its owners. *See* Ervast v. Flexible Prods. Co., 346 F.3d 1007, 1009 (11th Cir. 2003) (holding that ERISA did not preempt state law breach of fiduciary duty claims regarding ESOP stock). Such a situation raises interesting questions regarding the application of ERISA's preemptive force; however, those questions are beyond the scope of this article.

extent" the individual exercises or has discretionary authority over the administration of a plan or its assets. The determination of this status tends to be a mixed question of law and fact.[260]

In *In re Electronic Data Systems Corp. "ERISA" Litigation*,[261] the plaintiff alleged that the company, board members, officers, and relevant plan committees assumed functions sufficient to result in fiduciary status.[262] According to the plaintiffs, Electronic Data Systems (EDS) had made favorable statements about its financial prospects but had taken on a great deal of undisclosed risk by using a "mega-deals" business model.[263] On September 18, 2002, EDS announced revenue and quarterly earnings that were much lower than expected.[264] The next day the stock price dropped by over fifty percent.[265] The court determined that if plaintiffs' allegations were accurate, they were, in effect, pleading that officers and directors became "functional fiduciaries by actually exercising authority and control respecting management of Plan assets."[266] The plaintiffs also argued that board members became functional fiduciaries because they appointed other plan fiduciaries and had ultimate responsibility for the actions of other fiduciaries.[267] The court agreed that either exercising review authority or merely having a duty to monitor the fiduciaries appointed by the board would be sufficient to confer fiduciary status on the board members.[268]

B. Liability for Those Who Aid in Fiduciary Breaches

Finding functional fiduciary status is difficult because ERISA recognizes co-fiduciary liability, and perhaps even liability for nonfiduciaries who aid or participate in a fiduciary breach.[269] The standard for co-fiduciary liability, however, limits the liability of one fiduciary for the acts of another fiduciary to situations where the for-

260. *See In re* Elec. Data Sys. Corp. "ERISA" Litig., 305 F. Supp. 2d 658, 665 (E.D. Tex. 2004); *In re* Enron Corp. Sec., Derivative & "ERISA" Litig., 284 F. Supp. 2d 511, 543 (S.D. Tex. 2003).
261. 305 F. Supp. 2d 658 (E.D. Tex. 2004).
262. *Id.* at 666–67, 668.
263. *Id*. at 661–62.
264. *Id*. at 662.
265. *Id*.
266. *Id*. at 666.
267. *Id*.
268. *Id*. at 666–67; *see also In re* Tyco Int'l Ltd. Multidistrict Litig., No. 02-1335-PB, 2004 U.S. Dist. LEXIS 24272, at *16 (D. N.H. Dec. 2, 2004) (categorizing board members as fiduciaries because of their power to appoint and retain plan administrators).
269. *See* 29 U.S.C. § 1105 (2000).

mer has knowledge of a fiduciary breach or commits a fiduciary breach that enables another fiduciary breach.[270]

It is less clear whether a nonfiduciary violates ERISA by participating in a fiduciary breach. In *Mertens v. Hewitt Associates*,[271] the Supreme Court suggested in dictum that ERISA does not allow such claims against nonfiduciaries.[272] In a subsequent case, the Court decided that nonfiduciaries could be liable for participating in prohibited transaction violations under ERISA.[273] The Court's rationale did not limit potential liability to nonfiduciaries who participate in prohibited transactions.[274] It did, however, require that the nonfiduciary "knew or should have known" of the circumstances establishing the prohibited transaction.[275]

C. Settlor Functions

A trilogy of Supreme Court decisions clarifies the category of actions in which benefit plan actors, including officers and directors, do not act as ERISA fiduciaries.[276] These actions have come to be known as settlor actions, after the settlor doctrine in trust law. Here, the settlor doctrine means that actions taken to establish, amend, or terminate an employee benefit plan are not fiduciary actions and do not create fiduciary obligations. This is true of welfare benefit plans, such as health care plans, as well as pension plans.[277] It is also true of 401(k) plans that are funded with employee contributions, as well as defined benefit pension plans funded exclusively by employers.[278] In the words of the Court, "ERISA's fiduciary duty requirement simply

270. *Id.*
271. 508 U.S. 248 (1993).
272. *Id.* at 253–54 ("And while ERISA contains various provisions that can be read as imposing obligations upon nonfiduciaries, including actuaries, no provision explicitly requires them to avoid participation (knowing or unknowing) in a fiduciary's breach of fiduciary duty. It is unlikely, moreover, that this was an oversight, since ERISA *does* explicitly impose 'knowing participation' liability on cofiduciaries.") (citation omitted).
273. *See* Harris Trust & Sav. Bank v. Salomon Smith Barney Inc., 530 U.S. 238 (2000).
274. *See* Dana M. Muir, *ERISA and Investment Issues*, 65 OHIO ST. L.J. 199, 226 (2004) (quoting *Harris Trust & Sav. Bank*, 530 U.S. at 246).
275. *Harris Trust & Sav. Bank*, 530 U.S. at 251.
276. *See* Hughes Aircraft Co. v. Jacobson, 525 U.S. 432, 444 (1999) (applying settlor doctrine to contributory retirement plan); Lockheed Corp. v. Spink, 517 U.S. 882, 890–91 (1996) (applying settlor doctrine to noncontributory retirement plan); Curtiss-Wright Corp. v. Schoonejongen, 514 U.S. 73, 78 (1995) (applying settlor doctrine to retiree health care plan).
277. *Hughes Aircraft Co.*, 525 U.S. at 443.
278. *Id*. at 444.

is not implicated where [the employer], acting as the Plan's settlor, makes a decision regarding the form or structure of the Plan such as who is entitled to receive Plan benefits and in what amounts, or how such benefits are calculated."[279]

Boards of directors typically have final authority to approve amendments to benefit plans or to terminate the company's plans. If those decisions were subject to ERISA's fiduciary standards, including the duty of loyalty to participants and beneficiaries,[280] the board's ERISA fiduciary obligations might conflict with its corporate law fiduciary obligations. For example, as corporations have faced rapidly escalating health care costs and limited financial resources in recent times, they have begun to pass increasing proportions of health care costs to employees or to trim benefit entitlements.[281] Such changes modify the terms of the employee benefit health care plan and require a plan amendment. If the board was obligated to consider only the best interests of employees, it may be precluded from approving such a plan amendment. After all, the amendment raises costs for employees. The settlor doctrine, however, establishes that this type of plan amendment, like all or nearly all plan amendments regarding plan form and structure,[282] is exempt from ERISA's fiduciary obligations.[283] As a result, the board may meet its state law fiduciary obligations without fear of conflicting obligations under ERISA.

The implementation of plan amendments, however, is subject to ERISA's fiduciary standards, as is ongoing plan administration. The paradigm case in this area is *Varity Corp. v. Howe*.[284] Here, Varity Corp. attempted to reduce its benefit costs associated with unprofitable lines of business. In relaying its plans to relevant employees, Varity Corp. knowingly and significantly deceived the plan participants for the purpose of saving money at their expense.[285] The Court determined that when communications about prospects for plan benefits are intended to help plan participants and beneficiaries make knowledgeable plan-related decisions, those communications consti-

279. *Id*.
280. *See infra* text accompanying notes 313–45 for a discussion of the standards.
281. *See* Varity Corp. v. Howe, 516 U.S. 489 (1996).
282. Whether there is any limit to the type of change that can be accomplished through a plan amendment and, thus, made without application of ERISA's fiduciary standards, remains an open question. In *Hughes Aircraft Co.*, the plaintiffs argued that the plan amendment constituted a sham transaction. The Court implied that a sham transaction might be sufficient to "implicate a fiduciary duty," but had not occurred in that case. 525 U.S. at 445.
283. *See Hughes Aircraft Co.*, 525 U.S. at 444.
284. 516 U.S. 489 (1996).
285. *Id*. at 504–05.

tute a plan administrative function.[286] As a result, those communications were fiduciary acts.[287]

The settlor doctrine has important implications for the employer stock issue. When the terms of a company-sponsored employee investment plan mandate the availability of employer stock as an investment option or as the vehicle for the company's matching contribution, the settlor doctrine may prevent the decisions to use company stock in that way from being fiduciary actions.[288] For example, in *Crowley v. Corning, Inc.* (*Corning II*),[289] the court ruled that neither the corporation nor the board members were ERISA fiduciaries with respect to their decisions or lack of oversight regarding company stock.[290] The court had held in an earlier decision (*Corning I*) that the terms of Corning's 401(k) plan specified that matching contributions would be made in Corning stock.[291] In *Corning II*, the court also interpreted the plan as requiring that employees have the option of investing their discretionary contributions in Corning stock.[292] The terms of the plan, and not the corporation or the board, controlled whether stock would be used to make the company's matching contribution and offered as an investment option. As a result, neither the corporation nor the board members were found to be fiduciaries for that purpose.[293]

In *Corning II*, the court distinguished two cases in which claims associated with employer stock were permitted to go forward against fiduciaries. It noted that, in both cases—*Moench v. Robertson*[294] and *In re WorldCom, Inc.*[295]—the relevant plan documents did not absolutely mandate the use of employer stock.[296] That should have been sufficient to distinguish those cases from the *Corning II* court's use of the settlor doctrine. Intriguingly, however, the court also distinguished the decline in Corning's stock price on the facts.[297] The

286. *Id*. at 502–03.
287. *Id*. at 503.
288. *See, e.g.*, Crowley v. Corning, Inc., No. 02-CV-6172, 2004 U.S. Dist. LEXIS 758, at *18–21 (W.D.N.Y. Jan. 14, 2004) (relying on the plan's language which did not grant the defendants discretion over the role of Corning stock).
289. No. 02-CV-6172, 2004 U.S. Dist. LEXIS 758 (W.D.N.Y. Jan. 14, 2004).
290. *Id*. at *12–14.
291. Crowley v. Corning, Inc., 234 F. Supp. 2d 222, 225 (W.D.N.Y. 2002).
292. 2004 U.S. Dist. LEXIS 758, at *18–19.
293. *Corning I*, 234 F. Supp. 2d at 228–30.
294. 62 F.3d 553, 571 (3d Cir. 1995).
295. 263 F. Supp. 2d 745 (S.D.N.Y. 2003).
296. *See Crowley*, 2004 U.S. Dist. LEXIS 758, at *19–21 (citing *Moench*, 62 F.3d at 571; *In re WorldCom*, 263 F. Supp. 2d at 764).
297. *Id*. at *22.

plaintiffs' losses in Corning stock were attributable to Corning's business decision, which turned out in hindsight to be a poor decision but not a fraudulent one, to get into the telecom market, which later crashed. In contrast, in both *Moench* and *WorldCom*, the drop in the stock price resulted at least in large part from "bad acts by corporate employees charged with fiduciary responsibilities under the Plan."[298]

D. Company-Sponsored Employee Investment Plans

Even in the current environment where the mere mention of Enron or WorldCom raises the specter of corporate scandals, readers may be tempted to shunt aside the employer stock cases as involving only a small number of companies that committed egregious frauds against its shareholders, or as insignificant in comparison to the stakes in traditional securities law or corporate law litigation. It is important to recognize, however, that since the IRS issued regulations in November 1981 "establishing the boundaries" of 401(k) plans,[299] their popularity has expanded to the point that assets held in these and other types of employer-sponsored defined contribution plans now hold more than $3.9 trillion.[300] As described by one commentator, the creation of 401(k) plans was a "fundamental shift" that "transformed individual account plans from their historical status as the receptacles of corporate profits to the receptacles of employee contributions."[301] For many employees, a defined contribution plan is now their only employer-sponsored retirement plan.[302] Even if those plans are free of fraud implications, the current structure of the domestic pension system implicates the financial security of the country's aging population. One recent study estimates that the income shortfall for basic living expenses for older Americans from 2020 to 2030 will reach at least $400 billion,[303] an amount that could threaten economic and political stability.

298. *Id*. at *5, *22–23.

299. Muir, *supra* note 12, at 6.

300. *Total Assets Increase in Retirement Plans*, WALL ST. J., Apr. 26, 2004, at C3.

301. Janice Kay Lawrence, *Pension Reform in the Aftermath of Enron: Congress' Failure to Deliver the Promise of Secure Retirement to 401(k) Plan Participants*, 92 KY. L.J. 1, 21–22 (2003–2004).

302. News Release, Employee Benefit Research Institute, New EBRI Research: Defined Contribution Worker Coverage Grows; Retirement Savers Continue Reliance on Stocks ("The segment relying solely on defined contribution retirement plans (such as 401(k)s), rose from 40.8 percent to 61.5 percent in the 1992–2001 period . . . ."), *at* www.ebri.org/prrel/pr650.html (Jan. 21, 2004).

303. Jack VanDerhei & Craig Copeland, *Can America Afford Tomorrow's Retirees: Results from the EBRI-ERF Retirement Security Projection Model*, 263 EBRI ISSUE BRIEF 1, 4 (2003).

The majority of large, publicly-owned companies that sponsor 401(k)-style plans offer company stock as an investment option in the plan.[304] Enron was not atypical in that it provided employees with twenty investment options, one of which was Enron stock.[305] Where company stock is an investment option, it is not unusual, particularly at large companies, for employees to concentrate their investments heavily in employer stock.[306] Empirical data show that where an employer-sponsored plan matches employee contributions with company stock, employees are more likely to invest their own contributions in company stock.[307] This decision seems irrational. Are 401(k)-style plans and their investments pension plans in the colloquial sense? It is true that ERISA defines and regulates 401(k) plans as pension plans.[308] These plans, however, permit employees to allocate their assets among a significant array of investment vehicles.[309] The plans typically permit employees to take loans against their account balances.[310] An employee who stops working for the employer sponsoring the plan may receive an immediate distribution of the assets held in the plan rather than being forced to wait until retirement age.[311] The former employee then may deposit the funds in a similar plan sponsored by a new employer or in an individual retirement account, or, although it results in a tax penalty, may simply keep or spend the money.[312] One might legitimately ask, then, whether 401(k) plans are truly pension plans, or whether they bear more resemblance to traditional investment accounts—albeit with a tax-favored status. In the

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304. *See* Lawrence, *supra* note 301, at 4, n.8.

305. *See id*. at 4.

306. *See* Maureen B. Cavanaugh, *Tax as Gatekeeper: Why Company Stock is Not Worth the Money*, 23 VA. TAX REV. 365, 378–79 (2003–2004).

307. Sarah Holden & Jack VanDerhei, *401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2000*, 230 EBRI ISSUE BRIEF 1, 13 (2001).

308. *See* 29 U.S.C. § 1002(2) (2000) (defining "pension plan" to include long-term deferral arrangements).

309. Lawrence, *supra* note 301, at 37 (". . . 401(k) plans now offer on average thirteen to fourteen investment options, with an increasing number of plan sponsors offering a brokerage option with virtually unlimited investment options.") (citations omitted).

310. Sarah Holden & Jack VanDerhei, *401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2003*, 272 EBRI ISSUE BRIEF 1, 9 (2004).

311. *See* MICHAEL J. CANAN, QUALIFIED RETIREMENT AND OTHER EMPLOYEE BENEFIT PLANS § 3.98 (1991).

312. *See* Norman P. Stein & Patricia E. Dilley, *Leverage, Linkage, and Leakage: Problems with the Private Pension System and How They Should Inform the Social Security Reform Debate*, 58 WASH. & LEE L. REV. 1369, 1402–07 (2001) (discussing the problem of "leakage"—which can occur when employees do not roll over plan distributions).

interests of transparency, we tend to refer to them in this Article as company-sponsored employee investment plans.

V. OBLIGATIONS OWED UNDER ERISA TO EMPLOYEE SHAREHOLDERS

In this section, we address the significant fiduciary and disclosure obligations that ERISA imposes on company-sponsored employee investment plans, businesses that sponsor those plans, and the individuals who have responsibility for the operation and management of the plans. Given the focus of this Article, we will concentrate on the obligations of officers, directors, and other actors at companies that sponsor benefit plans, and particularly on issues surrounding the use of company stock in those plans. We first explain the general legal standards surrounding plan governance. We then consider how the principles of fiduciary duty apply when companies provide opportunities for employees to invest in company stock through tax-favored plans—an area riddled with conflicts of interest, where overlapping federal securities law and corporate law create challenges in defining protections for shareholders. Although the courts have been elucidating these statutory concepts since ERISA's enactment in 1974, the principles are only beginning to be applied in the context of fiduciary breaches associated with employer stock in company-sponsored employee investment plans.

A. *Statutory Standards*

ERISA enumerates the obligations of fiduciaries. First, in what is commonly known as the "Exclusive Benefit Rule,"[313] fiduciaries must act "for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan[.]"[314] These obligations parallel the long-established duty of loyalty in trust and corporate law.[315] The time-honored principles of loyalty become more complex, however, when applied to an ERISA fiduciary. The drafters of ERISA explicitly deviated from traditional trust law and corporate law and permitted fiduciaries to take on conflicting roles, such as that of employer

313. *See* Daniel Fischel & John H. Langbein, *ERISA's Fundamental Contradiction: The Exclusive Benefit Rule*, 55 U. CHI. L. REV. 1105, 1107 (1988).
314. 29 U.S.C. § 1104(a)(1)(A) (2000).
315. *See supra* text accompanying notes 172–82.

and plan fiduciary.[316] Commentators have argued that, in the ERISA context, loyalty requires fiduciaries to be neutral in balancing the interests of various plan participants and beneficiaries.[317]

The real challenge for directors and other ERISA fiduciaries is to reconcile two lines of cases that flow from the conflicts of interest allowed under ERISA. One strand of law imposes absolute loyalty on fiduciaries, setting a standard of an "eye single to the interests of plan participants and beneficiaries."[318] This strand is consistent with traditional trust law and Justice Cardozo's famous quote that a trustee is held to "the punctilio of an honor the most sensitive[.]"[319] The other strand of law recognizes that employers may receive " 'incidental' and thus legitimate benefits . . . from the operation of a pension plan . . . ."[320] This strand of the law is unique to ERISA and is compelled in part by the statute's approval of conflicted fiduciaries. This strand also recognizes that employers sponsor benefit plans, including company-sponsored employee investment plans, for a variety of self-interested reasons including decreasing employee turnover, competitive issues, and tax incentives.

A second obligation imposed on ERISA fiduciaries is the requirement to act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."[321] At least superficially, this duty parallels the duty of care found in trust and corporate law.[322] However, the corporate law may be more complex and further developed than the ERISA law. Through its use of the business judgment rule, corporate law typically defers to business decisions made by a board of directors.[323] In this way courts avoid second-guessing business decisions and do not cause boards to become too risk averse.[324] Still, corporate law recognizes that there are times when the

316. *See* Dana M. Muir, *Fiduciary Status as an Employer's Shield: The Perversity of ERISA Fiduciary Law*, 2 U. PA. J. LAB. & EMP. L. 391, 414 (1999–2000).

317. *See* Fischel & Langbein, *supra* note 313, at 1138–42.

318. Donovan v. Bierwirth, 680 F.2d 263, 271 (2d Cir. 1982) (discussing duty of corporate directors who are trustees of pension plan).

319. Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928).

320. Lockheed Corp. v. Spink, 517 U.S. 882, 893 (1996).

321. 29 U.S.C. § 1104(a)(1)(B) (2000).

322. *See supra* text accompanying notes at 95–100, 172–82 (discussing those duties).

323. *See supra* text accompanying notes at 101–22.

324. *See supra* text accompanying notes at 105–08.

risk of conflicts of interest is so severe that stricter scrutiny is warranted.[325]

The scienter requirement that attaches to the duty of care is yet another instance where developing ERISA case law seems to diverge from the long established corporate law standard of gross negligence and perhaps even recklessness. Some courts and commentators have indicated that, under ERISA, there is no scienter requirement attached to claims for breach of the fiduciary duty of care. It is said, for example, that "a pure heart and an empty head are not enough" to protect an imprudent fiduciary.[326] But others appear to follow the traditional trust law standard of negligence. In *In re AEP ERISA Litigation*,[327] the defendants argued that plaintiffs' fiduciary claims should be dismissed because those claims completely circumvented the Federal Securities Acts' scienter requirement.[328] The court rejected the contention saying that circuit precedent establishes that ERISA fiduciaries breach their duties "'regardless of whether the fiduciary's statements or omissions were made negligently or intentionally.'"[329] Whether the courts settle on the threshold for ERISA fiduciary intent as a negligence or strict liability standard, it almost certainly will be a lower standard than corporate law's gross negligence standard. The two legal regimes are similar, however, in that they view the duty of care primarily as a procedural standard.[330]

Third, ERISA requires fiduciaries to diversify plan investments.[331] The DOL has recognized that fiduciary investment decisions may be considered in the context of the entire portfolio.[332] The commentators are divided over the extent to which ERISA's diversifi-

325. *See supra* text accompanying notes at 131–39.
326. Colleen E. Medill, *Stock Market Volatility and 401(k) Plans*, 34 U. MICH. J.L. REFORM 469, 483 (2000–2001) (quoting Donovan v. Cunningham, 716 F.2d 1455, 1467 (5th Cir. 1983)). *But see* Beach v. Commonwealth Edison Co., 382 F.3d 656, 658 (7th Cir. 2004) (calling problematic the lower court's view that "any material inaccuracy, even an unintentional error, violates that fiduciary duty").
327. 327 F. Supp. 2d 812 (S.D. Ohio 2004).
328. *Id.* at 819–20.
329. *Id.* at 825 (quoting James v. Pirelli Armstrong Tire, 305 F.3d 439, 449 (6th Cir. 2002)); *see also Beach*, 382 F.3d at 660 (questioning whether holding employees to a strict liability standard for inaccurate predictions would constitute poor policy).
330. *See* Regina T. Jefferson, *Rethinking the Risk of Defined Contribution Plans*, 4 FLA. TAX REV. 607, 630 n.100 (1998–2001) ("Fiduciaries . . . are apparently obligated to exercise only procedural prudence . . . ."); Jayne Elizabeth Zanglein, *Protecting Retirees While Encouraging Economically Targeted Investments*, 5 KAN. J.L. & PUB. POL'Y 47, 52 (1996) ("Prudence is measured in terms of procedural prudence.").
331. *See* 29 U.S.C. § 1104(a)(1)(C) (2000).
332. *See* Robert A. Levy, *The Prudent Investor Rule: Theories and Evidence*, 1 GEO. MASON L. REV. 1, 4 (Stud. Ed. 1994).

cation requirement adopts or tolerates modern portfolio theory.[333] There is remarkably little case law on the use of modern portfolio theory to define the scope of ERISA's diversification requirement, although what case law does exist tends to be supportive of the theory.[334] There is no direct analog to this duty in traditional corporate law, although trust law does contain prudent investment standards that includes an obligation to diversify investment of trust assets.[335] Finally, a fiduciary must act in accordance with the relevant plan documents, except to the extent those documents are inconsistent with ERISA.[336] Thus, statutory obligations supersede any conflicting provisions that might exist in plan documents.[337]

In addition to its fiduciary provisions, ERISA requires plans to make specified disclosures to plan participants and beneficiaries, as well as to the DOL and Internal Revenue Service.[338] From a broad perspective, the statutory disclosure provisions are similar in concept to the disclosure obligations imposed by the Federal Securities Acts. In both instances, the statute requires periodic reporting.[339] In each regime, the relevant regulatory body has provided detailed guidelines

333. For a definition of modern portfolio theory and discussion of its use in ERISA plans, compare Richard H. Koppes & Maureen L. Reilly, *An Ounce of Prevention: Meeting the Fiduciary Duty to Monitor an Index Fund Through Relationship Investing*, 20 J. Corp. L. 413, 436–37 (1995) ("The DOL was quick to recognize modern portfolio theory as an appropriate measure of prudent investment.") and Bradley P. Rothman, Note, *401(k) Plans in the Wake of the Enron Debacle*, 54 Fla. L. Rev. 921, 934 (2002) ("Generally, prudent diversification entails using modern portfolio theory . . . .") with Deborah M. Weiss & Marc A. Sgaraglino, *Prudent Risks for Anxious Workers*, 1996 Wis. L. Rev. 1175, 1177 (1996) ("[ERISA's] fiduciary rules acknowledge portfolio theory, but almost wholly fail to incorporate the insights of modern portfolio theory.").

334. *See, e.g.*, Laborers Nat'l Pension Fund v. N. Trust Quantitative Advisors, Inc., 173 F.3d 313, 317 (5th Cir. 1999) ("In general, the regulations provide that the fiduciary shall be required to act as a prudent investment manager under the modern portfolio theory rather than under the common law of trusts standard which examined each investment with an eye toward its individual riskiness."); Meyer v. Berkshire Life Ins. Co., 250 F. Supp. 2d 544, 553 (D. Md. 2003) (discussing expert's testimony regarding moderate risk portfolio).

335. *See* Restatement (Third) of Trusts § 227 (1992) ("In making and implementing investment decisions, the trustee has a duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so.").

336. 29 U.S.C. § 1104(a)(1)(D) (2000).

337. *Id.*

338. Edward E. Bintz, *Fiduciary Responsibility Under ERISA: Is There Ever a Fiduciary Duty to Disclose?*, 54 U. Pitt. L. Rev. 979, 980 (1992–1993).

339. *Compare* 29 U.S.C. § 1023 (2000) (requiring annual reports) *with* 15 U.S.C. § 78m (2000) (requiring filings with SEC).

on the form and content of disclosure.[340] But one important difference is that, unlike the securities laws under which issuers typically have no disclosure obligations unless imposed explicitly by law or regulation, the trend in the ERISA case law is to recognize that benefit plan fiduciaries have some disclosure obligations beyond those found in the statute and regulation.[341] The problem arises in defining the scope of that additional disclosure obligation.

The theory underlying the additional disclosure obligation for benefit plan fiduciaries is premised on ERISA's fiduciary framework and its grounding in traditional fiduciary principles. Trust law requires that a fiduciary who knows particular information would be of interest and value to a beneficiary must convey that information to the beneficiary.[342] Courts have imposed a similar obligation on ERISA fiduciaries.[343] The problem, however, lies in balancing the costs and benefits of potentially infinite disclosure requirements. On the one hand, plan members could become deluged with information, some of it of questionable value, and plan sponsors and plans might experience dramatically increased disclosure transaction costs. On the other hand, information possessed by plan sponsors and fiduciaries can be of critical value to a participant making a decision related to plan benefits.

In recent years, circuit courts have struggled to define the circumstances under which employers must inform employees about plan amendments under consideration. Consider the situation of an employee who is thinking about retiring at the same time the employer is evaluating the possibility of offering a three-month program that of-

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340. *Compare* 29 C.F.R. § 2520.103-1 (describing requisite contents of plan annual reports) *with* 17 C.F.R. § 240.15d-11 (describing requisite contents of annual reports to SEC).

341. *See* Bryan L. Clobes, *In the Wake of* Varity Corp. v. Howe*: An Affirmative Fiduciary Duty to Disclose Under ERISA*, 9 DePaul Bus. L.J. 221, 226–27 (1996–1997) ("The recent trend favors imposing upon fiduciaries the common law rule requiring them to disclose material information concerning existing plans and benefits when they know that silence might be harmful."); Joseph E. Czerniawski, Comment, Bins v. Exxon*: Affirmative Duties to Disclose Proposed Benefit Changes in the Absence of Employee Inquiry*, 76 Notre Dame L. Rev. 783, 808 (2000–2001) ("There has been considerable disagreement among the lower courts dealing with disclosure of proposed benefit changes, but there has been a trend towards a 'serious consideration' test as triggering fiduciary disclosure duties in these cases."); Melissa Elaine Stover, Note, *Maintaining ERISA's Balance: The Fundamental Business Decision v. The Affirmative Fiduciary Duty to Disclose Proposed Changes*, 58 Wash. & Lee L. Rev. 689, 691 (2001) (stating that "the current trend in the federal courts [is] to expand a plan administrator's disclosure duties by emphasizing her fiduciary obligation to provide material information to plan participants").

342. *See* Clobes, *supra* note 341, at 227.

343. *Id.*

fers enhanced retirement benefits in order to reduce its workforce. The employee would want to know about the likelihood of such a program and might lose substantial benefits by retiring just before the program is announced. Although the circuits articulate varying standards regarding when employees must be notified of plan amendments under consideration, the trend is to require disclosure, at least in response to employee questions, beginning at the point the amendments pass a materiality threshold.[344] Countless other situations, including the employer stock cases, raise similar legal issues.[345]

B. The Developing Employer Stock Case Law

The employees of Enron lost more than $2 billion by investing in Enron stock through employer-sponsored plans. Enron is perhaps the best known example of investments in employer stock gone awry.[346] But it is far from the only situation in recent years where employees have been disappointed in the results of investing in employer stock. In the aftermath of such experiences, employees have filed numerous lawsuits alleging ERISA breach of fiduciary duty and disclosure violations. The claims are more complex than they first appear. For example, the Enron plaintiffs asserted breaches of fiduciary and co-fiduciary duties of diversification, care, and loyalty.[347] Those claims were based, among other things, on allegations that the defendants failed properly to appoint and monitor other plan fiduciaries; caused, permitted, and encouraged employee investments in Enron stock even though the fiduciaries knew it was an imprudent investment; and locked down plan investments without adequate notice.[348] The Enron plaintiffs also alleged that the plan fiduciaries failed to disclose material information of which the fiduciaries had knowledge and knew

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344. *Id.* at 226–27 ("[Although] no uniform rule has emerged requiring affirmative disclosure of material information concerning either existing plans or changes under serious consideration[, the] recent trend favors imposing upon fiduciaries the common law rule requiring them to disclose material information concerning existing plans and benefits when they know that silence might be harmful."). *But see* Beach v. Commonwealth Edison Co., 382 F.3d 656, 658 (7th Cir. 2004) (finding no disclosure duty where former employee had not been plan participant).

345. *See* Jennifer A. Leahy, Note, *ERISA's Fiduciary Provisions and the Duty to Disclose: Circumstances When an Employer Is Subject to Fiduciary Standards*, 34 SUFFOLK U. L. REV. 595, 596 (2000–2001); Eugene P. Schulstad, Note, *ERISA Disclosure Decisions: A Pyrrhic Victory for Disclosure Advocates*, 34 IND. L. REV. 501, 501 (2000–2001).

346. *See supra* text accompanying notes 299–303.

347. *See In re* Enron Corp. Secs., Derivative & "ERISA" Litig., 284 F. Supp. 2d 511, 531–37 (S.D. Tex. 2003).

348. *See id.*

would be important to employee investment decision-making.[349] After a careful and extensive analysis, the district court in *Enron* denied the defendants' motions to dismiss the counts as to numerous defendants.[350]

Courts have begun to consider fiduciary duties involving employer stock in the context of motions to dismiss, but the analytical approaches are far from consistent. Developing legal standards have not yet been applied to the complex factual patterns of employer stock cases. The issues seen in *Enron*, therefore, can be expected to trouble the courts for some time to come, and the potential claims merit significant consideration. In the following discussion, we categorize claims according to alleged actions by the fiduciary. We discuss claims where the defendant is accused of: (1) continuing to offer employer stock as an investment option, automatically making matching contributions in employer stock, or prohibiting diversification out of employer stock when the fiduciaries knew or should have known that employer stock was an imprudent investment; (2) failing to properly appoint or monitor fiduciaries who had responsibility for investment-related decisions under the plan or communications regarding the plan; and (3) making material misstatements or omissions of disclosure regarding employer stock. We recognize that the categories are somewhat artificial in nature; there is some overlap in the legal analysis among the claims. Yet, dissecting the claims in this way helps elucidate both the applicable legal principles and the factual distinctions among the claims.

1. Employer Stock as an Imprudent Investment

Claims where fiduciaries are alleged to have continued to offer company stock as an investment option despite knowing that the stock was an imprudent investment, caused employer matches to be made in employer stock, or prevented employees from diversifying their plan accounts, implicate all of ERISA's fiduciary obligations. For example, the duty of loyalty is implicated where fiduciaries are reluctant to modify the availability of company stock in the employer plans because of a possible dramatic decrease in the stock price and, ultimately, a decline in the value of the fiduciaries' own stock or option holdings.[351] Similarly, one can imagine a number of scenarios where

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349. *See id.* at 537.
350. *See id.* at 682–84.
351. *See, e.g.*, Hill v. BellSouth Corp., 313 F. Supp. 2d 1361, 1365–66 (N.D. Ga. 2004) (alleging company's incentive plan for officers caused conflict of interest for officer-fiduciaries).

the resulting decline in the stock price, or even the fiduciaries' lack of confidence in the company's prospects, would negatively affect the fiduciaries, the company, or some other constituency.[352] As fiduciaries make decisions regarding the use of employer stock in company-sponsored employee investment plans, they should be motivated solely by the best interests of the plan participants and beneficiaries. Otherwise, the fiduciaries would seem to violate their duty of loyalty to plan participants—at least to the extent the decision is a fiduciary one.

The Supreme Court has allowed companies that sponsor benefit plans to enjoy some tangential gains from plan sponsorship.[353] However, fiduciaries must still abide by the oft-repeated standard that ERISA fiduciaries must act with "an eye single to the interests of participants and beneficiaries."[354] When making decisions about the use of company stock, fiduciaries may not weigh the detriment to the company that may result against the possible benefit to participants and beneficiaries. Courts have consistently recognized the supremacy and stringent obligations of the principle of loyalty and permitted, in this context, employee claims based on breach of loyalty to go forward.[355]

Fiduciaries who fail to reconsider the use of company stock in company-sponsored employee investment plans once that stock becomes a problematic investment choice also may violate their fiduciary obligation of prudence and due care. For example, in *In re WorldCom, Inc.*,[356] the plaintiffs alleged that plan fiduciaries failed to fulfill their responsibilities to evaluate the continued availability of WorldCom stock as an investment alternative under the plan.[357] The court agreed that plaintiffs pleaded a valid claim, noting that "[t]o the extent . . . that any Plan fiduciary had responsibility to decide or present views on the wisdom of the investment options, it would have

352. *See, e.g.*, *In re* Elec. Data Sys. Corp. "ERISA" Litig., 305 F. Supp. 2d 658, 673 (E.D. Tex. 2004) (alleging fiduciaries' obligation to protect corporation and act on behalf of plan participants and beneficiaries created conflict of interest).

353. *See* Hughes Aircraft Co. v. Jacobson, 525 U.S. 432, 445 (1999) ("[T]he incidental benefits conferred upon Hughes when it amended the Plan are not impermissible under the statute. It is irrelevant whether Hughes received lower labor costs or other such incidental benefits from implementing the noncontributory structure under the [plan] amendment.").

354. Donovan v. Bierwirth, 680 F.2d 263, 271 (2d Cir. 1982).

355. *See, e.g.*, *Hill*, 313 F. Supp. 2d at 1370 (denying motion to dismiss fiduciary breach claim predicated on conflict of interest); *Elec. Data Sys. Corp. "ERISA" Litig.*, 305 F. Supp. 2d at 673–74 (same).

356. 263 F. Supp. 2d 745 (S.D.N.Y. 2003).

357. *Id.* at 763.

been a breach of that duty not to alert WorldCom to the need to eliminate, or at least, to consider eliminating WorldCom stock as one of the investment alternatives."[358]

Even in situations involving ESOPs, which, by statute, must be designed to invest primarily in employer stock,[359] courts have held that a plan fiduciary may have a duty to review the continued prudence of investments in employer stock.[360] The ESOP cases adopt an abuse of discretion standard, giving fiduciaries a presumption of prudence for investments in employer stock, but plaintiffs may rebut the presumption by showing that "circumstances not known to the settlor and not anticipated by him would defeat or substantially impair the accomplishment of the purposes of the trust."[361] The absence of a statutory requirement that 401(k) plan assets be invested primarily in employer stock and the potential for conflicts of interest may militate for a more stringent level of scrutiny of fiduciary compliance with ERISA's prudence standards in those cases. Multiple courts, however, have cited the ESOP presumption when analyzing a 401(k) plan fiduciary's prudence.[362]

The ESOP cases raise one further complication with respect to fiduciaries' obligation of due care. As the Third Circuit noted in *Moench v. Robertson*,[363] if the fiduciary, in what it regards as an exercise of caution, does not maintain the investment in the employer's securities, it may face liability for that caution, particularly if the employer's securities thrive . . . ."[364] Thus, directors, officers, and others who serve as ERISA fiduciaries must not be so conservative in their evaluation of company prospects as to imprudently eliminate company stock as an investment option or source of matching contribution. By doing so, they could deny employees the opportunity to make a lucrative investment or force them to sell company stock at an unfavorable time.

The fiduciary obligation of diversification does not apply to fiduciaries of company-sponsored employee investment plans that have

358. *Id.* at 764.
359. *See* IRC § 4975(e)(7) (2000).
360. *See, e.g.*, Kuper v. Iovenko, 66 F.3d 1447, 1459 (6th Cir. 1995) ("A fiduciary may breach his duties to plan beneficiaries by failing to investigate and evaluate the merits of his investment decisions."); Moench v. Robertson, 62 F.3d 553, 571 (3d Cir. 1995) (same).
361. *Moench*, 62 F.3d at 571 (quoting Restatement (Second) of Trusts § 227 cmt. g (1959)).
362. *See, e.g.*, *WorldCom Litig.*, 263 F. Supp. 2d at 764–65 (citing *Moench*, 62 F.3d at 571).
363. 62 F.3d 553 (3d Cir. 1995).
364. *Id.* at 572.

successfully delegated the selection of investments to plan participants and beneficiaries. These plans commonly delegate investment decision-making with regard to employees' discretionary contributions.[365] Supporters of delegation argue that it provides individual plan investors with flexibility and respects their different tolerances for investment risk.[366] The delegation also redounds to the benefit of plan sponsors and fiduciaries because regulations, issued in 1992, permit an employer to avoid liability for poor investment choices if the plan meets specified criteria.[367] The regulations were issued under ERISA section 404(c),[368] and, hence, are known as the section 404(c) regulations. Plans that delegate investment choices in compliance with the regulations are known as participant-directed plans or section 404(c) plans.[369]

When plaintiffs who are members of participant-directed plans assert that their discretionary investments in company stock violate ERISA's diversification requirements, plan fiduciaries typically defend on the basis that ERISA section 404(c) precludes liability associated with the selection of investments.[370] Section 404(c), however, provides fiduciaries with only an affirmative defense and, thus, typically is inappropriate for resolution on a motion to dismiss.[371] Most

365. *See* Colleen E. Medill, *The Individual Responsibility Model of Retirement Plans Today: Conforming ERISA Policy to Reality*, 49 EMORY L.J. 1, 11 n.51 (2000).

366. *See* Jefferson, *supra* note 330, at 627.

367. *See* Pamela Perun & C. Eugene Steuerle, From Fiduciary to Facilitator: Rethinking the Role of Employers in Defined Contribution Plans, The Urban Institute 13–14 (Dec. 5, 2000) (unpublished manuscript, on file with authors), *available at* http://www.planetnow.com/pamelawork/facilitator.pdf.

368. 29 C.F.R. § 2550.404(c)-1 (1992).

369. *See* Sharon Reece, *Enron: The Final Straw & How to Build Pensions of Brick*, 41 DUQ. L. REV. 69, 86 (2002); Perun & Steuerle, *supra* note 367, at 13.

370. *See, e.g.*, *In re* Reliant Energy ERISA Litig., No. H-02-2051, 2004 U.S. Dist. LEXIS 1450, at *62–64 (S.D. Tex. Jan. 27, 2004) ("Defendants also contend that ERISA § 404(c) . . . relieves it of any potential fiduciary liability in this case . . . because participants in the . . . Plan exercised control over their accounts and are therefore responsible for any losses."); *In re* Enron Corp. Secs., Derivative & "ERISA" Litig., 284 F. Supp. 2d 511, 574–78 (S.D. Tex. 2003) (addressing defendants' claim that section 404(c) protects them from liability); Rankin v. Rots, 278 F. Supp. 2d 853, 868–69 (E.D. Mich. 2003) ("The [former CEO and Director of Kmart and the Outside Directors] argue that . . . under ERISA section 404(c), they have no liability for Rankin's losses to the Plan.").

371. *See, e.g.*, *Reliant Energy ERISA Litig.*, 2004 U.S. Dist. LEXIS 1450, at *63 n.57 ("REI's counsel conceded at oral argument on this motion [to dismiss] that because Section 404(c) provides an affirmative defense to liability, it likely is not a proper grounds on which to grant Rule 12(b)(6) dismissal."); *Rankin*, 278 F. Supp. 2d at 872 ("Whether or not section 404(c) applies is not a question on a motion to dismiss. Section 404(c) provides defendants with a defense to liability; it does not mean that Rankin has failed to make out a claim against them.").

of the lawsuits in the employer stock cases have not progressed beyond this point so there is little case law defining the threshold fiduciaries must meet to receive 404(c) protection. It is clear, though, that section 404(c) does not protect fiduciaries from liability for investment decisions unless the plan participants have the right to exercise control over their plan accounts, and, in fact, actually exercise that control.[372]

The allegations in *In re Enron Corp. Securities, Derivative & "ERISA" Litigation*[373] are typical of these cases. Plaintiffs alleged that the fiduciaries' failure to disclose material facts about Enron's true financial situation precluded the plaintiffs from exercising the necessary independent control over their plan accounts.[374] The Enron plaintiffs also contended that the plan fiduciaries did not qualify for section 404(c) protection because the plan "did not provide a broad range of diversified investment options, liberal opportunities to transfer assets among allocations, and sufficient information to make sound investment decisions, nor did the plan provide the requisite notice to participants that it intended to qualify as such a plan."[375] Plaintiffs in other cases have made similar arguments. As the *Enron* court put it, "If a plan does not qualify as a [section] 404(c) [plan], the fiduciaries retain liability for all investment decisions made, including decisions by the Plan participants."[376] The-yet-to-be defined standard for section 404(c) protection, then, will be a critical factor in these cases.

2. *Failing to Properly Appoint or Monitor Plan Fiduciaries*

Appointing plan fiduciaries is a fiduciary function, with a concomitant obligation to monitor those fiduciaries. Plaintiffs who allege wrongdoing associated with investments in company stock frequently allege that corporate directors or officers, who have appointment authority over plan administrators or plan investment committee members, failed in their obligation to properly appoint or monitor those lower level plan fiduciaries. For example, in *Rankin v. Rots*,[377] the plaintiffs alleged that Charles A. Conaway, Chairman, CEO, and Director of Kmart Corporation, breached his fiduciary obligations to

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372. *See Enron Corp. Secs., Derivative & "ERISA" Litig.*, 284 F. Supp. 2d at 574.
373. 284 F. Supp. 2d 511 (S.D. Tex. 2003).
374. *Id*. at 577.
375. *Id*. at 578.
376. *Id.*
377. 278 F. Supp. 2d 853 (E.D. Mich. 2003).

them by "failing to monitor or evaluate the performance of those appointed by him to fiduciary capacities . . . ."[378]

Claims attempting to categorize board members and others as fiduciaries because of their oversight capacity have not always been successful in surviving motions to dismiss in the employer stock cases. For example, in *In re WorldCom, Inc.*,[379] the plaintiffs alleged that WorldCom's status as Plan Administrator and Investment Fiduciary, as designated by the plan, meant that the company's directors had fiduciary responsibility to appoint and monitor plan fiduciaries.[380] The plaintiffs attempted to reinforce their argument by relying on the law of Georgia, where WorldCom was incorporated and which provides, as do most state corporation statutes, that boards of directors have the responsibility to oversee the corporation's business and management.[381] The court concluded that the plaintiffs' argument proved too much because its logical result would be that every person who supervised an ERISA fiduciary automatically would become an ERISA fiduciary.[382] Nor, according to the court, does the argument appropriately recognize the difference between board members' obligations as plan settlors, which do not result in any fiduciary duty, and their obligations as plan fiduciaries.[383]

The opposing approaches developed by the courts to address fiduciary appointment and monitoring obligations raise interesting implications for both policy makers and any corporate director or other person who appoints fiduciaries. Those who appoint fiduciaries will need to decide in the short term whether they assume greater risk in exercising appointment and oversight opportunities or in avoiding those responsibilities. Policy makers might look to either traditional fiduciary principles or to corporate law for guidance. Traditional trust law typically has precluded trustees from delegating responsibility, making that an inapt source of authority.[384] Corporate law, on the other hand, has confronted the question of officer and director oversight responsibility in a variety of contexts. The basic legal principles

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378. *Id.* at 863.

379. 263 F. Supp. 2d 745 (S.D.N.Y. 2003).

380. *Id.* at 760.

381. *Id.*

382. *Id.*

383. *Id.* at 761. For a discussion of the settlor doctrine, see *supra* text accompanying notes 276–98.

384. *See* Dana M. Muir, *Contemporary Social Policy Analysis and Employee Benefit Programs: Boomers, Benefits, and Bargains*, 54 WASH. & LEE L. REV. 1351, 1363 (1997).

are discussed above, and we consider the implications of those principles for the employer stock cases below in Part VI.

3. Material Misstatements and Omissions

The third category of complaints frequently raised by plaintiffs who have been harmed by making an investment in company stock through employer-sponsored plans consists of claims related to alleged misstatements or omissions about the stock or about the company's prospects more generally. These allegations are sometimes raised in order to argue that a particular person or entity is an ERISA fiduciary. For example, in *In re WorldCom, Inc.*, the plaintiffs alleged that company directors became ERISA functional fiduciaries by signing SEC filings made on behalf of WorldCom.[385] Some of those filings incorporated ERISA-required documents and some ERISA-required documents incorporated SEC documents by reference.[386] The court, however, declined to find that signing the SEC filings caused the directors to become ERISA fiduciaries.[387] In a rather cursory manner, the court determined that the directors signed those documents in their corporate roles and not in their roles as ERISA fiduciaries, thus applying the settlor doctrine in this context.[388]

The *Enron* court confronted the difficult questions subsumed in allegations that the plaintiffs had been misled about the value of Enron stock. The court's opening statement on the issue is a warning: "The fiduciary's duty to disclose is an area of developing and controversial law."[389] However, it is generally accepted, as the *Enron* court went on to note, that it is a breach of fiduciary duty to make an affirmative misrepresentation about future benefits that would induce reliance by a reasonable person.[390] On the other hand, the Supreme Court has left open the question of whether a fiduciary has an affirmative obligation to make disclosures in the absence of a specific statutory or regulatory obligation or a direct question from a participant.[391]

385. 263 F. Supp. 2d at 760.
386. *Id*.
387. *Id*.
388. *Id*.; *see also In re* Tyco Int'l, Ltd. Multidistrict Litig., No. 02-1357-PB, 2004 U.S. Dist. LEXIS 24272 (D. N.H. Dec. 2, 2004) (declining to attribute fiduciary status to Tyco Int'l because it distributed SEC-mandated materials).
389. *In re* Enron Corp. Secs., Derivative & "ERISA" Litig., 284 F. Supp. 2d 511, 555 (S.D. Tex. 2003).
390. *Id*. at 556. *But see* Beach v. Commonwealth Edison Co., 382 F.3d 656, 658 (7th Cir. 2004) (calling problematic the lower court's view that "any material inaccuracy, even an unintentional error, violates that fiduciary duty").
391. 284 F. Supp. 2d at 556.

Ultimately, the *Enron* court found that the plaintiffs' claims against a number of defendants for failure to disclose were sufficiently stated. Both Enron and the Compensation Committee allegedly withheld information about Enron's actual financial condition from the Administrative Committee.[392] Furthermore, a wide variety of fiduciaries, including the directors on the Compensation Committee and Kenneth Lay, "allegedly breached their fiduciary duty to protect the plan participants and beneficiaries through failure to disclose to them . . . that what they knew or should have known, through prudent investigation, was a threat to the pension plans or to correct any material misinformation."[393]

Critical questions surround the nascent doctrine on disclosure obligations in the context of employer stock offered through company-sponsored employee investment plans. Certainly, employees who purchase company stock should not be any more susceptible to fiduciary deceit than non-employees who purchase company stock. One of the foundational concepts of the Federal Securities Acts is to prevent fraud in the sale and purchase of securities.[394] But to what extent do ERISA fiduciaries have disclosure obligations in excess of those imposed by the Federal Securities Acts? Does the risk of investing both human and financial capital in the same enterprise entitle employees to additional protection? Or should the employees be held accountable for the additional risk they voluntarily take when putting all their eggs in one basket? Should plan fiduciaries face a higher level of fiduciary duty vis-à-vis the offering of company securities through company-sponsored employee investment plans? After all, fiduciaries have exceptional access to company information and it may benefit the company, for example for tax purposes and by putting stock in friendly hands, to offer company stock through the plans. Or, on the other hand, should plan fiduciaries be protected against extensive disclosure obligations under ERISA to foster plan sponsorship and employee ownership, together with all of the benefits that plans and employee ownership can bring to the company and the employees?[395]

Rationalizing disclosure duties under ERISA and the Federal Securities Acts has been a challenge for the courts. In *Rankin*, Conaway, the Kmart Chairman, CEO, and Director, and the outside

392. *Id*. at 657.
393. *Id*. at 658.
394. *See supra* text accompanying notes 25–27.
395. For a discussion of the history and benefits of employee ownership, see Dana M. Muir, *Groundings of Voice in Employee Rights*, 36 VAND. J. TRANSNAT'L L. 485, 489–94 (2003).

directors argued that even if they had any fiduciary duties under ERISA to disclose information about Kmart's prospects, "they could not as a matter of law [have] breached them because to have disclosed non-public information about Kmart would have violated securities laws."[396] The courts have approached that argument differently in the employer stock cases. One court has suggested that disclosing non-public company information before acting on the information would violate securities laws.[397] In *In re McKesson HBOC Inc. ERISA Litigation*, the district court went further and stated, "[f]iduciaries are not obligated to violate the securities laws in order to satisfy their fiduciary duties."[398] The *Rankin*, *WorldCom*, and *Enron* district courts, however, all rejected that argument. They accepted the contrary position, also advocated by the DOL, that in general, it appears that ERISA fiduciaries can and should satisfy extensive disclosure duties under ERISA and the securities laws even though that may also require public disclosures beyond those needed to meet the minimum standards of the Federal Securities Acts.[399] The same dangers of insider trading violations arise if the plan fiduciaries' superior knowledge leads them to sell employer stock held by the plan. However, if fiduciaries were to stop the plan from purchasing employer stock, that action would not constitute insider trading. As discussed above,[400] a section 10b-5 violation requires either a purchase or a sale of securities.

C. *Remedial Limitations*

Even when plaintiffs are successful in identifying plan fiduciaries and proving those fiduciaries breached their obligations, they still face a remedial hurdle. If the company-sponsored employee investment plan remains in place, the participants and beneficiaries could seek recovery to the plan.[401] ERISA explicitly grants a court broad discretion in fashioning relief that flows to a plan.[402] However, claims based on fiduciary breaches associated with employer stock would almost certainly result in individualized losses depending on the amount

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396. Rankin v. Rots, 278 F. Supp. 2d 853, 873 (E.D. Mich. 2003).
397. Hull v. Policy Mgmt. Sys. Corp., No. 3:00-778-17, 2001 U.S. Dist. LEXIS 22343, at *26 (D. S.C. Feb. 9, 2001).
398. 29 E.B.C. (BNA) 1229, 1236–37 (N.D. Cal. 2002).
399. *Rankin*, 278 F. Supp. 2d at 876–77; *In re* WorldCom Litig., 263 F. Supp. 2d 745, 766–67 (S.D.N.Y. 2003); *Enron Corp. Sec., Derivative & "ERISA" Litig.*, 284 F. Supp. 2d at 563–67.
400. *See supra* text accompanying notes 25–45.
401. Muir, *supra* note 274, at 223–25.
402. *Id*.

of stock held in an employee's account, that employee's maximum permitted deferral, and, perhaps, the employee's investment choices. Although inconsistent with both the language and intent of the statute and relevant Supreme Court precedent, one court recently denied relief that would have been awarded to benefit plan accounts because such relief is necessarily individualized.[403] The court was willing to assume that the defendants breached their fiduciary duties and plaintiffs suffered a loss, but dismissed all claims because it believed ERISA did not provide any relief.[404] A better position would have been that of courts such as the District Court for the Central District of California in *In re Syncor ERISA Litigation*,[405] which recognized that ERISA explicitly authorizes a wide range of relief against breaching fiduciaries.[406]

An employee with a valid fiduciary breach claim who cannot claim relief flowing to the plan, perhaps because of the limitations just discussed or perhaps because of the demise of the employer and the plan, may attempt to state a claim for relief under ERISA's catch-all remedial provision. In *Great-West Life & Annuity Insurance Co. v. Knudson*,[407] a five-justice majority of the Supreme Court construed the provision—which permits "other equitable relief"[408]—to include only traditional equitable relief and to exclude money damages.[409] Three barriers exist for plaintiffs seeking "appropriate equitable relief" under ERISA section 502(a)(3)(B) after *Great-West*. First, in order for a plaintiff to obtain restitution, the defendant typically must be unjustly enriched.[410] Second, in order to obtain *equitable* restitution, the defendant may need to possess specific property of the plaintiff's.[411] Third, even if the defendant has been unjustly enriched and is holding specific property of the plaintiff's, according to section 502(a)(3)(B), equitable relief must be appropriate.[412]

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403. *See In re* Schering-Plough Corp. ERISA Litig., No. 03-1204, 2004 U.S. Dist. LEXIS 16265, at *24–30 (D. N.J. June 28, 2004).

404. *Id.*

405. No. CV 03-2446 LGB, 2004 U.S. Dist. LEXIS 23887 (D. C.D. Cal. Aug. 23, 2004).

406. *Id.* at *57–58; *see also* Muir, *supra* note 274, at 235 (arguing in favor of standing in these cases).

407. 534 U.S. 204 (2002).

408. 29 U.S.C. § 1132(a)(3)(B) (2000).

409. 534 U.S. at 221.

410. *See Great-West*, 534 U.S. at 213; *see also* RESTATEMENT OF RESTITUTION AND UNJUST ENRICHMENT § 1 (1936).

411. *See* 534 U.S. at 213.

412. *See* Varity Corp. v. Howe, 516 U.S. 489, 515 (1996).

Each of these three limitations may prevent recovery by a defendant who has suffered as a result of a fiduciary breach. The Supreme Court, however, has yet to confront the issue of whether claims for fiduciary breach necessarily result in relief being equitable under section 502(a)(3)(B). There would be good reason for the Court to distinguish its prior remedial cases. A phrase from *Great-West* helps clarify the fundamental question in the fiduciary breach cases. The Court stated that: "whether [restitution] is legal or equitable depends on 'the basis for [the plaintiff's] claim' and the nature of the underlying remedies sought."[413] Thus, the inquiry in the typical case requires a two-pronged examination that looks at the basis of the claim as well as the type of remedy at issue. In some cases these two factors might point in different directions. The specific question is whether, in situations of fiduciary breach, it is sufficient that the cases are substantively equitable. In theory, that is a reasonable basis on which to categorize cases as equitable. The equity courts created trust law and, in that sense at least, trust and fiduciary standards are peculiarly equitable.[414]

In sum, the litigation involving the use of employer stock in company-sponsored employee investment plans is still in its infancy. Few cases have progressed beyond the motion to dismiss stage. Given the fact-intensive nature of inquiries on fiduciary status, plan compliance with the section 404(c) safe harbor, the scope of actual communications about employer stock, and consideration by plan actors of the use of company stock, much of the shaping of the law is yet to come. Even at this point, however, it is clear that no simple standards exist for determining the prudence of using employer stock in a company-sponsored employee investment plan. Nor is it clear the extent to which corporate directors and other individuals who appoint corporate fiduciaries should be expected to monitor, let alone insure, the behavior of those fiduciaries. Courts have struggled in other contexts with the bounds of an ERISA fiduciary's obligation to provide affirmative disclosure beyond the periodic and other disclosure explicitly required by the statute. All of these issues, and the availability of remedies, will trouble the courts for years to come as they address the company stock cases. More importantly than the result in any given case, the conceptual frameworks of fiduciary obligation that are developed in company stock cases will at least implicitly affect the existing structure of corporate and Federal Securities Law. We next consider the new intersection of these divergent bodies of law.

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413. 534 U.S. at 213 (quoting Reich v. Cont'l Cas. Co., 33 F.3d 754, 756 (7th Cir. 1994)).

414. *See* 1 Dan D. Dobbs, Dobb's Law of Remedies § 2.3(2) (2d ed. 1993).

VI.
A Coherent Approach to Director and Officer Obligations Vis-à-vis Employee Investment in Company Stock

It should be apparent at this point that ascertaining the obligations of corporate directors, officers, and others with respect to the use of company stock in company-sponsored employee investment plans requires the rationalization at a conceptual as well as practical level of complex and intersecting legal frameworks. To increase the transparency of the complexities, we will now consider ways in which the legal standards interact. We will also analyze conceptual similarities and differences that should be important to courts and policy makers as they confront the fallout from the recent market downturn and the numerous instances of corporate malfeasance.

A. Anomalies and Analogs: Securities Law and ERISA

The various regulatory regimes that apply to purchases of employer stock made through company-sponsored employee investment plans intersect in some anomalous ways. As a result, employees who have ERISA claims attributable to an event related to employer stock may have very different legal rights from an equivalently situated employee whose claim is not associated with an employer plan, or when compared to an investor who is not affiliated with the company. The employee's ERISA claims even differ substantially from the plan's Federal Securities Acts claims based on the very same stock transaction and company action.[415] Furthermore, the minimum standard established by ERISA may affect the obligations owed under the Federal Securities Acts by directors, officers, and others.

1. Affirmative Disclosure

As discussed above, the courts have struggled in recent years to establish the extent to which the affirmative disclosure obligations of ERISA fiduciaries exceed ERISA's periodic and other set reporting requirements.[416] Although the parameters of this disclosure obligation

415. *See supra* Part I.C. for a discussion of the structure of plan stock holdings that leads to multiple interests and regulation of the same stock transaction.
416. *See* Clobes, *supra* note 341, at 226–27 ("The recent trend favors imposing upon fiduciaries the common law rule requiring them to disclose material information concerning existing plans and benefits when they know that silence might be harmful."); Czerniawski, *supra* note 341, at 808 ("There has been considerable disagreement among the lower courts dealing with disclosure of proposed benefit changes, but there has been a trend towards a 'serious consideration' test as triggering fiduciary disclo-

have yet to be clearly delineated, it is generally accepted that when a plan amendment reaches the stage of serious consideration or meets some other materiality test, employers must disclose the potential amendment to employees who inquire.[417] This requirement is based in the specific trust law principle that fiduciaries must communicate information that the fiduciary has reason to know would be important to the beneficiary.[418] Relying on that concept, as well as the fiduciary duties of care and loyalty, courts tend to hold that, at least when "such investments [as employer stock in an ESOP] no longer serve the purpose of the [plan],"[419] plan fiduciaries have some obligation to evaluate lack of diversification due to large holdings of company stock in a company-sponsored employee investment plan.[420] Once consideration of a plan amendment that would change the use of employer stock in the plan reaches the stage of serious consideration or whatever materiality test is applicable in the particular circuit, then fiduciaries would seem to have the obligation to notify plan participants of the potential amendment at least if plan participants had inquired about the possibility of an amendment. Similarly, even if the potential change in use of employer stock does not require a plan amendment, the important effect that potential change would have on employee decision-making might give rise to a disclosure obligation under the same theory used to require disclosure in cases of formal plan amendments.

The *Enron* court went a step further on the disclosure issue and determined that ERISA might require the fiduciaries to disclose the risks associated with company stock even if that entailed the release of material, nonpublic information.[421] To the extent the courts generally accept and impose this type of affirmative disclosure obligation on plan fiduciaries, this also will affect reporting obligations under the

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sure duties in these cases."); Stover, *supra* note 341, at 691 (stating "the current trend in the federal courts [is] to expand a plan administrator's disclosure duties by emphasizing her fiduciary obligation to provide material information to plan participants.").

417. *See id.*

418. Clobes, *supra* note 341, at 227.

419. Moench v. Robertson, 62 F.3d 553, 571 (3d Cir. 1995). Courts citing *Moench* for this proposition include *In re* ADC Telecoms., Inc., No. 03-2989, 2004 U.S. Dist. LEXIS 14383, at *20–21 (D. Minn. July 26, 2004); *In re* CMS Energy ERISA Litig., 312 F. Supp. 2d 898, 913–14 (E.D. Mich. 2004); Hill v. Bellsouth Corp., 313 F. Supp. 2d 1361, 1367 (N.D. Ga. 2004); and *In re* Xcel Energy, Inc., Sec., Derivative & "ERISA" Litig., 312 F. Supp. 2d 1165, 1180 (D. Minn. 2004).

420. *See Moench*, 62 F.3d at 571; Kuper v. Iovenko, 66 F.3d 1447, 1458–59 (6th Cir. 1995).

421. *In re* Enron Corp. Secs., Derivative & "ERISA" Litig., 284 F. Supp. 2d 511, 565–66 (S.D. Tex. 2003).

securities laws. In the absence of a periodic disclosure requirement, such as a quarterly report, the Federal Securities Acts do not require firms to disclose material, nonpublic information.[422] In fact, during so called "quiet periods," such as when an issuer is in the process of registering its securities, the Federal Securities Acts may prohibit the disclosure of material, nonpublic information that would condition the market favorably toward the purchase of the issuer's stock.[423]

Once fiduciaries become obligated, however, for any reason, to disclose material, nonpublic information to one group of stockholders, such as employees who hold company stock through a company-sponsored employee investment plan, Reg. FD and section 10b of the 1934 Act require the contemporaneous public disclosure of that information.[424] Some courts, such as the *Enron* court, have reasoned that making this additional disclosure would resolve any inconsistencies between obligations under ERISA and the Federal Securities Acts.[425] They have not, though, discussed the oddity that the federal securities disclosure policy is driven by disclosure requirements imposed under what is essentially a labor statute. From a conceptual standpoint, one can assume that economic or strategic reasons supported the Federal Securities Acts' approaches that gave corporations flexibility in timing disclosures. Should ERISA's fiduciary protections for employee stockholders supersede the Federal Securities Acts' principle of disclosure flexibility? Nor have policymakers explicitly considered the possible conflict between ERISA's affirmative disclosure requirements, to the extent those disclosure requirements exist, and the Federal Securities Acts' limitations on disclosure during specific time frames, such as while the issuer is in the registration process.

Professor Susan Stabile has suggested that when an ERISA "fiduciary is in possession of material information that a reasonable participant/plan investor would find useful in determining whether to remain invested in company stock, it is not difficult to argue that an affirmative disclosure obligation exists."[426] This obligation is arguably derived from the traditional trust law duty of a trustee to communicate facts to a beneficiary that the trustee knows would be material to the beneficiary.[427] Requiring company disclosure of all material informa-

422. LOSS & SELIGMAN, *supra* note 20, at § 9(B)(4).
423. *See id.* at § 2(B)(1).
424. *See supra* text accompanying notes 25–36.
425. *See In re* Enron Corp. Secs., Derivative & "ERISA" Litig., 284 F. Supp. 2d 511, 563–67 (S.D. Tex. 2003).
426. Stabile, *supra* note 34, at 403.
427. *See* RESTATEMENT (SECOND) OF TRUSTS § 170(2) (1959); Rock & Wachter, *supra* note 68, at 653–54.

tion, however, would result in dramatic change in the operation of the Federal Securities Acts. Although new regulations issued under section 409 of SOX expanded the number of events for which public companies must report additional events on their Form 8-K,[428] the securities laws have never come close to requiring immediate disclosure of all material information that would be useful to investors. As other commentators have recognized, "the definition of materiality under the securities laws is very broad."[429] Under existing precedent, contingent events can be material even though it is uncertain they will occur.[430] Disclosure of all material information could result in a deluge of information.

Furthermore, in order for plan sponsors to make reasonable judgments about when reporting would be required under Professor Stabile's proposal, materiality would need to be defined in a way that permits predictability in its application. That is not currently the case. As the Second Circuit has stated, "since the importance of a particular piece of information depends on the context in which it is given, materiality has become one of the most unpredictable and elusive concepts of the federal securities laws."[431] The definition of materiality under the Federal Securities Acts may be too fact-specific to give plan sponsors comfort that they could comply with such a standard.[432] When they consider both the lack of precision in determining what they must disclose and the likelihood that Professor Stabile's definition would require disclosure of contracts, corporate combinations, and other sensitive business transactions that are being negotiated, corporations may terminate the use of employer stock in their company-sponsored employee investment plans rather than comply with this standard.

Considering the underlying rationales of the statutes in this way leads to one potential convergence. Courts have begun to suggest in some of the employer stock cases that both ERISA and the Federal Securities Acts require affirmative disclosure of the information at is-

428. Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, Securities Act of 1933 Release No. 33-8400, 82 SEC Docket 1480 (Mar. 16, 2004).

429. Dennis S. Corgill, *Insider Trading, Price Signals, and Noisy Information*, 71 Ind. L.J. 355, 363 (1996); *see also* Victor Brudney, *A Note on Materiality and Soft Information Under the Federal Securities Laws*, 75 Va. L. Rev. 723 (1989) (commenting on problems of defining materiality).

430. Basic Inc. v. Levinson, 485 U.S. 224, 238 (1988).

431. SEC v. Bausch & Lomb Inc., 565 F.2d 8, 10 (2d Cir. 1977).

432. *See* Joan MacLeod Heminway, *Materiality Guidance in the Context of Insider Trading: A Call for Action*, 52 Am. U. L. Rev. 1131, 1153 (2003) ("Attempts to more clearly define materiality for various federal securities law purposes . . . have failed. These failures may be attributable to concerns that the task is too fact-dependent, seemingly making the job too difficult.").

sue.[433] According to multiple courts that have evaluated company stock claims, fiduciaries have an obligation to consider action limiting the plan's use of employer stock where "the company is on the brink of collapse or undergoing serious mismanagement."[434] In this context, serious mismanagement does not appear to mean mere errors of judgment by management but instead may require some type of illegal action. For example, in *In re Syncor ERISA Litigation*,[435] the plaintiffs alleged that management had engaged in an ongoing, intentional illegal bribery scheme that was approved by senior management and involved actions in a minimum of seven countries.[436] Companies in such severe financial distress as to be on the brink of collapse or involved in similarly serious mismanagement would typically face at least corrective reporting obligations under the Federal Securities Acts. They also would be required during the registration process to disclose those matters. Therefore, limiting ERISA's affirmative disclosure obligations to these and similarly egregious situations would largely negate the potential and serious conflict between ERISA affirmative disclosure and the underlying theory of the Federal Securities Acts.

2. *Purchase or Sale Requirement*

Once a director, officer, or other actor makes a statement regarding company stock, the possibility arises that the statement may be deceptive and thus fraudulent. Fraud may also be committed by a company actor who fails to communicate material information as required by a mandatory disclosure requirement. In such situations, the Federal Securities Acts differ significantly from the standards developing under ERISA in the company stock cases. Consider the position of Employee X who participated in a 401(k) plan at her employer, Company A. ERISA prohibits fiduciaries from making deceptive statements in connection with an employee benefit plan. Assume a plan fiduciary made untruthful negative statements about Company

433. *See In re* ADC Telecoms., Inc., ERISA Litig., No. 03-2989 ADM/FLN, 2004 WL 1683144, at *3–4 (D. Minn. July 26, 2004) (noting that fiduciary liability could attach based upon public disclosures including SEC filings and implying that same fraudulent disclosures could form basis for both ERISA and securities fraud claim); *In re* CMS Energy ERISA Litig., 312 F. Supp. 2d 898, 915–16 (E.D. Mich. 2004) (stating that disclosure of contested information arguably was required by both federal securities laws and ERISA).

434. *In re* Syncor ERISA Litig., 351 F. Supp. 2d 970, 981–82 (C.D. Cal. 2004) (quoting Wright v. Oregon Metallurgical Corp., 360 F.3d 1090, 1098 (9th Cir. 2002)).

435. 351 F. Supp. 2d 970 (C.D. Cal. 2004).

436. *See id*. at 975.

A's short term prospects in order to keep the stock price low because of a contemplated repurchase program. If, because of the fraudulent statement, Employee X did not purchase Company A securities that X otherwise would have bought through the 401(k) plan, X would have a claim for breach of fiduciary duty under ERISA. In contrast, assume X alleges that, but for the fraud, she would have purchased company securities through her private brokerage account. In the latter situation, Employee X has no right to bring a securities fraud claim under the Federal Securities Acts because the relevant provision, section 10b of the 1934 Act, requires the existence of an actual securities sale or purchase.[437] Because Employee X did not buy or sell employer securities she has no standing to bring a section 10b claim even though the fraudulent deception caused her harm. Similarly, if the fraud prevented a non-employee from purchasing Company A securities, the defrauded investor would have no standing to bring a claim under section 10b.

If one were to begin with the conceptual premise that all equally-situated shareholders should be entitled to equivalent legal rights, the standing distinction between plaintiffs with ERISA-based claims and those with federal securities law claims clearly conflicts with that premise. That does not automatically determine, however, which of the approaches to standing is superior. The limits under the Federal Securities Acts have long been justified on the basis that they preclude claims by plaintiffs who did not take an affirmative and identifiable action in response to the defendant's conduct.[438] The approach is thought to preclude many specious suits. It does, however, fail to remedy actual harms experienced by investors who, because of fraudulent statements, do not purchase or sell securities. Determining the proper balance between shareholder protection and preventing opportunistic suits is difficult but, regardless of the outcome, we do not see any reason to treat plaintiffs who are participants in company-sponsored employee investment plans more favorably than employees and others who purchase and sell the same stock through other investment mechanisms such as brokerage accounts.

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437. *See supra* text accompanying note 32.

438. *See* Joseph Conahan et al., *Securities Fraud*, 40 AM. CRIM. L. REV. 1041, 1076 n.231 (2003). *But see* Stabile, *supra* note 34, at 414–16 (arguing that the Securities Litigation Uniform Standards Act militates in favor of state law claims in instances where no purchase or sale occurs because it does not preempt state common law claims in those circumstances).

3. *Scienter Standards*

Even if a plaintiff is able to meet the purchase or sale requirement of a section 10b claim, she still would have to show scienter. The circuit courts of appeal require a section 10b plaintiff to prove at least recklessness on the part of each defendant.[439] When an employee brings the section 10b misrepresentation or omission claim as an ERISA breach of fiduciary duty claim, however, it appears that at most the plaintiff will only need to prove a negligent misrepresentation or omission made by the fiduciary.[440] There are even indications that the ERISA standard may approach a strict liability standard.[441]

Once again, the success of a misrepresentation or omission suit may depend entirely on whether a plaintiff is bringing the claim based on participation in a company-sponsored employee investment plan and the fiduciary duties owed under that plan, or because of actions connected with a purchase or sale of employer securities unrelated to a benefit plan.[442] As with the purchase and sale standing requirement of section 10b, we do not find any conceptual basis to support a distinction in one case as opposed to the other. Where everything is held constant other than the investment mechanism used to facilitate the purchase of company stock, the level of scienter in a fraud suit also should remain constant.

4. *Remedial Considerations*

In each of the instances considered thus far, employees who assert rights in their roles as benefit plan participants or beneficiaries enjoy more protection under ERISA than does the prototypical investor that brings Federal Securities Acts claims based on the same or equivalent material deceptions or omissions. Participants and beneficiaries may have greater access to disclosure, enjoy superior standing rights, and face a more lenient scienter standard. Nevertheless, even if the participants or beneficiaries win an ERISA-based fiduciary claim, they may face substantial obstacles to recovery. An employee with a

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439. *See supra* text accompanying notes 29–31.

440. *See supra* text accompanying notes 326–30.

441. *See supra* text accompanying notes 329–30.

442. Not only may the scienter standards be different but it is not clear whether fraud needs to be pled with particularity in the ERISA cases. *Compare In re* AEP ERISA Litig., 327 F. Supp. 2d 812, 821–22 (S.D. Ohio 2004) (refusing to apply Rule 9(b) of Federal Rules of Civil Procedure's heightened pleading requirement) *with* Vivien v. WorldCom, Inc., No. C02-01329 WHA 2002 WL 31640557, at *7 (N.D. Cal. July 26, 2002) (applying, in part, pleading requirements of Rule 9(b)). *See also* Stabile, *supra* note 34, at 421–22 (discussing other procedural differences between claims brought under ERISA and claims brought under Federal Securities Acts).

valid fiduciary breach claim who cannot claim relief flowing to the plan will have no option but to state a claim for relief under ERISA's catch-all remedial provision.[443] Where fiduciary breach is not an issue, the Supreme Court has construed the provision permitting "other appropriate equitable relief"[444] to include only traditional equitable relief and to exclude money damages.[445]

Because courts of equity originated the concept of fiduciary obligation, as well as all of the traditional remedies flowing from breach of those obligations, there are good reasons to believe that the limitation on relief to traditional equitable relief should not preclude recovery in ERISA fiduciary breach cases. The courts should recognize that all ERISA claims for fiduciary breach and the remedies traditionally available for fiduciary claims are inherently equitable. However, if the courts do not make this distinction between fiduciary and other ERISA claims, plaintiffs would most likely need to state a claim for traditional equitable restitution. That would require a showing that the defendants hold an identifiable item of value that in good conscience belongs to the plaintiffs.[446] It is difficult in most circumstances, other than perhaps situations where they have traded on informational advantages, to contemplate a situation where the breaching fiduciaries would be in possession of an identifiable sum of money or securities that equity would view as, in good conscience, belonging to the plaintiffs. The 1934 Act, however, provides a prevailing plaintiff with a choice between rescission and damages with damages often being calculated as out-of-pocket damages for a violation of section 10b.[447] There is no principled reason, other than an overly narrow and slavish adherence to ERISA's statutory language, to permit recovery to plaintiffs who prove statutory violations of the Federal Securities Acts while denying recovery to plaintiffs who prove violations of ERISA's fiduciary obligations. Those fiduciary duties, after all, were intended to protect plan assets from malfeasance by corporate actors.[448]

B. Enforcement Anomalies and Analogs: State Corporate Law and ERISA

A comparison of the Federal Securities Acts and ERISA yielded numerous conceptual clashes in shareholder rights granted by the re-

443. *See supra* text accompanying notes 407–13.
444. 29 U.S.C. § 1132(a)(3) (2000).
445. Great-West Life & Annuity Ins. Co. v. Knudson, 534 U.S. 204 (2002).
446. *See supra* text accompanying notes 444–45.
447. LOSS & SELIGMAN, *supra* note 20, at § 11(C)(4)(d)(ii).
448. Muir, *supra* note 316, at 205.

spective statutes. In contrast, the interaction of state corporate law and ERISA offers some intriguing insights for rationalizing obligations owed to shareholders. Unlike securities law, both state corporate law and ERISA are grounded in fiduciary duty. As is evident from our discussion in Parts III and IV, fiduciary standards under corporate law evolved differently from the ERISA standards. Yet the corporate law standards derived from the same conceptual framework—trust law—and, in many ways, are analogous to ERISA; both rely largely on the principles of care and loyalty.

Although ERISA applies fiduciary principles of care and loyalty in employer stock cases, it does not explicitly set the standards by which compliance with fiduciary obligations should be judged. Corporate law, by comparison, has developed a complex framework to evaluate the affirmative business decisions made by corporate boards. It is also crafting an analytic approach to determine oversight obligations. In the next two subparts, we consider how corporate law can inform the evolving ERISA jurisprudence in these two areas. Given the shared conceptual underpinnings, state corporate law provides a particularly rich source of doctrine with which to build an analytic framework for use in company stock cases.

1. Affirmative Decisions by Corporate Officers and Directors

Consider the concepts intrinsic to the corporate law approach to evaluating affirmative decisions by corporate officers and directors, as set forth in Part III. The business judgment rule is predicated on the appropriateness, in some situations, of deference. The core concepts of sufficient information and investigation, good faith, absence of conflicts of interest, and corporate purpose determine the availability of the business judgment rule in specific cases as well as in broad categories of transactions. Where conflicts are inherent in a board decision, such as in a hostile tender offer situation, or in interested party transactions, the board forfeits the deference its decision typically receives. The business decision then receives substantive scrutiny by the reviewing court. In transactions where the entire board is not affected by conflicts of interest, the board may avoid that higher level of scrutiny by establishing a SLC.[449]

At one level, the business judgment doctrine is analogous to the settlor doctrine emerging from ERISA jurisprudence. Both doctrines recognize that courts are not well positioned to second-guess many business decisions. Both doctrines prevent the negative consequences

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449. *See supra* text accompanying notes 192–203.

that could result if laws caused decision-makers to become too risk averse. Finally, both doctrines are highly protective of corporate actors. But, in fact, the settlor doctrine immunizes from ERISA all, or nearly all, decision-making regarding plan adoption, amendment, or termination.[450] That immunization typically occurs regardless of whether the decision is made for the best interests of plan participants or draws arbitrary and capricious distinctions among participants. Using corporate law standards, however, a board's benefit plan decisions still could be challenged. Under corporate law, a typical affirmative decision by a board of directors to establish the terms of a benefit plan would seem to be protected by the business judgment doctrine.[451]

This creates an interesting and little-noticed interstice between ERISA and corporate law. Consider the situation where a corporation first establishes a 401(k) plan. Assume the terms of the plan provide that the company will match dollar-for-dollar any contributions made by an employee up to the first four percent of employee contribution. If employees sought to challenge that company match as being an ERISA fiduciary violation because it is too low, not fair, or on some other basis, the claim would fail because the decision on employer match is a settlor function.[452] As such, it is insulated from review under ERISA's fiduciary standards. The decision on benefit plan terms, however, is still an affirmative decision made by the corporate board. If a shareholder brought a challenge against the decision under corporate law, the decision would be protected under the business judgment rule. So long as the board acted while having all reasonably available information, was not operating under a conflict of interest, had a corporate purpose, and acted in good faith the decision would stand.

In theory, the same result might occur if the board included in the terms of the plan a provision that the corporation's match would be made in company stock and, with limited exceptions, must remain invested in company stock. The board also may write the plan to provide that employees would have the option to invest their contributions in employer stock. Again, the board's actions determine

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450. *See supra* text accompanying notes 276–98.

451. As a side note, corporate officials that subject the corporation to liability for ERISA violations could incur personal liability exposure for breach of their corporate law fiduciary duty of care. If the basis of a shareholder claim involved a business decision, the case would turn on whether the defendants obtained all reasonable information before making the decision, whether the decision was made in good faith, and whether the defendants fulfilled their duty of loyalty. If the answer to any of these questions is no, there may be liability for breach of fiduciary duty.

452. See *supra* text accompanying notes 276–98 for a discussion of the settlor doctrine.

plan terms. As such, the actions may be protected from ERISA claims by the settlor doctrine. If so, the action would be subject to review only under corporate law. But, more typically, the terms of the plans allow some flexibility and courts are willing under some circumstances to subject the decision to use employer stock in the plan to ERISA's fiduciary standards.

If one accepts, as the majority of courts have done, that there are some fiduciary constraints on the use of employer stock in company-sponsored employee investment plans, the problem comes in defining the boundaries of the constraints. In the employer stock cases, the courts have looked to ESOP decisions, which hold that fiduciaries may rely on a presumption favoring the use of employer stock. However, ESOP plaintiffs may rebut that presumption by showing that "the company is on the brink of collapse or undergoing serious mismanagement."[453] In these circumstances, but only in these circumstances, the fiduciaries had an obligation to reconsider the use of company stock in the plan. It is reasonable to ask whether the concepts of deference in corporate law support this high level of deference to ERISA fiduciaries.

One explanation offered for the deferential business judgment standard in state corporate law is that it ensures that legal standards do not cause corporate officers and directors to become too risk averse.[454] Concern with risk aversion should also play a role in developing the standards governing the conduct of fiduciaries who decide whether to offer company stock as an investment option or use it to match the employees' contributions to the plan. After all, decision-makers might theoretically be held liable for fiduciary breach if they decide not to utilize company securities in such a manner and the stock performs well.[455] Decision-makers should not be held to a standard that forces them to hew to such an impossibly narrow path in the use of company stock that they effectively become guarantors of employee investments.

Two other federal statutory factors favor the use of company stock in company-sponsored employee investment plans and, thus, show deference for decision-makers who follow the incentives established by federal law. First, ESOPs must invest primarily in employer stock and, unlike in the defined benefit plan realm, there is no statutory limitation on the amount of employer stock that can be held in a

453. *In re* Syncor ERISA Litig., 351 F. Supp. 2d 970, 981–82 (C.D. Cal. 2004) (quoting Wright v. Oregon Metallurgical Corp., 360 F.3d 1090, 1098 (9th Cir. 2002)).
454. *See supra* text accompanying note 105.
455. *See supra* text accompanying note 384.

401(k) plan.[456] Second, federal tax law provides strong economic incentives for employers to use company stock to match employee contributions to company-sponsored employee investment plans.[457] Increasing risk aversion to the use of company stock may result in the elimination of company matching contributions rather than the contributions being made in a different form.[458] Such a result would hardly seem to be good policy, especially in light of the statutory provisions that favor the use of company stock. Thus, concerns about risk aversion and consistency with federal policy that favors employee ownership militate in favor of deference to those decision-makers who determine whether a company-sponsored employee investment plan utilizes employer stock.

Our analysis, however, should extend beyond deference. Consider again the corporate law factors for deference to business decisions: good faith, absence of conflicts of interest, and corporate purpose. There are two ways in which employees who participate in ERISA-regulated, company-sponsored employee investment plans differ from the typical corporate shareholder. First, most company-sponsored employee investment plans offer employees only a limited number of choices of investment vehicles. Plan participants may then need more protection than the typical investor who can choose among the vast array of public securities and debt instruments. Second, as Professor Jennifer O'Hare contends, employee investors require more protection than non-employee investors because employees are so likely to trust their employers and, thus, act on formal and informal employer communications.[459]

Furthermore, while the deferential business judgment rule is used to evaluate board decisions, there are situations in corporate law where the courts more closely scrutinize the decision of the board of directors. These situations generally involve potential conflicts of interest implicating the duty of loyalty. For example, in the hostile takeover context, the Delaware courts have shown that they are willing to scrutinize a decision to resist a takeover attempt more closely than an ordinary business decision. In hostile takeovers, the courts evaluate the reasonableness of the anti-takeover device and make a determination regarding whether the device was reasonable in relation to the threat

456. *See supra* text accompanying notes 355–58.

457. Maureen B. Cavanaugh, *Tax as Gatekeeper: Why Company Stock Is Not Worth the Money*, 23 VA. TAX REV. 365, 382–89 (2003).

458. *Id*. at 410–11.

459. Jennifer O'Hare, *Misleading Employer Communications and the Securities Fraud Implications of the Employee as Investor*, 48 VILL. L. REV. 1217, 1218–28 (2003).

the takeover posed to the corporation.[460] The difference between the analysis in the anti-takeover cases and cases involving other business decisions is that the courts will second-guess the reasonableness of the directors' decision to employ the anti-takeover device. In addition, the courts are even willing to order the directors to conduct an auction for the company where they find a sale or break-up of the company inevitable.[461] Moreover, courts will evaluate the entire fairness of interested party transactions in some circumstances. In these cases, it appears that the conflict of interest inherent in the decision is the driving force behind the courts' stricter scrutiny of the transactions.

Perhaps a similar two-tiered scrutiny would be useful in evaluating decisions made by directors and others regarding the use of employer stock and other investment options in company-sponsored employee investment plans. That is, in some instances, courts would continue to utilize the current standard for evaluating fiduciary prudence in investment selection. The standard frequently is stated as "an objective standard requiring [the fiduciary] (1) to employ proper methods to investigate, evaluate and structure the investment; (2) to act in a manner as would others who have a capacity and familiarity with such matters; and (3) to exercise independent judgment when making investment decisions."[462] The duty of a fiduciary to be informed and undertake a reasonable investigation when making a choice of a plan investment alternative is at least as stringent a duty as that of a board to inform itself of all reasonably available information before making a business decision. Similarly, the requirement that an ERISA fiduciary exercise independent judgment might be compared to the developing doctrine of good faith in corporate law. In *Disney*, the Delaware Chancery Court allowed the plaintiffs to pursue their claim that the directors "failed to exercise *any* business judgment and failed to make *any* good faith attempt to fulfill their fiduciary duties to Disney and its stockholders."[463]

Furthermore, while courts and commentators, including the authors of this article, typically refer to the business judgment rule as a deferential standard, the rule is not without teeth. Those teeth may be sharpened in the wake of the recent corporate scandals. As currently applied, ERISA's fiduciary requirement of prudence also has teeth and

460. Unocal Corp. v. Mesa Petroleum Corp., 493 A.2d 946, 954–57 (Del. 1985).
461. *See* Revlon Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 185 (Del. 1986).
462. Ulico Cas. Co. v. Clover Capital Mgmt., Inc., 335 F. Supp. 2d 335, 340 (N.D.N.Y. 2004); *see also* Katsaros v. Cody, 744 F.2d 270, 279 (2d Cir. 1984) (using objective prudent person standard).
463. *In re* Walt Disney Co. Derivative Litig., 825 A.2d 275, 278 (Del. Ch. 2003).

requires serious investigation and consideration of investment transactions.[464] But, if the plan fiduciaries meet the three-part objective standard, including investigation and evaluation, and the fiduciaries select investment options that have no affiliation with the employer (such as a mutual fund family that has no other relationships with the company), then the fiduciaries' decision would comply with ERISA section 404(c)'s prudence requirement. This approach would be consistent with the courts' current standards in such circumstances. It would also be analytically consistent with its theoretical analog in corporate law.

However, in situations that present inherent conflicts of interest, such as decisions involving the use of employer stock in company-sponsored employee investment plans, stricter scrutiny may be appropriate. An analysis such as that used in corporate law anti-takeover cases, where courts evaluate the reasonableness of the ERISA fiduciaries' decisions, may be in order. This is not to say that employer stock should not be permitted, and perhaps even encouraged, in company-sponsored employee investment plans. Certainly the analysis should not result in an automatic "fail" as seems to occur in strict scrutiny constitutional cases. Instead, we suggest serious court scrutiny of the circumstances in which employer stock is used. The use of such employee protective measures as independent investment advice, diversification rights, real warnings about the dangers of investing human and financial capital in the same company, and even a voluntarily imposed maximum percentage threshold for employer stock, would register in favor of a finding of reasonableness.

Alternatively, legal standards may be developed to encourage ERISA fiduciaries to minimize their conflicts of interest when making decisions about the use of employer stock in company-sponsored employee investment plans. To decrease the possibility of conflicts under corporate law, boards sometimes delegate decision-making to a subset of directors who do not have a conflict of interest in the transaction under consideration.[465] Similarly, corporate directors and other officials who make decisions about the use of employer stock in company-sponsored employee investment plans might negate or at least lessen the conflicts of interest inherent in those decisions by hiring an independent expert fiduciary to make or to assist in making the decisions. Although skeptics legitimately question the independence of any expert hired by a conflicted party, this approach at least increases

464. *See, e.g.*, *Katsaros*, 744 F.2d at 279–80 (upholding lower court's decision that fiduciaries violated duty of prudence).
465. *See supra* text accompanying notes 192–203.

the visibility of the conflicts of interest. Presumably the fiduciary obligations owed by the independent fiduciary also would weigh in favor of an unbiased decision. If the inherent loyalty concern is neutralized, then the fiduciary's decision should receive the level of deference accorded to a board decision under the business judgment rule.

2. *Oversight Obligations by Corporate Officers and Directors*

Courts that look to the corporate law treatment of oversight obligations of corporate officers and directors may glean valuable insight for company stock cases. Courts have struggled and come to opposing conclusions on whether ERISA mandates that corporate officers and directors appoint and monitor plan fiduciaries.[466] Even in *Enron*, after the court determined that those who appoint plan fiduciaries have the "duty to insure that the selected fiduciaries in turn complied with their fiduciary duties,"[467] the standard of duty was still undecided. The judge recognized that some courts have placed restrictions on the ERISA oversight responsibilities of corporate officers and directors. Specifically, she cited a case where the court had held that directors "do not breach duties in the absence of 'notice of possible misadventure by their appointees.' "[468]

It may be worthwhile in such cases for the courts to consider a *Caremark*-like analysis. Under a *Caremark* approach, if an ERISA claim alleges breach of duty due to failure to monitor the actions of others, the court would likely consider whether the defendants either knew or should have known that the violation was occurring; whether a reasonable compliance system was in place; and if there was not a compliance system, whether one should have been implemented. Unlike the standard quoted by the *Enron* court, which seems to require actual notice of wrongdoing, using a "should have known" approach prohibits officers and directors from playing the ostrich; they cannot bury their heads in the sand and avoid knowledge of misadventure.

The question still remains of what might constitute a reasonable compliance system in the context of using employer stock in a company-sponsored employee investment plan. In our view, it is critical that the fiduciary charged with oversight of the plan investment options perform periodic reviews. Such a review should consider the suitability of company stock as an investment choice. In this way the

466. *See supra* text accompanying notes 377–84.
467. *In re* Enron Corp. Secs., Derivative & "ERISA" Litig., 284 F. Supp. 2d 511, 661 (S.D. Tex. 2003).
468. *Id.* at 555 (quoting Newton v. VanOtterloo, 756 F. Supp. 1121, 1132 (N.D. Ind. 1991)).

oversight responsibility reinforces the standards just discussed, which in turn should ensure prudent investment choices. Periodic reviews should also ensure compliance with ERISA section 404(c) and any protective mechanism actually adopted by the plan, such as those suggested above, as measures to mitigate conflicts of interest. This legal regime would incent board-level fiduciaries to ensure that periodic reviews of a plan's investment options take place. At the same time, it would not hold the board or any other fiduciary liable for insuring employee investment choices where the plan complies with ERISA section 404(c).

Conclusion

The recent corporate scandals, stock market corrections, and losses suffered by employees who purchased employer stock through company-sponsored employee investment plans raise difficult issues. Given the magnitude of losses in situations ranging from large-scale failures at companies such as Enron to small-scale stock price declines at financially solid companies, it is understandable that academics, lawyers, courts, and policymakers have considered how these situations are located within the realm of ERISA regulation. It is critical, however, to take a broader view. The protections accorded to employee shareholders will not only affect the development of ERISA jurisprudence, but will potentially create unintended consequences in securities law. Thus, one must carefully consider the underlying policies of both ERISA and the federal securities law regimes when detailing the contours of fiduciary standards in these situations. If not, serious anomalies with disclosure rules and fiduciary obligations will occur.

Although continually evolving, state corporate law may well provide a model for the courts to consider when establishing shareholder rights and fiduciary obligation in the context of company-sponsored employee investment plans. The fiduciary obligations imposed by ERISA and state corporate law are, in each case, grounded in traditional trust law. State corporate law has the advantage of a long history of adaptation to the unique considerations inherent in balancing the obligations owed by directors and other corporate actors to shareholders. We do not argue that ERISA fiduciary obligation should mirror corporate standards. However, as courts take up the new challenges presented by the employer stock cases, they should not ignore the fiduciary principles developed under state corporate law.