Trust Variation and ERISA's Misbegotten "Presumption of Prudence"

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Abstract

[To be added later . . . once I figure out where this is going.]

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Trust Variation and ERISA's Misbegotten "Presumption of Prudence"[†]

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I. Introduction

The U.S. Department of Labor reports that single-employer defined contribution pension plans with 100 or more participants held, directly or indirectly, $315 billion in employer securities in 2010, or about 9.7% of the plans' total gross assets of $3,234 billion.[1] A very large share of these employer securities, more than $202 billion, was held by employee stock ownership plans (ESOPs).[2] ESOPs are designed to invest primarily in employer stock, and so these holdings are largely undiversified.[3] The Employee Retirement Income Security Act of 1974 (ERISA),[4] allows certain types of defined contribution pension plans—which are also called individual account plans[5]—to make concentrated investments in the employer. In addition to an ESOP, a profit-sharing or stock bonus plan that explicitly authorizes the acquisition or holding of certain employer securities or employer real property is ordinarily classified as an "eligible individual account plan" (EIAP).[6] An EIAP is eligible to dispense with diversification: it can invest in specified types of employer securities or real property regardless of the general fiduciary duty to diversity plan investments, and is also excused from ERISA's outright ban on investing more than 10 percent of the fair market value of plan assets in employer securities and real property.[7] EIAP fiduciaries are *not* excused from their duties to act "solely in the interest of [plan] participants and beneficiaries" for the "exclusive purpose of providing benefits to

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[1] EMPLOYEE BENEFITS SECURITY ADMINISTRATION (EBSA), U.S. DEPARTMENT OF LABOR, FORM 5500 DIRECT FILING ENTITY BULLETIN: ABSTRACT OF 2010 FORM 5500 ANNUAL REPORTS Table 11 at 11 (2013), at http://www.dol.gov/ebsa/pdf/directfilingentity2010.pdf. A substantial share of these employer securities, about 22%, was owned indirectly through plan investments in various direct filing entities, particularly master trusts. *Id.* Table 12, Table 2 (master trusts account for virtually all indirect holdings of employer securities). For an explanation of the types of indirect investment vehicles utilized by pension plans, an overview of their holdings, and an analysis of the relationship between direct and indirect pension plan investments, see Peter J. Wiedenbeck et al., *Invisible Pension Investments*, 32 VA. TAX REV. ___ (2013) (forthcoming).

[2] EBSA, PRIVATE PENSION PLAN BULLETIN: ABSTRACT OF 2010 FORM 5500 ANNUAL REPORTS Table D14 at 61 (2012), at http://www.dol.gov/ebsa/PDF/2010pensionplanbulletin.PDF. The number is more than the $202 billion because that figure includes only direct plan investments; ESOPs reported another $329 billion held in master trusts, some portion of which consists of employer stock owned by master trusts.

[3] ERISA § 407(d)(6), 29 U.S.C. § 1107(d)(6) (2006); I.R.C. § 4975(e)(7); Treas. Reg. § 54.4975-11.

[4] Pub. L. No. 93-406, 88 Stat. 829 (1974).

[5] ERISA § 3(34), 29 U.S.C. § 1002(34).

[6] ERISA § 407(d)(3), 29 U.S.C. § 1107(d)(3). To qualify as an EIAP the benefits provided under the ESOP, profit-sharing, or stock bonus plan must not be taken into account in determining the benefits under a defined benefit plan (i.e., a traditional pension plan).

[7] ERISA §§ 404(a)(2), 407(b)(1), 29 U.S.C. §§ 1104(a)(2), 1107(b)(1).

participants and their beneficiaries;" and they are generally obliged to act prudently.[8] When an ESOP or other EIAP suffers large losses on its employer stock holdings, participants often bring suit claiming violation of these abiding duties of loyalty or reasonable care. Such "stock drop" litigation was particularly prevalent in the aftermath of the sharp stock price declines of 2008. For the most part, disappointed workers have gotten no relief, as their claims have been met with a presumption that continued investment in company stock is reasonable absent proof of impending collapse or other extremely dire circumstances.

This "presumption of prudence" finds its origin in *Moench v. Robertson*,[9] a suit for breach of fiduciary duties by former ESOP plan participants against members of the plan committee. The committee had continued to invest plan contributions in stock of the employer bank throughout a two-year period during which federal bank regulators repeatedly expressed concern about the financial condition of the bank and the stock price plummeted from $18.25 to pennies per share. Defendants, who were corporate directors as well as members of the plan committee, argued that even in that situation investing solely in employer stock was permissible due to the special nature of an ESOP. Because Congress intended the ESOP to be both an employee retirement benefit plan and a technique of corporate finance that would encourage employee ownership,[10] the Third Circuit concluded that neither goal should prevail to the exclusion of the other. In limited circumstances, therefore, "ESOP fiduciaries can be liable under ERISA for continuing to invest in employer stock according to the plan's direction".[11] To accommodate the ESOP's competing purposes the court held that an ESOP fiduciary who invests assets in employer stock is entitled to a presumption that it acted consistently with ERISA, but the plaintiff may overcome that presumption by introducing evidence that, owing to circumstances that the settlor did not know nor anticipate, continuing to invest in employer stock would defeat or substantially impair the accomplishment of the plan's purpose to provide workers retirement savings.[12]

The Third Circuit subsequently concluded that the *Moench* rationale is not limited to ESOPs but applies as well to other types of EIAPs, including plans that call for participant-directed investments. Specifically, *Edgar v. Avaya, Inc.* concerned a participant-directed 401(k) plan the terms of which required that an employer stock fund be among the available investment alternatives.[13] The *Moench* presumption, as it is called, has now been adopted by six other circuits,[14] but the opinions generally fail to address the premises and scope of rule. Moreover,

[8] ERISA §§ 404(a), 29 U.S.C. § 1104(a). Prudence, however, is not demanded "to the extent that it requires diversification".

[9] 62 F.3d 553 (3d Cir. 1995).

[10] *Id.* at 569.

[11] *Id.* at 556.

[12] *Id.* at 571.

[13] 503 F.3d 340, 343, 347 (3d Cir. 2007).

[14] Lanfear v. Home Depot, Inc., 679 F.3d 1267, 1281 (11th Cir. 2012); In re Citigroup ERISA Litigation, 662 F.3d 128 (2d Cir. 2011); Quan v. Computer Scis. Corp., 623 F.3d 870, 881 (9th Cir. 2010); Kirshbaum v. Reliant Energy, 526 F.3d 243, 254 (5th Cir. 2008); Pugh v. Tribune Co., 521 F.3d 686, 701 (7th Cir. 2008); Kuper v. Iovenko, 66 F.3d 1447, 1458 (6th Cir. 1995).

thus far no consensus has developed on how dire the employer's prospects must become to render continued investment in employer stock imprudent.[15]

II. *Moench* and Traditional Trust Variation

Moench attempts to resolve the conflict between multiple plan objectives when the goals of employee ownership and employee retirement security become incompatible. The standard announced by the Third Circuit was taken from the rule on administrative deviation in the Second Restatement of Trusts, which provides in part:

> The court will direct or permit the trustee to deviate from the terms of the trust if owing to circumstances not known to the settlor and not anticipated by him compliance would defeat or substantially impair the accomplishment of the purposes of the trust; and in such case, if necessary to carry out the purposes of the trust, the court may direct the trustee to do acts which are not authorized or are forbidden by the terms of the trust.[16]

The *Moench* court, unfortunately, provided an erroneous citation for this rule.[17] Perhaps for that reason, most of the ERISA cases have failed to recognize or engage with its trust law origins.[18]

[15] *Edgar*, 503 F.3d at 349 n. 13 ("We do not interpret *Moench* as requiring a company to be on the verge of bankruptcy before a fiduciary is required to divest a plan of employer securities."); Lalonde v. Textron, Inc., 369 F.3d 1, 6 (1st Cir. 2004) (because the "important and complex area of law implicated by plaintiffs' claims is neither mature nor uniform . . . we believe that we would run a very high risk of error were we to lay down a hard-and-fast rule"); Brieger v. Tellabs, Inc., 2009 U.S. Dist. LEXIS 49747, at *37 (N.D. Ill. June 1, 2009) (leaving open whether the standard is "impending collapse or something short of that"); In re Ford Motor Co. ERISA Litigation, 590 F. Supp. 2d 883, 892-93 (E.D. Mich. 2008) (rejecting the "imminent collapse standard in favor of a rule requiring divestiture "at the point at which company stock becomes so risky that no prudent fiduciary, reasonably aware of the needs and risk tolerance of the plan's beneficiaries, would invest any plan assets in it, regardless of what other stocks were also held in the plan's portfolio").

[16] Restatement (Second) of Trusts § 167(1) (1959). Further, § 167(2) says that where the trustee reasonably believes there is an emergency he may deviate from the terms of the trust without first obtaining judicial authorization.

[17] After announcing the presumption that ESOP investments in employer stock are consistent with ERISA's fiduciary duties, the *Moench* opinion observes that "In attempting to rebut the presumption, the plaintiff may introduce evidence that 'owing to circumstances not known to the settlor and not anticipated by him [the making of such investment] would defeat or substantially impair the accomplishment of the purposes of the trust.' Restatement (Second) § 227 comment g." 62 F.3d at 571. The quoted language, however, actually appears in comment q to Restatement (Second) of Trusts § 227. Even the correct comment is not the primary authority, it simply parrots the wording of the operative rule, § 167(1) of the Second Restatement. Compounding confusion, *Moench* quotes and cites Restatement (Third) of Trusts § 228. Only a few provisions of the Third Restatement, those relating to the prudent investor rule, were available when *Moench* was decided, but one of those, Restatement (Third) of Trusts § 228 cmt. e (1992), paraphrases the distributive deviation rule and cites § 167 of the *Second* Restatement. When the Third Circuit subsequently extended the *Moench* presumption to other types of eligible individual account plans, it repeated the mistaken citation to comment g of the Second Restatement. *Edgar*, 503 F.3d at 348.

[18] But see Lanfear v. Home Depot, Inc., 679 F.3d 1267, 1281 (11th Cir. 2012); In re McKesson HBOC, Inc. ERISA Litig., 391 F. Supp. 2d 812, 830 n.16 (N.D. Cal. 2005).

The almost unthinking importation of traditional trust variation principles into ERISA elides several serious difficulties. The automatic assumption that the employer sponsoring an EIAP is the "settlor" of the pension trust is one problem. Even if the plan sponsor may be treated as settlor, *Moench* and its progeny overlook an essential premise of the Second Restatement's administrative deviation rule: it would not apply to a private trust that is amendable in the way that a pension trust is required to be.

A. Trust Variation and Tax Qualification

Administrative deviation is designed to promote the accomplishment of the settlor's objectives by relieving the trustee of restrictions on her managerial authority in situations where an unexpected change has brought those restrictions into conflict with the core purposes of the trust.

> [T]he court in conferring power on the trustee is attempting to prevent the failure or substantial impairment of the purpose for which the settlor created a trust. It is permitting the trustee to do not what the settlor intended to permit him to do but what it thinks the settlor would have intended to permit if he had known of or anticipated the circumstances that have happened. Even though the settlor has expressly forbidden what the court permits to be done, the theory is that he would not have forbidden it, but on the contrary would have authorized it if he had known of or anticipated the circumstances. In so doing the court is not interpreting the terms of the trust but is permitting a deviation from them in order to carry out the purpose of the trust.[19]

The obligation to invest in employer stock (whether imposed directly by the plan's terms or indirectly by participant direction) is a restriction on a plan trustee's power that can undermine the goal of accumulating adequate retirement saving if the employer's financial health is in jeopardy. For that reason, administrative deviation offers an enticing framework for addressing the competition between employee ownership and retirement security under ERISA.

The purposes of the trust, of course, are the settlor's purposes, just as it is the settlor's understanding (i.e., whether threatening circumstances were then known or anticipated) that circumscribes the scope of administrative deviation. *Moench* and its followers proceed on the assumption that the employer sponsoring the plan is settlor of the pension trust, but it's not necessarily so.

The settlor is the person who creates the trust.[20] Creation of an inter vivos trust is typically accomplished by transferring legal ownership of property to another person to manage the property or its proceeds as trustee for the benefit of the transferor or a third person.[21] Ordinarily the transferor also sets the terms of trust, but a property owner may transfer property on terms established by another person, and in that instance the owner-transferor is the settlor of

[19] IIA AUSTIN W. SCOTT & WILLIAM F. FRATCHER, SCOTT ON TRUSTS § 167, at 287-88 (4th ed. 1987) [hereinafter SCOTT ON TRUSTS].

[20] RESTATEMENT (THIRD) OF TRUSTS § 3(1) (2003).

[21] *Id.* § 10(b).

the trust, not the drafter of the instrument. It is even possible to transfer property to a trustee subject to the terms of a preexisting trust established by someone else (e.g., a spouse or other family member), and in that case the trust has multiple settlors.[22]

Analogously, a plan sponsor does not become settlor of the associated pension trust by specifying the terms of the program. Instead, anyone who contributes to the fund is a settlor, presumably including employees who make elective deferrals under a 401(k) plan or similar salary reduction arrangement.[23]

Formally, of course, the employer corporation is owner of the funds contributed to the plan. But where those contributions are made pursuant to a cash-or-deferred arrangement or other salary reduction authorization, the employer is merely acting as agent for those employees who choose to direct a portion of their pay into the retirement savings program. When it comes to nonelective or employer matching contributions, the company seems to be committing its own resources to the pension plan, and so to that extent could be viewed as settlor. Yet the lesson of the tax law nondiscrimination rules, properly understood, is that ostensible employer financing of qualified retirement plan savings is a ruse.[24] The system is financed by employee participants who forego a portion of their current compensation (or future pay increases) in exchange for "employer" contributions, and by the enormous tax subsidy associated with the preferential tax treatment accorded qualified plan savings.[25] Plan sponsorship is voluntary, and in a competitive labor market an employer will not offer a plan that entails an overall net compensation cost increase.[26] Therefore, a pension, profit-sharing, or stock bonus plan that is formally funded exclusively by required employer contributions is in substance paid for by covered workers (via reduced take-home pay) with the assistance of other American taxpayers. If on attends to the incidence of the economic burden of qualified plan saving, the sponsoring employer corporation is not in any real sense a settlor of the pension trust. The company has no skin in the game.

The significance of this insight is that the expectations or purposes of the employer sponsoring an ESOP or other EIAP should have no immediate bearing on the availability of administrative deviation once continued investment in employer stock comes to jeopardize workers' retirement savings. However highly the company may prioritize the goal of employee

[22] UNIF. TRUST CODE § 103(15) (2000) ("If more than one person creates or contributes property to a trust, each person is a settlor of the portion of the trust property attributable to that person's contribution . . . .").

[23] I.R.C. §§ 403(b) (annuity plans for public school and charitable organization employees), 408(p)(2)(A) (simple retirement plans for small employers), 457(b) (eligible deferred compensation plans for state and local government and tax-exempt organization employees).

[24] *See generally* PETER J. WIEDENBECK, ERISA: PRINCIPLES OF EMPLOYEE BENEFIT LAW 20-23, 303-11 (2010). Bruce Wolk, *Discrimination Rules for Qualified Retirement Plans: Good Intentions Meet Economic Reality*, 70 Va. L. Rev. 419, 429–33 (1984).

[25] According to the Treasury, the net cost of the preferential treatment of qualified retirement plans (including 401(k) plans and Keogh plans, but excluding individual retirement accounts) is projected to be approximately $145 billion in fiscal year 2013. Executive Office of the President, Analytical Perspectives, Budget of the United States Government, Fiscal Year 2013, Table 17-2 at 258 (2012), available at http://www.gpo.gov/fdsys/pkg/BUDGET-2013-PER/pdf/BUDGET-2013-PER.pdf. Going by congressional estimates, the figure is only $101 billion. Staff of the Joint Comm. on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 2012–2017, at 39 (2013), available at https://www.jct.gov/publications.html?func=startdown&id=4504.

[26] *See* WIEDENBECK *supra* note 24, at 18-19.

ownership, no firm assets are at stake, so it's not their call. More precisely, it's not *directly* the company's call. The corporation, of course, writes the plan, and therefore sets the terms under which employees choose to contribute (whether by authorizing elective deferrals or simply by continuing to work for the sponsor). Plan terms clearly require or permit undiversified investment in employer stock, and under ERISA's disclosure regime a settlor-employee should be credited with basic awareness of the conflicted goals of the plan. To that extent the sponsoring company *indirectly* fixes the equity court's agenda upon a request for administrative deviation. When push comes to shove, however, the "purposes of the trust" should be determined by reference to settlor-employees' understanding of the plan, based on the summary plan description (SPD) and other accessible disclosure documents, not the detailed, technical and secret understanding of the employer-sponsor.[27] That distinction is important, because the average worker is not an investment professional; abstract notice about the riskiness of undiversified investments in employer stock, delivered when the business is flying high, will not be internalized as "you'll be betting your retirement on a long shot and we won't let you cash in your chips." Once the employer falls on hard times and the conflicting goals of the plan become salient, an employee will prioritize her interest in a comfortable retirement over employee ownership, and that participant-centered perspective casts a very different light on the "purposes of the trust" than if the sponsoring employer is treated as settlor.

As co-settlors, the purposes of the trust should also be evaluated from the standpoint of U.S taxpayers. [Taxpayer contributions are made pursuant to their representatives' decision to subsidize employee ownership despite the risk to retirement security. So initially at least, taxpayers must be deemed to share Congress' purposes in allowing undiversified investment in the corporate employer. But under changed circumstances, once the corporate sponsor falls on hard times, should taxpayers' prioritization of conflicting purposes be accorded independent weight? To be completed later.]

B. Amendment Authority

The operation of the traditional administrative deviation standard depends on the settlors' objectives, as explained above. In addition, the rule is premised on the need for *judicial* intervention. If the settlor possesses the power to modify the trust to respond to a change in circumstances, then the trustee has no need to petition the equity court for revision of trust terms.[28] ERISA demands that every employee benefit plan "provide a procedure for amending

[27] ERISA § 102, 29 U.S.C. § 1022 (SPD must be "written in a manner calculated to be understood by the average plan participant, and shall be sufficiently accurate and comprehensive to reasonably apprise such participants and beneficiaries of their rights and obligations under the plan"); 29 C.F.R. § 2520.102-3 (SPD contents). The question of the binding effect of the SPD and inferences drawn therefrom is explored in WIEDENBECK *supra* note 24, at 65-83. *But see* Cigna Corp. v. Amara, 563 U.S. ___, 131 S.Ct. 1866 (2011) (SPD is not the plan).

[28] Traditional doctrine holds that trust terms are fixed unless the settlor expressly reserves the power to revoke or modify the trust. RESTATEMENT (SECOND) OF TRUSTS 331 & cmt. g; IV SCOTT ON TRUSTS, *supra* note 19, § 331; *but see* RESTATEMENT (THIRD) OF TRUSTS 63 & cmt. c (matter of interpretation if power not expressly reserved, supplemented by rebuttable presumptions).Therefore the trustee is motivated to seek administrative deviation in order to obtain insulation from breach of trust claims brought by a dissident beneficiary based on failure to follow the original terms of the trust.

such plan, and for identifying the persons who have authority to amend the plan".[29] In the case of a single-employer plan, amendment authority (which is commonly called a "settlor function" in ERISA opinions addressing the scope of fiduciary responsibilities) is invariably assigned to the employer-sponsor or a representative thereof. The plan sponsor could therefore intervene to lift the employer stock investment restriction (or preference) and so require diversification. Hence the glib assumption that the employer corporation is settlor of the pension trust is at odds with recourse to administrative deviation to protect the "settlor's purposes". The employer sponsoring an ESOP or EIAP can fix the problem if it sees a need to do so, and if it does not take steps to authorize diversification, then there is clear-cut evidence of the ostensible settlor's actual purposes under current conditions: namely, the "settlor" continues to privilege employee ownership over retirement security. Ironically, if the plan sponsor were properly characterized as settlor, as the *Moench* line of cases assumes, then the trust law analogy indicates that administrative deviation would not apply, and even if it did, the petition for revision of the plan terms (lifting the employer stock investment restriction) should be denied.

This line of analysis suggests that administrative deviation is a distraction. If the corporate employer sponsoring an EIAP is ascribed the role of trust settlor, then in holding out hope of administrative deviation the *Moench* court charted an illusory path to relief. And indeed, case outcomes overwhelmingly reject employee-participants' claims for relief. Continued holding of employer stock is found acceptable even in circumstances that caused it to shed 50%, 70%, or more of its value, and most of the complaints are dismissed at the pleading stage, never even reaching discovery. Notwithstanding the federal courts' nod to administrative deviation, maybe something else is going on in the ERISA stock drop cases.

> If it appears that the settlor did, however, anticipate the circumstances and clearly provided that the trustee should nevertheless have no power to act in such a way as to prevent the failure of the trust, it would seem that the court would not be justified in permitting the trustee so to act, unless the provision is against public policy. Such a provision may be against public policy, however, in extreme cases where to give effect to it would result in the destruction of the trust property.[30]

Perhaps *Moench*'s "presumption of prudence" really functions only as a narrow escape hatch to prevent total destruction of the trust assets in spite of the employer's unambiguous preference for that result. That approach would not effectuate the sponsor's primary purpose; it would override it, but only in truly exigent circumstances. Rephrased in ERISA's terms, such a public policy exception warns that there may come a point where continuing to privilege employee ownership will be taken to demonstrate that the plan fiduciary has stopped acting "for the exclusive purpose of [] providing benefits to participants and their beneficiaries".[31]

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[29] ERISA § 402(b)(3), 29 U.S.C. § 1102(b)(3) (2006). The required procedure can be as simple as a declaration that the plan can be amended by "the Company," leaving to corporate law the specification of who may act for the company and in what manner. Curtiss-Wright Corp. v. Schoonejongen, 514 U.S. 73 (1995).

[30] IIA SCOTT ON TRUSTS, *supra* note 19, § 167, at 288.

[31] ERISA § 404(a)(1)(A), 29 U.S.C. § 1104(a)(1)(A). Observe that the EIAP diversification exception applies to the prudence requirement "to the extent that it requires diversification" but does not relax the duty of loyalty or the exclusive benefit rule. ERISA § 404(a)(2), 29 U.S.C. § 1104(a)(2).

Administrative deviation offers a more coherent concept if we put aside the formalistic notion of employer-as-settlor, to focus instead on plan participants and taxpayers, who bear the economic burden of pension plan funding.[32] As co-settlors in substance, participants initially subscribed to or acquiesced in the schizophrenic objectives of the plan. Ordinarily, however, ESOP participants are locked into employer stock investments, having no ability to amend the plan (modify trust terms) individually or collectively. If acute risk to their retirement savings materializes, it is sensible to ask a court to authorize a change in investments to carry out the employee-settlors' prioritization of trust purposes.

In addition to ESOPs, this analysis supports liberal access to administrative deviation to quit any EIAP holdings of *non-publicly-traded employer securities*. Consider, for example, a profit-sharing plan that calls for 40 percent of contributions to go into stock of the closely-held employer, with the remainder invested as determined by the plan trustee, named fiduciary, or investment manager.[33] Under such a program participants are locked in to high-risk investments in company stock by both the terms of the plan and the illiquid nature of their ownership position. If a profit-sharing plan includes a cash-or-deferred arrangement (i.e., is a 401(k) plan), ERISA ordinarily demands diversification of assets attributable to workers' elective deferrals.[34] Congress took this step in 1997, recognizing that 401(k) plans had become a major source of pension benefits for many workers, and that "[r]equiring participant contributions to be invested in employer securities or employer real property could have an adverse impact on the retirement security of plan participants."[35] Despite this protection of elective deferrals, employer matching and non-elective contributions can still be required to be invested in company stock that is not publicly traded. Hence, traditional administrative deviation doctrine suggests that settlor-participants who formerly acquiesced in the plan's multiple purposes should be granted a hearing when circumstances change.

The balance of equities is different for a non-ESOP EIAP that holds *publicly-traded employer securities*. Since 2006, participants in a defined contribution plan that holds any publicly-traded employer securities must have the right to move money out of employer stock into diversified investment options.[36] That divestment authority must be immediately exercisable with respect to the employee's elective deferrals, but can be withheld until completion of three years of service applied to funds attributable to employer contributions. Accordingly, do-it-

[32] *See supra* Part IIA.

[33] As a general rule, ERISA gives the plan trustee exclusive authority to manage investments unless the plan provides that the trustee is subject to the direction of the named fiduciary or investment authority is delegated to one or more investment managers. ERISA § 403(a), 29 U.S.C. § 1103(a).

[34] ERISA § 407(b)(2), 29 U.S.C. § 1107(b)(2). The elective deferral portion of the fund is deemed to be a separate plan that is not an EIAP. Diversification of funds attributable to salary reduction contributions is not required if not more than one percent of the employee's compensation is required to be invested in employer securities or realty, or if the value of the assets in all defined contribution plans sponsored by the employer is not more than 10% of the total asset value of all single-employer pension plan maintained by the employer. Also exempt from the elective deferral diversification rule are 401(k)-type ESOPs.

[35] STAFF OF THE JOINT COMM. ON TAXATION, 105TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997, at 445.

[36] ERISA § 204(j), 29 U.S.C. § 1054(j); I.R.C. § 401(a)(35). The right to diversification under ERISA § 204(j) was deliberately crafted to work in tandem with the rules governing participant-directed investments, under § 404(c). See *supra* note 40.

yourself risk protection is available to any participant who is likely to have accumulated a significant account balance. If plan participants are kept abreast of new developments that threaten the employer's financial health, then it would seem that a claim founded on administrative deviation principles is unwarranted, because the participant-settlors have the ongoing right to modify the plan (i.e., switch investments) in response to changed circumstances.

Today, most defined contribution pension plans are 401(k) plans, under which workers can elect to contribute part of their pay, and to which the employer may also make matching or nonelective contributions.[37] More than 90% of 401(k) plans allow participants to direct the investment of all or a portion of their accounts, with 89% of 401(k) plan active participants (53.7 million workers in 2010) having investment authority over the full balance.[38] Typically, participants are allowed to select their investments from a menu of mutual funds.[39] Company stock can be offered as an investment option under a participant-directed defined contribution plan only if the stock is publicly traded.[40] That condition limits company stock fund offerings to very large corporations,[41] yet the Labor Department reports that $160 billion of employer securities is held in 401(k) plans that give participants the right to direct the investment of all or a portion of their account balances.[42] Hence a large share of company stock investments—roughly 50 percent of the total for defined contribution plans—is attributable to plans under which the settlor-participants possess ongoing investment management authority. Those pension trusts would not be candidates for distributive deviation under the traditional approach.

III. Modern Trust Variation

Trust law has continued to evolve over recent decades. Trust variation standards have been among the most dynamic areas of doctrinal development. That development has all been in

[37] The Labor Department reports that in 2010, 79.3% of all defined contribution plans were 401(k)-type plans (i.e., included a cash-or-deferred arrangement) and these plans account for 82.4% of active participants in defined contributions plans. EBSA, *supra* note 2, Tables A1, D3.

[38] EBSA, *supra* note 2, Table D6(b). The historical growth in the number and workforce coverage of 401(k) plans is presented in PETER J. WIEDENBECK & RUSSELL K. OSGOOD, EMPLOYEE BENEFITS Figures 2-2, 2-3 (2d ed. 2013).

[39] Ordinarily, a defined contribution plan calling for participant-directed investments is designed to comply with ERISA § 404(c), 29 U.S.C. § 1104(c). If the plan offers a suitable range of investment options and provides participants adequate information, then plan fiduciaries (including the trustee) are not liable for any loss that results from a participant's exercise of control over the assets in his account. ERISA § 404(c), 29 U.S.C. § 1104(c); 29 C.F.R. § 2550.404c-1. *See generally* Wiedenbeck, *supra* note 24, at 136-46. That insulation from responsibility for investment losses includes losses traceable to the participant's failure to adequately diversity investments.

[40] The regulations under section 404(c) impose special conditions if employer securities are an investment option. Fiduciary immunity is limited to investments in company stock that is publicly traded with sufficient frequency and volume to assure that participant orders to buy or sell can be carried out expeditiously, among other requirements. 29 C.F.R. § 2550.404c-1(d)(2)(ii)(*E*)(*4*). Hence EIAPs that provide for participant-directed investments offer employer securities as an option only if they are publicly traded.

[41] In 2011, only 2.3% of participant-directed 401(k) plans offered company stock as an investment option, but these plans accounted for 38% of participants. Jack VanDerhei et al., *401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2011*, EBRI ISSUE BRIEF No. 380, at 22, 26 (Dec. 2012).

[42] EBSA *supra* note 2, at Table D9 at 54. Some ESOPs contain an elective contribution feature and therefore are also classified as 401(k) plans. I.R.C. §§ 401(k)(1), 4975(e)(7). Consequently, some portion of the $160 billion in participant-directed 401(k) plan holdings of employer securities is also counted in the $202 billion in ESOP holdings reported earlier. *See supra* note 2 and accompanying text.

the direction of liberalization, broadening the circumstances under which the trustee or trust beneficiaries can modify the original terms of the trust. On permissible trust investments, the Restatement (Third) of Trusts provides:

> In investing the funds of a trust, the trustee
>
> (a) has a duty to conform to any applicable statutory provisions governing investment by trustees; and
>
> (b) has the powers expressly or impliedly granted by the terms of the trust, and, except as provided in §§ 66 and 76, has a duty to conform to the terms of the trust directing or restricting investments by the trustee.[43]

A comment to this section recognizes that investment directions imposed by the trust terms "are ordinarily binding on the trustee in managing trust assets, thus often displacing the normal duty of prudence."[44] That ordinary obligation, however, is subject to the exception in § 66, which states the modern rule on equitable deviation, both administrative and distributive.

> The court may modify an administrative or distributive provision of a trust, or direct the trustee to deviate from an administrative or distributive provision, if because of circumstances not anticipated by the settlor the modification or deviation will further the purposes of the trust.[45]

Under this approach it's not necessary "that the situation be so serious as to constitute and 'emergency' or to jeopardize the accomplishment of trust purposes."[46] This, of course, displaces the far more restrictive "defeat or substantially impair" standard for administrative deviation under § 167 of the Second Restatement, the rule invoked by *Moench*. The Uniform Trust Code adopts a similar approach, noting in commentary that: "While it is necessary that there be circumstances not anticipated by the settlor before a court may grant relief . . . the circumstances may have been in existence when the trust was created."[47]

These authorities suggest that where the implications of competing purposes—such as retirement security and employee ownership—are not adequately appreciated when employee-settlors contribute (indirectly) to an EIAP, then the subsequent appearance of serious financial threat to value of company stock investments can constitute "circumstances not anticipated by the settlor". And once such unforeseen jeopardy comes in view, under the modern approach it is clear that a court could authorize distributive deviation without finding that the financial health of the company has deteriorated to the point of pending financial collapse. Yet that seems to be

[43] Restatement (Third) of Trusts § 91 (2007). *Accord id.* § 76(1) ("duty to administer the trust diligently and in good faith, in accordance with the terms of the trust and applicable law"). A comment elaborates that the "normal duty of a trustee to obey the terms of the trust also does not apply to provisions that are invalid because they are unlawful or against public policy." *Id.* cmt b(1).

[44] *Id.* § 91 cmt. e.

[45] Restatement (Third) of Trusts § 66(1) (2003). Additional guidance on distributive deviation is provided in § 65(2), which conditions judicial approval of a modification inconsistent with a material purpose of the trust on a finding that the reasons for the modification outweigh the material purpose. This is a modern liberalized version of the "*Claflin* doctrine," analyzed in *Wiedenbeck*, *supra* note **Error! Bookmark not defined.**.

[46] Restatement (Third) of Trusts § 66(1), cmt. a (2003).

[47] Unif. Trust Code § 412 cmt. (2000).

the just the sort of dire circumstances (emergency situation) that the ERISA cases insist upon as a predicate to lifting a plan mandate to invest in employer stock.[48]

In addition to expanding administrative deviation, modern trust law makes massive incursions on the *Claflin* doctrine, the traditional American view that a trust cannot be modified or terminated, even if all beneficiaries consent, where the change would undercut some material purpose of the settlor.[49] Under contemporary standards, material purposes that would obstruct change are not lightly to be inferred, and even where apparent an equity court may authorize change if it determines that the reason for modification outweigh the material purpose.[50] The participants of an EIAP are also the primary beneficiaries of the pension trust. As settlors, of course, it's fair to charge them with a material purpose of employee ownership, but perhaps an under-appreciated objective of their former selves should readily yield when new conditions trigger a reevaluation of priorities.

The unanimous consent requirement frequently prevented change even if the material purpose doctrine did not, because any disabled, minor, unborn, or unascertained beneficiary could not give a legally binding consent. A pension trust may have hundreds or thousands of trust beneficiaries, many of them contingent (an employee's designated beneficiary is subject to change), some of whom cannot be located (common for terminated vested employees), and others are simply disengaged and unresponsive. As such, modification by consent of all beneficiaries would seem to be out of the question. Contemporary trust law may be significantly less restrictive along this dimension as well, by offering a variety of mechanisms for securing the necessary approval, including virtual representation and court appointment of representatives for absent beneficiaries.[51] [Discussion of *Claflin* doctrine and the implications of its recent liberalization needs lots more explanation and development. Preceding two paragraphs should be expanded into several pages; may need to subdivide Part III.]

The lesson here is that prevailing state law standards governing trust variation do not impose the extremely restrictive (well-nigh insuperable) barriers that the federal courts following *Moench* mistakenly assume. The interpretation of ERISA, the Supreme Court has frequently

[48] *Edgar*, 503 F.3d at 349 n. 13 ("We do not interpret *Moench* as requiring a company to be on the verge of bankruptcy before a fiduciary is required to divest a plan of employer securities."); Lalonde v. Textron, Inc., 369 F.3d 1, 6 (1st Cir. 2004) (because the "important and complex area of law implicated by plaintiffs' claims is neither mature nor uniform . . . we believe that we would run a very high risk of error were we to lay down a hard-and-fast rule"); Brieger v. Tellabs, Inc., 2009 U.S. Dist. LEXIS 49747, at *37 (N.D. Ill. June 1, 2009) (leaving open whether the standard is "impending collapse or something short of that"); In re Ford Motor Co. ERISA Litigation, 590 F. Supp. 2d 883, 892-93 (E.D. Mich. 2008) (rejecting the "imminent collapse standard in favor of a rule requiring divestiture "at the point at which company stock becomes so risky that no prudent fiduciary, reasonably aware of the needs and risk tolerance of the plan's beneficiaries, would invest any plan assets in it, regardless of what other stocks were also held in the plan's portfolio").

[49] *See generally* RESTATEMENT (SECOND) OF TRUSTS § 337; IV SCOTT ON TRUSTS § 337; Peter J. Wiedenbeck, *Missouri's Repeal of the* Claflin *Doctrine: New View of the Policy Against Perpetuities?*, 50 MO. L. REV. 805(1985).

[50] RESTATEMENT (THIRD) OF TRUSTS § 65; Unif. Trust Code § 411 cmt.

[51] Unif. Trust Code § 411 cmt and §§ 305-305; *see also* Wiedenbeck, *supra* note 49, at 812-15 (Mo. Rev. Stat. § 456.590.2 authorizes judicial consent on behalf of disabled, minor, unborn or unascertained beneficiaries).

admonished, should be guided in the first instance by reference to its trust law origins.[52] Yet trust law is not static, so the question becomes: Trust law, when? The Third Circuit's resort to the Second Restatement's rule on administrative deviation fairly captures doctrinal development as of 1974, but does ERISA's date of enactment freeze (ossify?) background interpretive principles? As applied to employee benefit plans, was trust law fixed in a perpetual state of arrested development in 1974? Some cases seem to assume so.[53]

That can't be right. Trust variation principles, after all, function for the most part as rules of interpretation, setting forth considerations to be deployed in response to a petition to adapt the long-term multiparty trust relationship to altered circumstances. Even legislative updates to state trust variation standards are generally applied to preexisting irrevocable trusts—trusts created before enactment are not grandfathered.[54] Presumably, that's because the "purposes of the trust" continue to guide decision making. [Need more here.]

IV. Trust Variation and ERISA's Evolution

At a doctrinal level, federal courts' handling of trust variation law in the ERISA stock drop cases has been simplistic, naïve, and anachronistic, as the preceding discussion demonstrates. The central insight of the *Moench* line of cases is nevertheless valid: judicial intervention may be necessary where changed circumstances render incompatible the schizophrenic purposes of an EIAP. At a policy level, does resort to trust variation law afford the appropriate mechanism to resolve this conflict? Unfortunately, trust variation law is at best a poor proxy for

Trust variation law seeks to salvage a bad situation by reference to the settlor's likely objectives, express or implied. The conflicting objectives embedded in an ESOP or EIAP are not a simple expression of the employer's desires to which the workforce assents; rather, they are enabled, incentivized and shaped by the qualified plan tax subsidy. At core, the ERISA issue does not really concern the purposes and priorities of the settlor(s), however defined.

> Instead of trying to discern and carry out the intentions of the settlor when powers and purposes conflict, in the stock drop cases the courts are trying to discern and carry out the purposes of Congress when employee ownership and retirement security objectives become irreconcilable. The question is one of statutory interpretation, not plan interpretation.[55]

[52] Firestone Tire & Rubber Co. v. Bruch, 489 U.S. 101, 110 (1989) (ERISA's "fiduciary responsibilities provisions codify and make applicable to ERISA fiduciaries certain principles developed in the evolution of the law of trusts"); Varity Corp. v. Howe, (1996), and quotes from more recent cases.

[53] *E.g.*, In re McKesson HBOC, Inc. ERISA Litig., 391 F. Supp. 2d 812, 831 n.16 (N.D. Cal. 2005) (observing that the *Moench* unanticipated circumstances rule was derived from the Restatement (Second) of Trusts § 167, which "reflected the state of the law in 1974 when Congress 'codif[ied] and ma[de] applicable to [ERISA] fiduciaries certain principles developed in the evolution of the law of trusts."' (quoting Firestone, 489 U.S. at 110, and H.R. Rep. No. 93-533, at 11)).

[54] *E.g.*, Unif. Trust Code § 1106 (2000); *but see id.* §411(a).

[55] WIEDENBECK, *supra* note 24, at 151.

The policy question, in other words, is about accommodating Congress' conflicting purposes and priorities. Filling this lacuna is a job for the federal courts under ERISA, to be accomplished by development of federal common law rules that advance the objectives of employee benefit plan regulation.

What are those regulatory objectives and how should they be prioritized in the case of pension plan investments in company stock? Answering that question requires recourse to ERISA's history, and not simply a static view of the compromises and political alignments of 1974. Just as trust law has evolved significantly since 1974, so too has ERISA. It is one of the most frequently and extensively amended federal statutes, and post-1974 developments have an important bearing on the proper balance of considerations that should be reflected in a federal common law standard for pension trust variation.

- Historically, profit-sharing and stock bonus plans originated as short-term in-service deferred compensation programs designed to provide a worker productivity incentive. Treas. Reg. § 1.401-1.
- In contrast to qualified plan provisions of the tax law, ERISA title I applies only to long-term deferred compensation; note original reference to "profit-sharing retirement plans".
    - Briefly explain EIAP definition's reference to "thrift, or savings plan"?
    - Also explain carve out of ESOP integrated with DB plan, as in floor-offset arrangements.
- Present data on formerly ubiquitous (pre-1990) combination of profit-sharing and stock bonus DC plans with pension plan (DB or MPPP), showing the decline of secondary plan sponsorship that accompanied the rise of 401(k) plans.
- Briefly outline early history of ESOPs, Kelso's conversion of Russell Long, GAO studies of the 1980s.
- General application of IRC § 72(t) early distribution penalty to all tax-subsidized savings arrangements in 1986 as the turning point in congressional understanding of qualified plan purposes.
- Emphasize ESOP dissonance with ERISA's fundamental standard of fiduciary decision-making: "exclusive purpose of providing benefits". But that (arguably) clear-cut overriding statutory prioritization seems at odds with Congress' belated response to ENRON collapse which continued to give ESOPs a pass. Every tax subsidy creates its own dedicated constituency. . . .
- Legislative solution to allow ESOPs only if participant accrues equal or greater benefits under a diversified pension plan? Could even apply to preexisting plans, but with long-term transition relief akin to ERISA's general 1974 prohibition on holdings of employer securities or real estate excess exceeding 10% FMV plan assets.

V. Conclusion