

**AN ANALYSIS OF DOL ERISA LITIGATION 2002-2012:
LESSONS FOR A DISCOURSE ON RESPONSIBILITIES OF ESOP FIDUCIARIES**

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Introduction

“Dramatic growth in recent years has thrust private pension plans into a central role in determining how older Americans live in their retirement years,” noted President Gerald Ford at the signing ceremony of the Employee Retirement Income Security Act (ERISA) on Labor Day, September 2, 1974, expressing his acknowledgement of the growth of these pension plans over the previous decades in the United States.² Ford’s statement was marked by an awareness of some of the challenges that related to the growth of these plans:

Yet, this same growth in pension plans has brought with it a host of new problems. Many workers have ultimately lost their benefits – even after relatively long service – because when they left their jobs, they thereby gave up rights to hard-earned pension benefits. Others have sustained hardships because their companies folded with insufficient funds in the pension plan to pay promised pension. In addition, some pension funds have been invested primarily for the benefit of the companies or plan administrators, not for the workers. It is essentially to bring some order and humanity into this welter of differences and sometimes inequitable retirement plans within private industry.³

Central to addressing the challenges that Ford articulated, were issues related to the evolving role of fiduciaries in retirement plans. As entities whose existences have largely been enabled by ERISA, Employee Stock Ownership Plans (ESOPs) are directly impacted by how the Department of Labor, as the entity that manages elements of ERISA addresses issues related to fiduciary conduct.

¹ This is a draft paper being developed for the June 2013 Meeting of the Beyster/Kelso Fellows. Do not cite without permission. Any comments would be appreciated. The author can be contacted at: kfarmbry@rutgers.edu.

² Gerald Ford – Statement on the Employee Retirement Income Security Act of 1974 – September 2, 1974.

³ Ibid

This paper provides an analysis of Department of Labor ERISA litigation related to fiduciary roles between the years 2002 and 2012. It aims to provide a general framework for considering the discourse related to ESOP fiduciaries as they might think about their roles in a ERISA context.⁴

The paper begins with a brief overview of general roles of fiduciaries as framed in common-law discourse. I then observe the role of the fiduciary as established in ERISA. It is in this section that I point out the fact that much of ERISA's conceptualization of a "fiduciary" is a direct result of how some of the underlying concerns of retiree investment security that underscored ERISA's framing. I also explore provisions within ERISA that provide an overview of the liabilities for breaches of fiduciary duty. Next, I present the methodology and results from a two-phase analysis of Department of Labor ERISA enforcement action between 2002 and 2012. From this analysis, I explore trends in litigation pursued by the Department of Labor for corrective actions against ERISA fiduciaries. I close with both an overview of general implications for considering fiduciary roles in an ERISA context for ESOPS and some concluding thoughts for how the Department of Labor might consider ERISA fiduciary enforcement action in the future.

A Brief Overview Fiduciary Responsibilities and Roles

The issue of the role of fiduciaries has been a central concern in both trust and business law for centuries. The 1726 case of *Keach v. Sanford*, provided one of the common-law foundations for much of the evolution of the concept of a fiduciary in trust law. In *Keach*, an

⁴ These years are critical in a discourse related to the challenges that those serving as fiduciaries might have encountered, as they included some of the pressing points in investor protections that ERISA aimed to address. There were several important crises of legitimacy that the institutions involved with investor protections faced. For example, the 2008 financial crisis and the 2008 Madoff case, provided examples of some of the challenges encountered.

English Court ruled that a trustee who had managed an estate, which included a lease to a valuable piece of land, could not renew the lease for his own benefit. As the Chancellor noted:

This may seem hard, that the trustee is the only person of all mankind who might not have the lease: but it is very proper that rule should be strictly pursued, and not in the least relaxed; for it is very obvious what would be the consequences of letting trustees have the lease on refusal to renew *cestui que use*.⁵

In 1928, then New York Court of Appeals Judge Benjamin Cardozo articulated what has become one of the more recent foundations of the concept of a fiduciary. In the case of *Meinhard v. Salmon*. In this case, Cardozo noted:

[M]any forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. 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. As to this there has developed a tradition that is unbending and inveterate... Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.⁶

The legacy of *Keach*, *Meinhard*, and other cases shaping fiduciary roles is largely one of exploring how fiduciaries might conceptualize their responsibilities in an ERISA context.

How ERISA Shapes Fiduciary Responsibilities

Much of the question of the 1974 Employee Retirement Income Security Act was found in both the growth in the number of pension funds during the 1950s and 1960s and numerous attempts by pension sponsors to use pension funds for purposes that did not primarily benefit current and future retirees. A critical turning point in the evolution of the conversation on the need for extensive pension reform was the emergence of the 1963 Studebaker case, in which the

⁵ Sel Cas Ch. 61 (1726)

⁶ *Meinhard v. Salmon*, 249 N.Y. 458 at 464 (1928).

Studebaker Company ended its pension plan, and left several thousand employees without their promised pension funds.

As a result of these concerns the congressional drafters of ERISA integrated language that defined a fiduciary, and set the context for shaping how this role of fiduciaries would evolve in conjunction with the development of ERISA. In Section 3(21) of ERISA, a fiduciary is defined in the following manner:

[A] person is a fiduciary with respect to a plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary responsibility in the administration of such plan.

Title I, Part 4 of ERISA examines the roles and responsibilities of fiduciaries. Specifically, Section 404(a)(1) established the ERISA standard of prudence and notes that a fiduciary shall “discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries” and –

- (A) For the exclusive purpose of:
 - a. Providing benefits to participants and their beneficiaries;
 - b. Defraying reasonable expenses of administering the plan;
- (B) With the care, skill, prudence, and diligence under the circumstances the prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;
- (C) By diversifying the investments of the plan so as to minimize the risk of large losses, unless, under the circumstances it is clearly not prudent to do so; and
- (D) In accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this title.

Section 406 of ERISA presents nine areas of prohibited transactions. Many of these transactions are guided by general “prudent man” concepts, which are adopted from other areas of trust law into ERISA. These prohibited transactions include:

1. A sale, exchange, or lease of property between the plan and a party in interest;
2. A loan of money or other extension of credit between the plan and a party in interest;
3. The furnishing of goods, services, or facilities between the plan and a party in interest;
4. The transfer to, or use of plan assets by or for the benefit of, a party in interest;
5. The acquisition of employer securities or of employer real property in violation of limits set forth in ERISA;
6. A fiduciary deals with plan assets for his or her own interest or his or her own account;
7. A fiduciary acts on behalf of parties with interests adverse to a plan in a transaction involving the plan;
8. A fiduciary receives consideration for his or her personal account from a party dealing with a plan in connection with a transaction involving plan assets (ie., a kick-back); or
9. A transfer of property that is subject to a mortgage or lien from a party in interest to a plan, where the plan assumes a mortgage or lien.

The Employee Benefits Security Administration (EBSA) is the entity that ensures the security of retirement, health, and other benefits for citizens. One of EBSA’s central roles is to take public action against organizations that violate elements of the ERISA statute. One of the mechanisms that EBSA implements to help regulate the activities of those institutions that it regulates and oversees is through legal action that it undertakes against companies and individuals that it deems in violation of ERISA.

The mission of EBSA states that it is "to assure the security of the retirement, health and other workplace related benefits of America's workers and their families." The organization notes that it "accomplish this mission by developing effective regulations; assisting and educating workers, plan sponsors, fiduciaries and service providers; and vigorously enforcing the law." In this role, it is largely responsible for litigation against violators and the development of corrective action against violators.

A general framework for liability of fiduciaries under ERISA is shaped by section 502(a) of ERISA and specifically is outlined in 502(a)(1), 502(a)(2), and 502(a)(3). Of these, 502(a)(2) enables the Department of Labor, or a plan participant, beneficiary, or fiduciary, to obtain relief against a fiduciary for any losses to the plan resulting from a breach of fiduciary duty and to require restoration of any profits a fiduciary received through the use of plan assets. This section allows for other relief, including removal of the fiduciary as the court may see fit.

Methodology

Having provided a broad introduction to the general framework for ERISA fiduciary activities, I turn to this project's examination of Department of Labor action in relation to ERISA fiduciary violations. This examination was conducted in two phases. In the first phase, I relied upon press releases provided by EBSA to identify stages of action promoted by EBSA in the area of ERISA-related litigation. In this phase, I analyzed press releases generated by EBSA between 2002 and 2012 for any indication of the words "sue" or "suit" as indication of legal action undertaken by the Department of Labor. I then coded each of the results according to the accused violation that the EBSA was holding the parties accountable for conducting.

In the second phase, I conducted two Westlaw searches.⁷ I limited the searches to federal cases between 2002 and 2012. The first search used the terms “ERISA,” “fiduciary,” and “Chao.” The second search used the terms “ERISA,” “fiduciary,” and “Solis.”⁸ These searches resulted in the identification of 84 cases that were then examined. These cases were coded and categorized for the type of fiduciary violation that the Department of Labor claimed had occurred.

Phase I Results

Phase I generated a total of 483 press releases in which the Department of Labor, acting through EBSA, indicated that it was undertaking some legal action against ERISA fiduciaries. After identifying the press releases, I coded and categorized these cases into four main areas, based on the violations cited by the Department of Labor: failure to forward contributions; failure to terminate plans, misuse of funds, stock valuation failure. Table One presents the categorizations identified.

Table One: Categorizations of EBSA press releases indicating pending legal action.

Area	Description	Number	Percent of Total
Failure to Forward Contributions	Fiduciary did not forward employee contributions to fund.	283	58.6
Failure to Terminate	Company ceases	110	22.8

⁷⁷ Westlaw is a commonly used legal database that provides cases at a number of different jurisdictional levels. In this case, I examined cases at the federal-level.

⁸ “Chao” refers to Elaine Chao, Secretary of Labor between 2001 and 2008. “Solis” refers to Hilda Solis, Secretary of Labor between 2009 and present.

Plan	operations and fiduciary fails to end plan		
Misuse of Funds	Fund diverted from plan to other uses.	79	16.4
Stock Valuation Failure	Stock value overinflated as stocks are transferred to account.	11	2.3
Totals		483	100%

Following my development of the categorization of the cases, I analyzed samples of cases in each of the four areas identified. This analysis provided an illustration of some of the specific issues that arose leading to the Department of Labor’s arguments.

Failure to Forward Contributions

A total of 283 cases (58.6%) were instances in which the sponsor companies failed to forward their contributions to the trust. An analysis of several of these cases provides an overview of some of the reasons that these cases arose as they did. One of the frequent characteristics noted was that the cases that emerged in this area were those that had provided an overview of the failures to forward the contributions of various entities.

Several of these cases included companies that were in the midst of financial difficulty, and where the retention of employer contributions enabled companies to progress through periods of financial shortfall.

Many of the cases served as instances where EBSA noted violations were for amounts lower than \$5,000. It is worth considering potential reasons that EBSA might pursue cases where there is a small amount in the violation of concern. In some cases, there might simply be a relatively simple case for EBSA to pursue, given the level of resources that a company might place in a small amount – thus encouraging the company to simply pursue a settlement of the case. EBSA may ultimately however want to pursue a process of policy-making through litigation by establishing case precedent that will help guide future activities of ERISA fiduciaries.

Failure to Properly Terminate Plan

Plan termination is a common occurrence in the pension arena. There are numerous considerations in this area. What are the proper processes for plan termination, and what happens if such processes are not followed? In cases where a plan has a substantial portion of its holdings in a sponsoring company's securities (ie. in an ESOP), what are some of the proper processes for valuing the shares of a plan? In some cases, termination may occur alongside a question of how to effectively identify someone to serve as a fiduciary to continue with plan management following the termination of a plan?

Failure to properly terminate plans is the next area that surfaced in cases that were examined (110 cases or 22.8% of the total). This includes cases where companies may have ceased operations, and failed to properly cease operations of their plans.

The 2010 case of the Swigonski Management Group, which offered a 401(k) plan for employees of its three restaurants, provides an illustration. In this instance the Department of Labor alleged that the founder of the group failed to perform his fiduciary duties by not appointing a new trustee for the plan following the termination of the company's operations in February 2006. In this instance the Department of Labor requested the U.S. District of New York to appoint an independent fiduciary to manage the plan.

Misuse of Funds

Seventy-nine cases (16.4% of the total) were instances where there was a misuse of funds. Such cases are illustrated by instances where funds allocated to plans are rerouted for either personal benefit, or for business-needs that are not permissible transactions.

The 2010 case of *Solis v. Colette Mordo* illustrates some of the challenges that were encountered in this instance. In this case, the plan sponsor allegedly misused \$4.6 million of assets of the defined benefit plans of two companies with which their plan was engaged. According to the complaint, the defendant fiduciary authorized the plans to make unauthorized loans to and transfer assets of the plans to members of her family and two other enterprises she oversaw.

Stock Valuation Failure

Eleven cases (or 2.3% of the total) were instances in which stock valuation was a central factor. Valuation is both one of the more complex elements of ERISA activity and an area where a number of ESOPS face challenges. For companies where shares are traded in open markets, the valuation challenges are not as major as in those instances where companies are not found on

markets. This challenge stems both from the possibility of variation in valuation techniques. It also stems from the fact that the Department of Labor has yet to adopt regulations on how trustees should determine the value of employer securities for an ESOP in closely held companies.⁹ As a result, the Department of Labor finds itself in a position where it is attempting to regulate an area where it has yet to establish firm guidelines.

The 2010 case of *Solis v. Steven D. Westra* illustrates some of the challenges related to stock valuation failures. In this case, Steven D. Westra, a fiduciary of the Westra Construction Company in Wisconsin permitted his company's stock to be overvalued as his company-sponsored ESOP was about to purchase several shares. Ultimately, Westra permitted the ESOP to purchase 40,000 shares of non-voting convertible preferred company stock for \$4 million on the basis of flawed valuation reports. Several months following the purchase, the company upon which the stock had been purchased ended operations, thus dramatically devaluing the stock.

The 2012 case of *Department of Labor v. Firor and First Bankers Trust Services* provides another case. In this instance, the defendant, First Bankers Trust Services is alleged to have permitted the plan to purchase 100 percent of the company's stock from the company's CEO and the relatives of the CEO for \$15.5 million. In the course of reviewing the transaction, EBSA determined that First Bankers Trust failed to examine in various assumptions presented in the report that ultimately led to an overvaluation of the company. In this instance EBSA held First Banker's Trust liable for the flawed valuations.

Phase Two - Results

While Phase One of the project provided a general overview of issues that EBSA identified as being worthy of legal action; Phase Two provided an opportunity to examine cases

⁹ Although regulations were proposed in 1988.

that actually went to trial. These cases were categorized into five areas. They included the four noted in Phase One and a fifth category, which included “failure to administer for the exclusive benefit of plan participants.

Table two provides an overview of how these cases were categorized.

Table Two: Phase Two results

Area	Description	Number	Percent of Total
Failure to Administer for Exclusive Benefit of Plan Participants	Fiduciary did not adhere to notion that their primary duty is to the plan participants (often indicates some form of self-dealing).	6	7.1
Failure to Forward Contributions	Fiduciary did not forward employee contributions to fund.	17	20.2
Failure to Terminate Plan	Company ceases operations and fiduciary fails to end plan	14	16.7
Misuse of Funds	Fund diverted from plan to other uses.	38	45.2

Stock Valuation Failure and Accounting Failure	Stock value overinflated as stocks are transferred to account.	9	10.7
Totals		84	100

Misuse of Funds

In the examination of cases that actually went to trial, instances of misuse of funds provided the greatest number of instances in which ERISA fiduciary violations were presented. Here, thirty-eight or 45.2% of the cases examined were categorized in this area. The 2011 case of *Solis v. Food Employers Labor Relations* provides an example.¹⁰ This case provided an instance where a plan's assets became intertwined with funds misappropriated through Bernard Madoff's securities fraud violations. In this instance, the violations resulted in over \$10 million in losses from the plan's assets.

Failure to Forward Contributions

A total of 17 cases (20.2%) were instances in which the companies failed to forward their contributions to the sponsored plan. The 2012 case of *Solis v. Sonora Environmental LLC* provides an illustration of some of the challenges that arose in the failure to forward such contributions. In this instance, the defendants, who are owners of a company that sponsored a

¹⁰ 644 F 3d 221

401(k) plan failed to remit \$38,000 in employee pay to the plan as had been committed in the plan documents.¹¹

Failure to Terminate Plan

Failure to properly terminate plans is the next area that surfaced in cases that were examined (14 cases or 16.7% of the total) was the area of next largest amount.

Stock Valuation Failure

Nine cases (or 10.7% of the total) were cases in which stock valuation was a central factor. The case of Solis v. Webb provides an illustration of how some of these stock valuation failure cases might surface.¹² In this case, Defendant Dennis Webb was an officer and director of a company known as Entrepreneurial Ventures, Inc. (EVI) that established an ESOP plan in 1999. In 2002, prior to a sale of company stock from the defendant to his co-defendants the stock was valued at a rate that the Department of Labor alleged was much greater than fair market value.

Failure to Administer for Exclusive Benefit of Plan Participants

A final set of cases, which appeared in the final analysis of legal action were instances in which fiduciaries failed to administer programs for the exclusive benefit of plan participants. In this instance, six cases or 7.1% of the total were in cases in which fiduciaries did not adhere to

¹¹ Order – Solis vs. Sonora Environmental, LLC CV 10-00675-TUC-JGZ – October 2010

¹² 2012 WL 4466536

the principles of ensuring that they managed the plans for the benefits of those that entrusted them.

In the case of *Chao v. Malkani*, a plan established by the owner of the Information Systems and Networks Corporation (ISN) ceased receiving payments from the sponsoring company for a five year period.¹³ During that time, the plan also paid \$435,761 in plan assets to the company to help the company cover operational expenses. After being warned by the Department of Labor that such actions were in violation of ERISA, the plan fiduciaries later ordered the plan to pay another \$706,264 to the company for an additional set of operational expenses.

General Implications for Fiduciary Roles in ESOPS

The creation of ESOPS as a result of ERISA has leveraged numerous opportunities in the fields of employee ownership. Their creation has also brought about a number of areas where fiduciaries working with ESOPS need to be aware of their exposure to both common-law and statutory concerns.

Both stages for this research suggest that there is a clear need for examining of the preparation of fiduciaries in ERISA-related agencies as they aim to fully comprehend the various roles and responsibilities that come with their ERISA efforts.

In the instances of ESOPs, there are a number of considerations in exploring some of the roles of fiduciaries. First, is that when it comes to Department of Labor formal litigation against fiduciaries, the largest percentage of cases appear to be in areas where there has been a misuse of funds. Thus ESOP fiduciaries must ensure that their usage of plan funds adhere to guidelines established by ERISA, and in cases where ERISA has not formally established guidelines err on

¹³ CA-00-3491-8-WDQ – June 22, 2006

the side of caution regarding the use of any plan funds (keeping in mind that funds are for the use of current and future retirees). This area of concern might be of particular caution in the instance of ESOPS because of the reinvestment/corporate finance elements of ESOPS.

A thread of discussion that surfaced in several of the cases revolved around defining who a fiduciary is. As Monica Gallagher, a former administrator with the Department of Labor noted:

...there is no room in the fiduciary analysis for an argument that a person's own perception of his status is relevant, much less controlling. For example, if a person's own perception occupies a position to which the plan documents assign discretionary authority or responsibility, that person is a fiduciary, whether or not he thinks he is. And on the other side of the same coin, a person who does not believe he is a fiduciary because he personally holds no position identified as such in the plan documents may still be one if he, in fact, performs the functions, exercises control, or has the powers specified in the definition.¹⁴

Critical then is a second area of concern that will influence many of the areas in determining who the fiduciaries are.

Conclusions

I have attempted to provide an overview of some of the concerns related to the roles of fiduciaries and efforts undertaken by the Department of Labor to facilitate the advancement of these roles through legal or other means. Department of Labor litigation provides an overview of some of the challenges that the Employee Benefits Security Administration, as the agency that is largely responsible for federal oversight of ERISA litigation found itself examining over the years. This initial analysis of Department of Labor ERISA fiduciary cases provides an oversight into potential areas of concern of this agency, and as a result, some of the activities related to ESOPs as an area overseen by EBSA.

¹⁴ Monica Gallagher – *Recent Developments in Concepts Relating to Fiduciary Liability*
The Forum (Section of Insurance, Negligence and Compensation Law, American Bar Association)
Vol. 16, No. 4 (Spring 1981), pp. 753-764