

Pension Plan Investments in Employer Securities: More Is Not Always Better

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As various employee benefit arrangements providing for employees' receipt of part of their compensation in the form of employer stock grow in popularity, the desirability of significant investments by employer-sponsored pension plans in employer securities becomes an important public policy issue. In this Article, Professor Stabile suggests a manner in which pension plans' investments in employer securities should be regulated. After surveying the current legal regime applicable to the acquisition of employer securities by pension plans and voting and tender decisions with respect to such securities, Professor Stabile analyzes arguments advanced in support of substantial accumulations of employer stock by pension plans and concludes that such arguments are not compelling. She then argues that significant investment in employer securities by pension plans leads to insufficient diversification of employees' retirement portfolios and improves managers' ability to defeat hostile takeovers and shareholder proposals. Professor Stabile concludes that the Employee Retirement Income Security Act of 1974 ("ERISA"), the primary federal statute regulating pension plans, should set the maximum allowable limit on the amount of an employee's assets that may be invested in his employer's stock and on the percentage of an employer's securities that may be held by pension plans maintained by the employer.

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Introduction

Many employees, particularly those employed by public companies, receive some portion of their compensation in the form of their employer's stock.¹ Employers believe that stock compensation enhances worker productivity by giving employees a stake in the performance of the company, thus aligning workers' interests with those of stockholders.² Employers also like compensating employees with stock because doing so puts employer securities in hands perceived to be friendly to managements' interests.³

In addition to stock that may be conveyed to employees as current income in the form of stock options⁴ or bonus stock,⁵ a portion of employees'

1. See Kerry Capell, *Options for Everyone*, BUS. WK., July 22, 1996, at 80 (noting that since 1989, an estimated 2000 companies have instituted broad-based stock option plans); Michael A. Hiltzik, *More Firms Giving a Stake to Employees*, L.A. TIMES, June 15, 1996, at A1 (noting that between 8.5% and 13% of top U.S. corporations grant stock or options to some members of the company, with about 3% of top 1,000 publicly held companies granting some form of options or restricted stock to all employees). Service and high technology organizations demonstrate the most extensive use of employee benefit plans of this sort. (discussing a 1993 survey noting that stock plans are offered by over 50% of high technology corporations). See Alisa J. Baker, *Stock Options—A Perk That Built Silicon Valley*, WALL ST. J., June 23, 1992, at A20 (noting that stock option plans are often used by start-up firms in place of non-equity compensation); Hiltzik, *supra*.

2. See *infra* notes 66-67 and accompanying text.

3. See *infra* notes 142-143 and accompanying text.

4. Stock option plans involve the granting to employees of options to purchase shares of the company's stock. Generally, although not always, the options are not immediately exercisable at the time of grant, but become exercisable after completion of a period of employment following the date on which the options are granted. Satisfaction of individual or company-wide performance objectives also may be a condition of the exercisability of the options. Generally, the option price—the price at which the employee may purchase the shares—is the fair market value of the shares on the date of grant. See Joseph Bankman, *The Structure of Silicon Valley Start-Ups*, 41 UCLA L. REV. 1737, 1750-51 (1994); Michael W. Melton, *The Alchemy of Incentive Stock Options—Turning Employee Income Into Gold*, 68 CORNELL L. REV. 488, 492-93 (1983).

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retirement income is often paid in, or measured by the performance of, the employer's securities. This is true regardless of the type of pension plan an employer maintains.⁶ The Employee Retirement Income Security Act of 1974 ("ERISA"),⁷ the primary federal statute regulating private pension plans,⁸ both allows and facilitates the holding by plans of shares of employer securities.⁹ The result is that pension plans today hold hundreds of billions of dollars of such shares.¹⁰ While the statute places some limits on a pension plan's holding

5. Under a stock bonus plan, an employee is granted shares of an employer's stock. The grant is a form of bonus that is paid in stock instead of cash. Generally, the shares granted must be "earned" by working for the employer for a number of years after the award or by the attainment of certain performance goals. Prior to the time the shares are earned, or vested, they can be forfeited by the employee. See Michael R. Flyer, *Employee Benefits and Executive Compensation*, 803 A.L.I.-A.B.A. 233, 264 (1993).

6. There are two broad categories of pension plans: defined benefit and defined contribution. See 29 U.S.C. § 1002(34-35) (1994); see also text accompanying notes 16-22. From an employee's point of view, a significant difference between the two types of plans is who bears the investment risk. In a defined benefit plan, risk of investment loss is borne by the employer, who promises to provide a particular benefit without regard to investment income made on funds contributed to the plan. In a defined contribution plan, the employee bears the investment loss since she is only entitled to what is in her account upon retirement. Historically, defined benefit plans were the dominant form of pension plan. However, the balance between defined benefit and defined contribution plans has shifted dramatically in recent years. See *infra* notes 95-101 and accompanying text.

7. 29 U.S.C. §§ 1001-1461 (1994). ERISA regulates both pension plans and welfare benefit plans. Pension plans are plans that provide both employer-sponsored retirement income and deferral of income by employees beyond retirement. See 29 U.S.C. § 1002(2)(A). Welfare benefit plans include any program that provides benefits for contingencies such as illness, accident, disability, death or unemployment. See 29 U.S.C. § 1002(1). Welfare benefit plans are not subject to ERISA's funding requirements. See 29 U.S.C. § 1081. As a consequence, employer's generally deal with plan benefit costs on a "pay as you go" basis. See JOHN H. LANGBEIN & BRUCE A. WOLK, *PENSION AND EMPLOYEE BENEFIT LAW* 508-09 (2d ed. 1995). Consequently, such plans do not raise the issue of investments in employer securities.

8. ERISA regulates most pension plans of private employers. Its basic substantive provisions apply to pension plans of private employers other than those that are unfunded and maintained primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees and excess benefit plans. See 29 U.S.C. § 1051(2), (7) (1994). The Internal Revenue Code (the "Code") also regulates pension plans by establishing conditions that must be met in order for such plans to receive favorable tax treatment. See I.R.C. § 401(a) (1997).

ERISA does not apply to pension plans maintained by governmental entities. See 29 U.S.C. § 1003(b)(1) (1994). With respect to the fiduciary standards discussed in this Article, many state and local governmental plans are regulated by laws that mirror or closely approximate ERISA's fiduciary rules. See, e.g., CAL. EDUC. CODE § 22250 (West 1994) (governing teachers' retirement system); CAL GOV'T CODE § 21428 (West 1995) (governing public employee's retirement system); N.Y. RETIRE. & SOC. SEC. LAW §§ 177(9)(b), 422 (McKinney 1987 & Supp. 1997) (governing New York's public pension funds). Of course, the issue of voting and tender of employer securities is one that does not arise for governmental plans.

9. The term "employer security" means a security issued by an employer of employees covered by the plan, or by an affiliate of such employer. 29 U.S.C. § 1107(d)(1) (1994).

10. See United States Department of Labor Advisory Council on Employee Welfare and Pension Benefits Plans, Report of the Working Group on Employer Assets in ERISA Employer-Sponsored Plans (1997) (including Summaries of Testimony of Thomas J. Healey, Partner, Goldman, Sachs & Co.) (reporting that 2.8% of defined benefit plan assets are invested in employer securities); Ellen E. Schultz, *Frittered Away: Some Workers Find Retirement Nest Egg Full of Strange Assets*, Wall St. J., June 5, 1996, at A1 (according to Access Research Inc., a financial services consulting firm, nearly a quarter of the \$675 billion in 401(k) plans is invested in employer securities).

and acquisition of employer securities, those limits apply only to a small portion of the universe of pension plans.¹¹

The significant investment in employer securities by pension plans has at least two unfortunate consequences. First, the retirement portfolio of many employees is not sufficiently diversified. As employees of Color Tile, Inc., a national retail chain that filed for bankruptcy in January 1996 discovered, the potential impact of insufficient pension-asset diversification can be devastating. Employees of that company saw their retirement savings virtually disappear because, at the time of bankruptcy, such a high percentage of the company's retirement plan was invested in the employer.¹² Investing too high a percentage of an employee's retirement assets in employer securities subjects the employee's current and future security to the fortunes of a single entity.

Second, a significant accumulation of an employer's stock in the hands of employee benefit plans strengthens management immunity against unwanted takeovers and against shareholder proposals that may be beneficial to the company but at odds with management's desires. Whether voting and tender decisions are made by a plan fiduciary or passed through to participants, it is likely that such decisions will favor the interests of current management, potentially harming both the corporation and its shareholders.

While suggesting increased regulation of pension plans may not be popular among politicians and businesses clamoring for less governmental regulation across the board, this Article proposes that there should be more restrictive limitations imposed on the acquisition of employer securities by all types of pension plans. This Article argues that it is harmful to both plan participants and beneficiaries and to corporate shareholders to allow such significant plan holdings of employer securities.¹³ Part I of the Article explains the current law applicable to the acquisition of employer securities and voting and tender decisions with respect to pension plans. Part II then explores the arguments that have been advanced in support of encouraging pension plan investments in employer securities, concluding that the purported benefits of

11. See *infra* notes 26-32 and accompanying text.

12. See *Retirement Policy: Democratic Lawmakers Introduce Bill to Protect Workers' Section 401(k) Plans*, BNA PENSIONS AND BENEFITS DAILY, July 17, 1996, at 1-4 [hereinafter *Retirement Policy*].

13. The Article addresses only employer securities held by plans. It does not focus on corporate control disputes where a plan holds shares of a non-affiliated company the employer is interested in acquiring or on the voting of shares of other non-affiliated companies held by a plan for investment. With respect to the former, see, for example, *Leigh v. Engle*, 727 F.2d 113, 124 (7th Cir. 1984), stating that fiduciaries did not act solely in the interest of plan beneficiaries when they invested plan assets in companies involved in corporate control contests with employer, when fiduciaries were actively engaged in the corporate control contests and failed to make an independent investigation of the investment options available to the plan, and when the plan's investment decisions never deviated from the employer's business interests). With respect to the voting of shares of companies other than the employer, see generally Department of Labor Opinion Letter to Robert A.G. Monks, Institutional Shareholders Services, Inc., 17 Pens. Rep. (BNA) 244 (Jan. 23, 1990).

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such investments are vastly overstated and do not support significant accumulations of employer securities by pension plans. Part III discusses the first of two problems created by excessive plan investments in employer securities—the danger to plan participants of insufficient diversification of retirement assets. Part IV discusses the second problem—the entrenchment effect of excessive plan investments in employer securities. The conclusion of the Article is that ERISA should be amended to reduce significantly both the percentage of an employee's pension assets that may be invested in employer securities (addressing the diversification concern) and the percentage of an employer's securities that may be held by pension plans maintained by that employer (addressing the entrenchment concern).

I. Current Law Regarding Acquisition of Employer Securities and Voting of Such Shares

ERISA generally requires that assets of pension plans be held in trust by one or more trustees.¹⁴ The statute provides that the trustee has exclusive authority and discretion to manage and control such assets,¹⁵ including authority both to acquire shares of an employer's stock and to vote and tender such shares.

A. Acquisition of Employer Securities

ERISA recognizes two broad categories of pension plans: defined benefit plans and defined contribution plans. In a traditional defined benefit pension plan, an employer pays retired employees a cash pension benefit, the amount of which is based on a pre-determined formula.¹⁶ Each year during a participant's working life, the employer makes contributions to a trust in order

14. See 29 U.S.C. § 1103(a) (1994). The Code also requires as a condition to plan qualification that pension plan assets be held in trust. See I.R.C. § 401(a) (1997).

15. See 29 U.S.C. § 1103(a). Although ERISA does not explicitly label a trustee as a fiduciary, the nature of the trustee's duties and possession of the discretion to manage and control plan assets makes the trustee a fiduciary within the meaning of ERISA. ERISA provides that persons are plan fiduciaries to the extent they (1) exercise discretionary authority or control over plan management or exercise discretionary authority or control over the disposition of plan assets, (2) render investment advice regarding plan assets for a fee or other compensation or have authority or responsibility to do so; or (3) have any discretionary authority or responsibility in plan administration. See 29 U.S.C. § 1104(3)(21)(A) (1994); *Evans v. Bexley*, 750 F.2d 1498, 1499 n.2 (11th Cir. 1985) (trustee of an employee benefit plan is a fiduciary); *Freund v. Marshall & Isley Bank*, 485 F. Supp. 629, 635 (W.D. Wis. 1979) ("by the very nature of their positions," plan trustees are fiduciaries). *But see Maniace v. Commerce Bank*, 40 F.3d 264, at 268 (8th Cir. 1994), *cert. denied*, 115 S. Ct. 1964 (1995) (directed trustee with no discretion with respect to purchases and sales of company stock by an ESOP held not to be a fiduciary).

16. See 29 U.S.C. § 1002(35) (1994). For example, a plan may provide that retirees receive an annual pension benefit equal to 2% of the retiree's final compensation times the number of years the retiree was employed by the employer.

to fund the benefits payable upon retirement,¹⁷ and a trustee (who may be an officer or director of the employer)¹⁸ or other fiduciary appointed by the employer determines how best to invest those funds. One investment a defined benefit plan may make, in order to fund its obligation to pay participants their promised pension, is an investment in employer securities.

In an individual account or defined contribution plan, the employer, and sometimes the employee, make periodic contributions to a pension trust. Those contributions are allocated to individual accounts maintained in the name of each employee covered by the plan.¹⁹ The pension benefit a retired employee is entitled to receive is simply the value of that employee's individual account in the plan at the time of retirement.²⁰ An increasingly popular type of defined contribution plan is a 401(k) plan, which allows employees to make pre-tax contributions to a plan, which contributions are often matched by employers.²¹ These plans commonly allow participants to direct the investment of their account balances, offering participants a number of investment options. Frequently, one of those options is an employer stock fund.²²

Another popular type of defined contribution plan is an employee stock ownership plan (an "ESOP").²³ An ESOP is an individual account pension plan that is designed to invest primarily in employer securities.²⁴ An employer who establishes an ESOP contributes either stock or cash to the ESOP, which is then used by the ESOP trustee to purchase shares. When shares are

17. ERISA and the Code contain minimum funding requirements to ensure that funds are available to pay pension benefits when they are due. See 29 U.S.C. § 1082(a)(1) (1994); I.R.C. § 412 (1997). The employer generally satisfies that obligation by making cash contributions to the plan, which cash is then invested by a plan fiduciary. One of those investments may be in employer securities.

18. See *infra* notes 195-197 and accompanying text.

19. See 29 U.S.C. § 1002.

20. See *id.* Thus, in a defined contribution plan, employees are not promised a specified pension benefit. Instead, benefits are determined by contributions and investment gains and losses on those contributions, as opposed to a predetermined formula, as in a defined benefit plan.

21. See Senator Barbara Boxer's *Statement Regarding 401(k) Pension Protection* (Senator Boxer's Senate Office, Wash., D.C.), July 15, 1996. Senator Boxer notes that in 1995, 401(k) plans held \$675 billion in assets, up 650% from \$105 billion dollars in 1985; in 1995, there were 228,000 401(k) plans, compared to 65,000 in 1985. See *Labor Department Seeks More Funds for Section 401(k)*, BNA PENSIONS & BENEFITS DAILY, May 13, 1996, at 4 (reporting statement of Olena Berg, DOL Assistant Secretary for Pension and Welfare Benefits, that new plans being adopted by employers tend to be defined contribution plans such as 401(k) plans).

22. See Portia Richardson, *Making Workers Act Like Owners*, INSTITUTIONAL INVESTOR, Nov. 1995, at 31 (noting that two-thirds of companies surveyed in 1994 offered company stock as a 401(k) option); John Woyke, *Can Employers Stock Link Employees to Company*, PENSION WORLD, Dec. 1993, at 36 (noting that 55% of defined contribution plans other than ESOPs permit employees to elect to invest in employer securities).

23. Approximately 9500 U.S. corporations have ESOPs, covering more than 10 million employees. See Edward J. Giblin et al., *When Employees Own the Company . . .*, ACROSS THE BOARD, Oct. 1, 1995, at 42 (citing National Center for Employee Ownership). But see Jack Scis, *ESOPs: After the Boom Days of the 1980s, Popularity of ESOPs Levels Off*, NEWS & REC., Dec. 17, 1995, at E1 (noting that after a rapid rise in the 1980s the number of new ESOPs has leveled off).

24. See I.R.C. § 409(a)(2) (1997).

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contributed or purchased, they are placed in a suspense account and are referred to as “unallocated shares.” Shares are then allocated to individual plan participants on the basis of a formula. For example, shares might be allocated proportionally to compensation. Retirement benefits from an ESOP are generally paid in stock. If the stock of a company were not publicly traded, the employee would have the option of selling back to the employer shares distributed by the ESOP.²⁵

Historically, the only specific limits²⁶ ERISA imposes on acquisitions of employer securities by pension plans apply to defined benefit plans. Defined benefit plans may invest in employer securities only if no more than 25% of the outstanding stock of the same class is owned by the plan and at least 50% of the outstanding stock of the same class is owned by persons independent of the employer.²⁷ Additionally, employer securities cannot exceed 10% of the assets of a defined benefit plan.²⁸ Congress attempted to address two concerns in enacting these limits. The first was a concern over self-dealing, since employers often serve as plan administrator, as trustee, or in some other fiduciary capacity to a plan.²⁹ The second was a concern over diversification of the trust fund that is to pay benefits owed to plan participants.³⁰

While a two-fold limit applies to the defined benefit pension of a

25. See JOSEPH RAPHAEL BLASI, *EMPLOYEE OWNERSHIP: REVOLUTION OR RIPOFF* 2-5 (1988); Henry C. Blackiston, III et al., *ESOPs: What They Are and How They Work*, 45 BUS. LAW. 85 (1989) (discussing the mechanics and application of ESOPs); D. Bret Carlson, *ESOPs and Universal Capitalism*, 31 TAX L. REV. 289 (1976) (examining the legislative history of ESOPs).

ESOPs differ from other tax-qualified pension plans in that they can borrow funds to acquire employer securities. In a “leveraged ESOP,” the ESOP borrows to acquire the securities and the employer makes contributions over time that are used to repay the loan. As employer contributions are used to repay the loan, shares are allocated to participants’ accounts. Various provisions of the Code have made leveraged ESOPs attractive from a tax point of view. For example, § 404(a)(9) of the Code provides that when an ESOP borrows funds, the employer’s annual contributions to the plan for repayment of principal and interest are deducted in an amount of up to 25% of the annual compensation of participants. See I.R.C. § 404(a)(9). See Sean S. Hogel, *The Employee as Investor: The Case for Universal Application of the Federal Securities Laws to Employee Stock Ownership Plans*, 34 WM. & MARY L. REV. 189, 208 (1992) (discussing the general tax issues relating to ESOPs); Scott P. Spector, *Special Rules and Tax Provisions Relating to Employee Stock Ownership Plans (ESOPs)*, in PRACTISING LAW INST., UNDERSTANDING ERISA 1994: AN INTRODUCTION TO BASIC EMPLOYEE RETIREMENT BENEFITS I (1994).

26. ERISA also imposes general duties on fiduciaries of pension plans that may make an impact on a fiduciary’s decision to acquire shares. These duties apply to fiduciaries of both defined contribution and defined benefit plans. See *infra* text accompanying notes 45-54.

27. See 29 U.S.C. § 1107(d)(5), (f)(1) (1994).

28. See 29 U.S.C. § 1107(a)(2) (providing that plans other than individual account plans may only acquire qualifying employer securities if, immediately after the acquisition, the fair market value of employer securities and real property held by the plan does not exceed 10% of the fair market value of the plan’s total assets).

29. See S. REP. NO. 93-127, at 31 (1973), *reprinted in* 1974 U.S.C.C.A.N. 4838, 4868 (explaining that limited exception for pension plan investment in employer securities reflects the fact that employers act as administrators, trustees or other fiduciaries of plans).

30. See S. REP. NO. 93-383, at 3 (1973), *reprinted in* 1974 U.S.C.C.A.N. 4890, 4892 (explaining that heavy plan investment in employer securities is not in the best interest of plan participants).

participant's account balance plans, except for a recently enacted limitation that applies only to a small percentage of defined contribution plans,³¹ ERISA imposes no limit on either the percentage of an individual account plan's assets that may be invested in employer securities or the percentage of an employer's stock that can be held by an individual account plan.³² Thus, defined contribution plans may invest up to 100% of their assets in employer securities if the plan so allows as well as hold a substantial percentage of an employer's outstanding securities.

It is not surprising that when ERISA was enacted Congress chose to place employer securities limits only on defined benefit plans and not on defined contribution plans. The predominant form of pension plan in 1974 was the defined benefit plan and ERISA was passed as a result of the abuse and mismanagement of those plans.³³ The defined contribution plans that did exist were predominantly profit-sharing plans that often supplemented an employer's defined contribution plan. Congress viewed those profit sharing plans as primarily aimed at motivating employees rather than providing retirement income.³⁴

Although Congress did not thoroughly discuss ESOPs prior to enacting ERISA, in the years since the statute's passage, Congress has encouraged employee ownership of corporations, particularly through the use of ESOPs,³⁵

31. See *infra* note 143 and accompanying text.

32. See 29 U.S.C. §§ 1107(b)(1), 1197(d)(5) (1994); see also 29 U.S.C. § 1108(e) (1994) (specifically exempting ESOPs from the 10% limit).

33. Specifically with respect to employer securities, one of the examples of "misuse, manipulation and poor management" of pension plan trust funds cited in the October 1971 hearings that preceded ERISA's adoption was a company that had a policy of investing more than one-half of its plan's assets in the company's own common stock and in the real estate of one of its subsidiaries. Michael S. Gordon, *Overview: Why Was ERISA Enacted?*, in U.S. SENATE SPEC. COMM. ON AGING, THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974: THE FIRST DECADE 6-25 (1984), quoted in LANGBEIN & WOLK, *supra* note 7, at 67, 74; see also S. REP. NO. 93-383, at 3, 14-19 (1973), reprinted in 1974 U.S.C.C.A.N. 4892, 4903-08 (noting that among other things, ERISA is designed to address fact that pre-ERISA law permits pension funds to be heavily invested in employer securities, which is not in the best interest of employees).

34. See S. REP. NO. 93-383, at 33 (1973), reprinted in 1974 U.S.C.C.A.N. 4890, 4918 (stating that the limitation on investment by plans in employer securities does not apply to profit-sharing and stock-bonus plans because such plans are intended as an incentive to employees by allowing them to share in profits of the company); S. REP. NO. 93-127, at 34 (1973), reprinted in 1974 U.S.C.C.A.N. 4838, 4869 (explaining that imitation on employer securities and general principles of diversification do not apply to profit sharing plans in recognition of their "special purpose"). Congress was also persuaded that the profit sharing tradition, exemplified by the Sears Roebuck profit sharing pension plan which gave retirees quite generous benefits, should be preserved.

35. A number of provisions of the Internal Revenue Code make ESOPs very attractive from a tax standpoint. See *supra* note 23. There were favorable ESOP provisions in almost every tax bill considered by Congress in the 1970s and 1980s, although there has been some congressional retraction of ESOP benefits since then. See, e.g., Aaron Bernstein, *Why ESOP Deals Have Slowed to a Crawl*, BUS. WK., Mar. 18, 1996, at 101. Most recently, the Small Business Job Protection Act, signed by President Clinton on August 20, 1996, eliminated the authority of lenders to deduct 50% of the interest on loans used to set up an ESOP. See Small Business Job Protection Act of 1996, Pub. L. No. 104-88, § 1602 (1996).

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as a means of “strengthening the free private enterprise system.”³⁶ Importantly, Congress views ESOPs as a “means of transferring the ownership of a company’s capital to its workers” and not as a replacement for “traditional pension arrangements.”³⁷

Congress’s decision to limit acquisitions of employer securities only by defined benefit plans is no longer defensible as it was in 1974. The pension plan landscape today has changed dramatically since 1974, because of the trend of employers toward defined contribution rather than defined benefit plans³⁸ and because the vast bulk of employer securities are held by defined contribution plans.³⁹ Parts III and IV discuss the problems created and perpetuated by the failure to impose limitations on defined contribution plan acquisitions of employer securities.

B. *Voting and Tender of Employer Securities*

As a general matter, the trustee makes voting and tender decisions with respect to employer securities held by a pension plan.⁴⁰ In a defined benefit pension plan, the plan trustee acts on her own when making such decisions.

However, in defined contribution plans, voting and tender rights are typically passed through to plan participants. In some cases the Internal Revenue Code requires the passing-through of voting rights.⁴¹ Even when not required,⁴² the passing-through of voting and tender decisions in defined

36. Tax Reform Act of 1976, Pub. L. No. 94-455, § 803(h) (1976); H.R. CONF. REP. NO. 1515, at 5-8 (1976), *reprinted in* 1976 U.S.C.C.A.N. 4234, 4234-37. For example, Congress is a strong supporter of the use of ESOPs in the defense industry, believing that ESOPs offer a cost-effective means to support critical sectors of the U.S. defense industry. *See* S. REP. NO. 101-384, at 174 (1990). It has also been suggested that “Congress created ESOPs to encourage the survival of smaller businesses, to avoid a trend of larger companies consistently buying out smaller ones.” Adam Feibelman, *Thinking About Retirement is a Full-Time Job for Executive Financial Services Founder*, 18 MEMPHIS BUS. J., June 3, 1996, at 3 (citing Kelly O. Finnell of Executives Financial Services, Inc.).

37. *See* S. REP. NO. 101-249 (1990), *available in* 1990 WL 263545, at *205 (“Although ESOPs can become a valuable source of retirement income to supplement Social Security, pension benefits and personal savings, they are not designed (or intended) to be an employee’s sole or primary retirement savings vehicle, or a replacement for a traditional pension arrangement.”).

38. *See infra* notes 97-101 and accompanying text.

39. *See supra* note 10.

40. This is a function of the fact that the trustee has exclusive authority and discretion to manage and control plan assets. *See supra* note 15.

41. The Code requires that any defined contribution plan other than a profit-sharing plan must pass through to participants any vote of employer securities involving the approval or disapproval of transactions such as mergers, liquidation, dissolution, or sale of substantially all of the assets of the employer if the employer’s stock is not readily tradable on an established market and if more than 10% of the assets of the plan are employer securities. *See* I.R.C. § 401(a)(22) (1997). Additionally, section 409(e) of the Code requires that, with respect to allocated shares (whether or not vested), an ESOP pass through to participants either all votes (in the case of an employer with a registration-type class of securities) or votes on the types of transactions § 401(a)(22) that require pass-through voting (in the case of an employer without a registration-type class of securities). *See* I.R.C. §§ 401(a)(22), 409(e) (1997).

42. The Code contains no requirement that tender decisions be passed through to plan participants and nothing in ERISA requires the pass-through of voting or tender decisions. *See* Newton

contribution plans is common. This practice stems from the belief that shares "belong" to plan participants in that they are allocated to individual participants, and any gain or loss that results from holding the shares is borne by participants.⁴³ It seems appropriate to allow the person whose economic interests are at stake to decide whether or not to tender shares and to vote on issues that may be of importance to the participant.⁴⁴ Thus, in defined contribution plans, while the trustee actually makes the decision whether to tender, it does so in accordance with the instructions of beneficiaries (as is required by ERISA).⁴⁵ As Part IV of this Article demonstrates, no matter who makes the voting decision with respect to employer securities, there is a danger of promoting management entrenchment.

C. General Standards Applicable to ERISA Plan Fiduciaries

Before delving into the purported benefits and problems created by pension plan holdings of employer securities, it is useful to have a familiarity with the legal standards generally applicable to decisions by plan fiduciaries. Although ERISA uses the language of common law fiduciary relationships and is rooted in the common law of trusts,⁴⁶ the duties imposed on plan

v. Van Otterloo, 756 F. Supp. 1121, 1126 (N.D. Ind. 1991) (stating that nothing in ERISA grants participants the right to be solicited for proxies in a shareholder election).

43. Voting and tender decisions are rarely passed through in defined benefit plans. First, in defined benefit plans, assets are not allocated to individual beneficiaries. Each beneficiary has the right to receive a promised benefit upon retirement, but no right to any particular assets owned by the plan. No participant has the right to vote particular shares owned by the plan. Second, because each participant is entitled to a promised benefit, the primary risk of gain and loss on any asset held by the plan falls on the employer, not on the beneficiaries. Obviously, the employee still bears the risk that the employer will not have assets available to fund the promised benefit. Still, the fact that in the first instance it is the employer that bears the risk of investment failure means that beneficiaries have less of an interest in tender and voting decisions than does the employer.

44. In the early years of an ESOP, there may be a significant number of shares as to which no participants have an economic interest because such shares are unallocated. See *supra* note 22. Plans generally include special provisions dealing with the voting of such shares. See *infra* note 184 and accompanying text.

45. See *infra* notes 177-180 and accompanying text.

46. See *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101, 110-11 (1989); *Eaves v. Penn*, 587 F.2d 453, 457 (10th Cir. 1978) (noting that ERISA's fiduciary standards "embody a carefully tailored law of trusts"). The legislative history of the statute indicates that Title I of ERISA was intended to apply rules and remedies similar to those that under traditional trust law govern the conduct of fiduciaries. See H.R. REP. NO. 93-1280, at 295 (1974), reprinted in 1974 U.S.C.C.A.N. 5038, 5076; see also S. REP. NO. 93-127, at 29 (1973), reprinted in 1974 U.S.C.C.A.N. 4838, 4865 (noting that Congress intended to provide under ERISA the full range of legal and equitable remedies available under the common law of trusts); H.R. REP. NO. 93-533, at 12 (1973), reprinted in 1974 U.S.C.C.A.N. 4639, 4649 (noting that ERISA's fiduciary provisions codify principles developed in the law of trusts); 120 Cong. Rec. S15,737 (daily ed. Aug. 22, 1974), reprinted in 1974 U.S.C.C.A.N. 5177, 5186 (statement of Sen. Williams) (stating that ERISA's fiduciary provisions are intended to make applicable the law of trusts). Thus, even though ERISA departs from trust law, expanding the rights of participants and beneficiaries, see H.R. REP. NO. 93-533, at 312-13 (1974), reprinted in 1974 U.S.C.C.A.N. 4639, 4650-51, the law of trusts is a useful analogy for thinking about the actions of fiduciaries with respect to the voting and tender of employer securities. But see H.R. CONF. REP. NO. 93-1280, at 302 (1974), reprinted in 1974

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fiduciaries are statutorily defined in section 404 of ERISA.⁴⁷

Potentially relevant to both acquisition and voting decisions is the fiduciary duty of prudence. Section 404(a)(1)(B) of ERISA provides that a plan fiduciary must act “with the care, skill, prudence, and diligence under the circumstances then 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.”⁴⁸ The legislative history of this section and the case law indicate that although this fiduciary duty was taken from the prudent person standard developed under the common law of trusts, the ERISA standard is intended to be more stringent.⁴⁹ Courts have developed a standard of prudence that is objective; subjective good faith is not a defense to a claim of breach of the duty of prudence.⁵⁰ Courts have generally required plan fiduciaries to follow adequate procedures for thoroughly investigating the substantive merit of each decision affecting the plan,⁵¹ inquiring into the conduct of the fiduciary in investigating the relative merits of a decision, but not reevaluating the merits themselves.⁵² The fiduciary’s conduct is measured at the time the action is taken, rather than in hindsight, based upon the success or failure of the course of action.⁵³ Thus, while pension plans may acquire employer securities, the decision of a fiduciary to acquire such securities must be a prudent one.⁵⁴

Section 404 of ERISA provides that a fiduciary must diversify the investments of the plan to minimize the risk of large losses, unless under the

U.S.C.A.N. 5038, 5083 (noting that Congress directed the courts to interpret the fiduciary standards of ERISA “bearing in mind the special nature and purpose of employee benefit plans”); Daniel R. Fischel & John H. Langbein, *ERISA’s Fundamental Contradiction: The Exclusive Benefit Rule*, 55 U. CHI. L. REV. 1105, 1113 (1988) (suggesting that the differences between ordinary trusts and pension trusts “undercut the rationale for routine application of trust law rules to employee benefit plans”).

47. 29 U.S.C. § 1104 (1994).

48. 29 U.S.C. § 1104(a)(1)(B).

49. See *Donovan v. Mazzola*, 716 F.2d 1226, 1231 (9th Cir. 1983) (interpreting the prudent person test in light of both trust law and the importance of employee benefits); *Penn.*, 587 F.2d at 463 (noting employees’ “legitimate expectations of cash distributions upon retirement or termination”); see also *Central States, Southeast & Southwest Areas Pension Fund v. Cent. Transp., Inc.*, 472 U.S. 559, 570 (1985) (examining ERISA in light of common law of trusts and noting the importance of assuring financial integrity of plans).

50. See *Katsaros v. Cody*, 744 F.2d 270, 279 (2d Cir. 1984); *Donovan v. Cunningham*, 716 F.2d 1455, 1467 (5th Cir. 1983); *Mazzola*, 716 F.2d at 1231.

51. See *Cunningham*, 716 F.2d at 1467; *Mazzola*, 716 F.2d at 1232-33; *Arakelian v. National W. Life Ins. Co.*, 680 F. Supp. 400, 405-06 (D.D.C. 1987).

52. See *Cunningham*, 716 F.2d at 1467.

53. See *DeBruyne v. Equitable Life Assurance Soc’y of United States*, 720 F. Supp. 1342, 1347-49 (N.D. Ill. 1989), *aff’d*, 920 F.2d 457 (7th Cir. 1990); *Donovan v. Walton*, 609 F. Supp. 1221, 1238 (S.D. Fla. 1985); *Marshall v. Glass/Metal Ass’n & Glaziers & Glassworkers Pension Plan*, 507 F. Supp. 378, 384 (D. Haw. 1980); *American Communications Ass’n, Local 10 v. Retirement Plan for Employees of RCA Corp.*, 488 F. Supp. 479, 483 (S.D.N.Y. 1980), *aff’d*, 646 F.2d 559 (2d Cir. 1980).

54. See *Fink v. National Sav. & Trust Co.*, 772 F.2d 951, 955 (D.C. Cir. 1985) (applying prudence standard to acquisition of employer securities by the trustee of a profit sharing plan).

circumstances it is clearly prudent not to do so.⁵⁵ While such language may seem comforting, Part III demonstrates that it does little to prevent insufficient diversification of pension plan assets.

Of primary significance in terms of evaluating voting and tender decisions by plan fiduciaries is the duty of loyalty. Section 404(a) of ERISA provides that plan fiduciaries must discharge their duties "solely in the interest of" the participants and beneficiaries.⁵⁶ Section 404(a)(1)(A) adds that fiduciaries must discharge their duties for the "exclusive purpose" of providing benefits to participants and their beneficiaries.⁵⁷ Together, the "solely in the interest of" and 'exclusive purpose' provisions are viewed as imposing on fiduciaries a duty of "complete loyalty to participants."⁵⁸ A breach of the duty of loyalty occurs when a fiduciary acts in her fiduciary capacity to benefit her own personal interest⁵⁹ or the interest of a third party⁶⁰ rather than the interest of a plan participant or beneficiary.

In addition to the general standards of fiduciary behavior set out in section 404 of ERISA,⁶¹ section 406 sets out certain prohibited transactions,⁶² several

55. See 29 U.S.C. § 404(a)(1)(C) (1994); see also *infra* note 94 and accompanying text.

56. 29 U.S.C. § 1104(a) (1994). The "solely in the interest of" language is derived from the Code and the Taft-Hartley Act. See I.R.C. § 401(a)(2) (1997); Labor Management Relations (Taft-Hartley) Act §§ 1-303, 29 U.S.C. §§ 141-187 (1988). It also has its roots in the law of trusts. See RESTATEMENT (THIRD) OF TRUSTS § 170(l) (1992) (imposing on trustee a "duty to administer the trust solely in the interest of the beneficiaries.").

57. 29 U.S.C. § 1104(a)(1)(A). The exclusive benefit rule is not violated by actions designed to defray "reasonable expenses of administering the plan." *Id.* The Code also has an exclusive benefit rule. Section 401(a)(2) of the Code provides that pension plan assets may not be used for any purposes other than for the exclusive benefit of employees or their beneficiaries. I.R.C. § 401(a)(2). Whereas violation of ERISA's exclusive benefit rule may result in personal liability of the fiduciary, violation of the Code provision may result in plan disqualification. See, e.g., *Winger's Dep't Store, Inc. v. Commissioner*, 82 T.C. 869 (1984).

58. *Donovan v. Bierwirth*, 680 F.2d 263, 271 (2d Cir. 1985). The duty of loyalty is separate from the duty of care/prudence discussed below, and it therefore may provide means for a recovery even if a fiduciary's conduct is found to have been prudent. See, e.g., *Leigh v. Engle*, 727 F.2d 113, 124 (7th Cir. 1984). However, courts will often rely on evidence establishing imprudence to also establish a breach of the duty of loyalty. Therefore, when there is a violation of the duty of prudence there will generally also be a violation of the duty of loyalty. See, e.g., *Bierwirth*, 680 F.2d at 270.

59. For examples of violations involving self-dealing, see *Dasler v. E.F. Hutton & Co.*, 694 F. Supp. 624, 632 (D. Minn. 1988) (noting that the stockbroker, determined to be a fiduciary, breaches duty to a plan by churning the plan's account); *Marshall v. Mercer*, 4 Employee Benefits Cas. (BNA) 1523, 1533-35 (N.D. Tex. 1983) (finding that the trustee breaches duty by failing to take any steps to collect on plan loans to himself and his wholly-owned corporation); *Donovan v. Daugherty*, 550 F. Supp. 390, 409-10 (S.D. Ala. 1982) (finding that trustees breach duty by allocating plan contributions to themselves).

60. For examples of fiduciary breaches involving a fiduciary acting for the benefit of a third party, see *Pension Benefit Guar. Corp. v. Solmsen*, 671 F. Supp. 938, 945-46 (E.D.N.Y. 1987) (holding that a fiduciary breaches a duty by using employee contributions for corporate purposes); *Donovan v. Williams*, 4 Employee Benefits Cas. (BNA) 1237, 1245 (N.D. Ohio 1983) (holding that trustees breach a duty when they fail to collect employer contributions and permit diversion of assets to union).

61. Section 404(a)(1)(D) of ERISA also provides that a fiduciary must act in accordance with the plan documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this subchapter. See 29 U.S.C. § 1104(a)(1)(D) (1994). The question that may arise with respect to voting and tender decisions is whether a fiduciary must follow the plan

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of which are potentially relevant to voting and tender decisions. A literal reading of those provisions would suggest that voting and tender decisions with respect to employer securities must be made in a manner that avoids the use of plan assets for the benefit of a party in interest,⁶³ self-dealing,⁶⁴ and acting in a conflict of interest situation.⁶⁵

II. Purported Benefits of Plan Investments in Employer Securities

Employers view investment in employer securities by pension plans as beneficial. Employers believe that putting their stock in the hands of plan participants aligns the interests of participant-employees with those of shareholders, thus encouraging greater productivity.⁶⁶ They also believe that employee ownership results in a perception by employees of greater influence over their employer, which may have a positive effect on employee morale.⁶⁷ There is, in fact, some evidence that companies with high amounts of employee ownership grow faster than those without such ownership.⁶⁸

documents even where doing so would be inconsistent with another ERISA provision. A number of courts have held that where the plan documents require a fiduciary to perform some duty that would violate ERISA, the fiduciary has a superior duty to adhere to the ERISA prescriptions. *See, e.g.,* Winer v. Edison Bros. Stores Pension Plan, 593 F.2d 307, 314 (8th Cir. 1979) (finding that ERISA supersedes "bad boy" clauses in plan document); *Newton v. Van Otterloo*, 756 F. Supp. 1121, 1127 (N.D. Ind. 1991) (stating that duty of loyalty supersedes discretion allowed by plan documents).

62. *See* 29 U.S.C. § 1106(a), (b) (1994).

63. *See* 29 U.S.C. § 1106(a) (stating that transactions with parties in interest that are expressly prohibited by ERISA will also generally give rise to excise tax under the Code); *see also* 29 U.S.C. § 1002 (1994) (defining the term "party in interest" to a plan to include, inter alia, fiduciaries of a plan, persons providing services to the plan, any employer whose employees are covered by the plan or a 50% owner of such employer, and employees, officers, or directors of such employer).

64. *See* I.R.C. § 4975 (c)(1)(e) (1997); 29 U.S.C. § 1106(b)(1) (1994).

65. *See* 29 U.S.C. § 1106(b)(2) (1994).

66. *See* Capell, *supra* note 1 (citing the goal of Sanford Weill, CEO of the Travelers Group, of getting the majority of Travelers employees to hold company stock in order to get everyone "to think like owners and build our wealth beyond what we would get in cash compensation"); Ed Carberry, *Employee Stock Ownership Plans: Uses and Advantages*, PLASTICS ENGINEERING, June 1, 1995, at 25 (asserting that ESOPs create a competitive edge by making employees more involved and concerned about the company's success); Mary Ellen Podlolik, *UAL Posts Profit in 1st Quarter*, CHI. SUN-TIMES, Apr. 26, 1995, at 67 (reporting that UAL Chairman Greenwald attributed positive first quarter performance, which followed dismal previous performance, in part to the implementation of an ESOP).

67. *See* Asron A. Buchko, *Employee Ownership, Attitudes, and Turnover: An Empirical Assessment*, HUM. REL., July, 1992, at 711 (discussing fact that employee perception of control has a stronger impact on employee commitment and turnover than the value of the ESOP); *ESOPs Overwhelmingly Performed Better and Increased Productivity in 1995, the Employee Ownership Foundation Finds*, PR Newswire, Oct. 1, 1996 available in WL, PRWIRE Database (reporting survey results that companies see a marked improvement in morale as a result of establishing an ESOP).

Employers also view the acquisition of employer securities by pension plans as a way of placing such securities in "friendly hands." In that sense, they view the acquisition not in terms of the benefit to company growth or to employees but rather as an anti-takeover device. *See infra* notes 142-143 and accompanying text.

68. *See* Carberry, *supra* note 65 (noting that highly participative companies grow 8% to 11% faster); Giblin et al., *supra* note 23, at 42 (reporting that from January 1991 to December 1994, the stock price performance of an index of about 350 public companies with at least 10% broad-based employee

Despite that evidence, there are reasons to question the purported benefits of employee ownership. First, the evidence suggests that of increased worker productivity and company growth is usually short-term.⁶⁹ It makes some sense that the initial euphoria over newly obtained employee stock ownership, for example, would cause employees to work harder or feel better about their employer. However, none of the evidence of increased productivity and growth demonstrates that the gains will be sustained over time. Thus, they do not necessarily result in a long-term benefit to the employer. In addition, from the employees' point of view, when we are talking about pension plan acquisitions of employer securities, only long-term gain is meaningful, because employees do not have access to their retirement funds until retirement. There is nothing to suggest that any increased productivity and growth will result in increased pension benefits.

Second, there is evidence suggesting that in those instances where employee ownership has a positive impact on corporate performance, the increased growth results because employee ownership is coupled with a participative management style.⁷⁰ The mere fact of employee ownership itself is not enough to create the positive results. For example, United Airlines is a company where significant employee ownership has resulted in increased productivity and profitability. However, the agreement reached between the company and its employees not only gives employees ownership of 55% of the company, but also gives them majority voting rights in the company, increased job security, three out of twelve places on the boards of directors, and veto power over major company decisions.⁷¹ In contrast, a study of 562 public companies revealed that while employees own an average of 13% of those companies, employees have board seats in fewer than a dozen of them.⁷²

Even if one accepts the general proposition that employee ownership is beneficial either because it increases worker productivity or for any other reason, one need not accept that such ownership should be fostered through pension plan acquisition of employer securities. None of the supposed aims of employee holdings of employer securities are advanced when a defined

ownership was more than double that of both the Dow Jones Industrial Average and the S&P 500); Gene Koretz, *How Japan Perks Up Productivity*, BUS. WK., Aug. 28, 1995, at 24 (reporting result of a study of Japanese manufacturing companies finding that companies setting up an ESOP reaped a 4% to 5% boost in productivity, usually after three to four years). *But see infra* notes 70-72 and accompanying text (suggesting that increased growth is not due to employee stock ownership alone).

69. Gains have generally been noted following adoption of a plan or within several years after adoption. *See sources cited supra* notes 65-67.

70. *See, e.g.*, Richardson, *supra* note 22, at 31 (noting that employee ownership combined with participative management yields greater productivity than passive employee ownership); George K.Y. Tseo & Eduardo L. Ramos, *Employee Empowerment: Solution to a Burgeoning Crisis?*, CHALLENGE, Sept.-Oct. 1995, at 25 (stating that while there is a weak positive correlation between productivity and worker ownership, there is stronger evidence that productivity and growth are correlated to equity ownership combined with worker participation in management).

71. *See* Susan Chandler, *United We Own*, BUS. WK., Mar. 18, 1996, at 96.

72. *See* Bernstein, *supra* note 34 (citing a study by Joseph R. Blasi of Rutgers University).

benefit pension plan invests in employer securities. Because defined benefit plans promise a fixed retirement benefit determined by a formula, assets of those plans are not allocated to individual employees.⁷³ An investment in employer securities, like any other investment by a defined benefit pension plan, merely supports the employer's obligations to pay pension benefits to participants, thus affecting the employer's required contributions to the plan.⁷⁴ However, because participants receive whatever benefit they have been promised by the employer regardless of where plan funds are invested or how the investments perform, neither the fact of the investment nor the performance of the employer's stock has any effect on the actual benefit paid to plan participants. Thus, ownership of employer securities by the plan does not give any beneficial ownership to plan participants. Indeed, it is quite likely that a defined benefit plan participant would not even have any knowledge of whether or not the plan had an investment in employer securities.⁷⁵

While both ESOPs and 401(k) plans do provide incidents of the benefits of ownership to plan participants, there is no reason to think that holding employer securities through such plans is the best way to achieve the benefits of employee stock ownership. The purported benefits of employee ownership flow simply from the fact of owning employer securities by employees, not from the form or means by which such shares are owned.⁷⁶ If employee ownership does lead to improved worker productivity, it is more likely to do so when employees hold stock directly than when they hold it through their pension plans. If anything, an employee's alignment with shareholder interests and perception of influence over the employer should be greater when the employee has shares of the employer's stock in hand than when the employee has only a right to receive such shares many years in the future.⁷⁷ This is

73. See 29 U.S.C. § 1002(35) (1994) (defining a defined benefit plan as "a pension plan other than an individual account plan"); Peter T. Scott, *A National Retirement Income Policy*, 44 TAX NOTES 913, 919 (1989) (asserting that "defined benefit plans do not establish individual accounts for each participating employee. Instead, plan assets are pooled in a trust which is funded to meet the aggregate benefit demands of the plan participants").

74. In the words of one commentator, in a defined benefit plan, "the pension fund is simply collateral for the promise of a defined level of retirement payout to be made by the employing firm." Gordon, *supra* note 32, at 24.

75. The summary plan description that ERISA requires a plan sponsor to provide to plan participants is not required to disclose where defined benefit funds will be invested. See 29 U.S.C. § 1022(b) (1994). The only disclosure as to the use of funds that is required by statute or regulation is where an insurance company or similar entity is maintaining a fund through which benefits are to be provided to plan participants. See 29 C.F.R. § 2520.102-3(q) (1997).

76. Although some commentators have noted improvements in employee morale following adoption of an ESOP, *see supra* note 67 and accompanying text, for the most part, those who liked such a link speak of employee ownership improving productivity and generally not of ownership through plans.

77. In the early days of an ESOP, before a significant number of shares are allocated to employees, *see supra* note 25 and accompanying text, the employees have no relationship to the shares at all. In the words of one of ERISA's sponsors testifying before the Joint Economic Committee in 1975, it is difficult to perceive "how workers suddenly can become more productive upon the receipt of stock

particularly true for younger employees, who may have difficulty being motivated by the beneficial ownership of shares whose value will not matter to them for twenty five or thirty years.⁷⁸

Thus, rather than offering employer stock as part of an employee's retirement income, an employer wishing to obtain the benefits of employee stock ownership can offer employees bonus stock or options to purchase shares of the employer's securities as part of the employees' current compensation. Given that the motivation for offering employees stock ownership is a non-retirement goal—in the sense that the direct benefit the employer seeks to achieve from such ownership is a current benefit to the employer flowing from increases in employee productivity and employee morale—it makes sense to seek that goal through current compensation. Ultimately, the function of a retirement plan is to provide retirement income. Non-retirement goals should be met in ways that do not interfere with a pension plan's retirement income provision function.

To be sure, there are differences—from both the employer's and the employee's perspective—between offering stock as part of a retirement plan and as a portion of current income.⁷⁹ An ESOP offers favorable tax advantages to an employer who wants to grant stock outright, thus costing less than a current grant of bonus stock.⁸⁰ Moreover, although bonus stock and options can both be granted with a vesting period, once the awards become nonforfeitable, nothing prevents employees from selling the shares. In fact, many employees exercise options and immediately sell shares as soon as the

by an encumbered trust in which they have no voting right and no financial relationship." Roger E. Alcaly, *Reinventing the Corporation*, N.Y. REV. OF BOOKS, Apr. 10, 1997, at 38, 40 (citing former Sen. Jacob Javits).

78. See William Smith et al., *Employee Stock Ownership Plans: Motivation and Morale Issues*, COMPENSATION AND BENEFITS REV., Sept. 1, 1990, at 37 (noting that "most contemporary motivation theories" suggest the desirability of "a close chronological link between effort and reward" and suggesting that it is difficult for ESOPs to motivate employees because of the long lag between effort and reward).

79. There is not necessarily any difference from a securities law point of view. The registration requirements contained in § 5 of the Securities Act of 1933 generally require registration of options and of employer securities to be acquired through 401(k) plan investment, since each involves a purchase of securities by the employee. See 15 U.S.C. § 77(e) (1994). Where registration is necessary, it may be done pursuant to a special form, Form S-8, that is available for employee benefit plans. The S-8 registration involves considerably less cost than general registration. See Registration and Reporting Requirements for Employee Benefit Plans, Exchange Act Release No. 33-6867 (June 6, 1990), available in 1990 WL 310688, at *2. Employers sometimes avoid the need to register option plans by making options available to only a small group of management-level employees, relying on either the exemptions from registration provided in Regulation D or in Rule 230.701 under the Securities Act of 1933. See 17 C.F.R. §§ 230.504-.506, .701 (1997). Neither an ESOP nor the granting of bonus stock as current income requires registration, since neither involves a purchase of securities. See Employee Benefits Plans, Exchange Act Release No. 33-6281, available in 1981 SEC LEXIS 2260, at *7 (Jan. 15, 1981).

80. See *supra* note 25.

options are vested.⁸¹ Thus, in order to maintain the incentive-based feature, employers must continue to make future grants to keep employee interests aligned with those of shareholders. Employers already offer future grants, however, because stock option plans commonly provide for annual grants to employees.⁸² If an employer believes there is sufficient benefit to the company from employee ownership of stock, it will be willing to make such periodic grants to maintain employee incentive.

There is also a tax difference to employees. An employee recognizes no income from either ESOP allocations or funds invested in a 401(k) plan until the employee receives a distribution from the plans upon retirement.⁸³ Bonus stock granted to an employee, which generally vests (becomes non-forfeitable) over a period of time,⁸⁴ becomes taxable at the time the employee vests in the shares,⁸⁵ and stock options generate taxable income either at the time the option is exercised or at the time shares obtained upon exercise are sold, depending upon the nature of the options.⁸⁶ However, the incentive effect of the stock in the hands of the employee is the same whether or not the stock was issued through a retirement plan.

Finally, even if there is some benefit in allowing some portion of an employee's investment in employer securities to be through pension plans, none of the evidence promoting employee stock ownership suggests a linear relationship between the benefit and the amount of the holdings. Thus, there is nothing to suggest that the massive accumulations of employer securities permitted to be held by defined contribution pension plans under current law are necessary to achieve the purported benefits of employee stock ownership. As will be further discussed in the following parts, I propose limits on pension

81. According to a 1996 study, two-thirds of the exercise activity of lower-level employees occurs six months after the options are vested and "in the money." Overall, 90% of the employees in the study sold their stock right after exercise. See Capell, *supra* note 1; see also Andrew R. Brownstein & Morris J. Panner, *Who Should Set CEO Pay? The Press? Congress? Shareholders?*, HARV. BUS. REV., May-June 1992, at 28, 35 (noting that less than 50% of the shares acquired upon exercise of stock options are held for a significant period of time); Joshua A. Kreinberg, *Reaching Beyond Performance Compensation in Attempts to Own the Corporate Executive*, 45 DUKE L. J. 138, 154 (1995) (noting that American executives hold employer securities less than two years on average).

82. See *Gaining in Popularity Among All Types of Companies: Annual and Long-Term Incentives*, COMPENSATION & BENEFITS REV., Mar. 1, 1989, at 4 (noting that 75% of public companies surveyed make yearly stock option grants, and that many companies also make annual restricted stock awards); Stephanie Y. Wilson, *When is Compensation Not Enough? Rethinking How to Reward the Workforce*, COMPENSATION & BENEFITS REV., Jan. 11, 1997, at 59 ("Most organizations reward employees on a 12-month cycle—annual merit increases, incentive payouts, or stock-option grants.").

83. See I.R.C. § 402(a) (1997).

84. See *supra* note 5.

85. When an employee is compensated with stock, or other property of the employer, the employee is subject to tax in the first taxable year in which the rights of the employee are transferable or are not subject to a substantial risk of forfeiture. See I.R.C. § 83(a) (1997).

86. See I.R.C. § 421(a) (1997). Normally, the employee would recognize income at the time the option is granted. However, if the employee has been granted an incentive stock option, which meets the requirements of section 422(b) of the Code, income recognition is deferred until the employee sells the shares acquired pursuant to the option exercise. See I.R.C. § 422(b) (1997).

plan acquisitions of employer securities, but would still allow employees to accumulate a reasonable amount of employer stock through their plan holdings. Those holdings, along with shares an employee holds outside of an individual's pension plan, should achieve the goals sought.

III. Insufficient Diversification of Retirement Assets

A. *The Diversification Problem*

A major problem with significant investment in employer securities by pension plans is that participants' retirement assets are less diversified. Employer-sponsored pension plans represent one of the three basic sources of retirement income,⁸⁷ the other two being private savings and Social Security. Both the failure of most Americans to accumulate significant retirement savings apart from their employer-sponsored pension plans⁸⁸ and concern about the future reliability of Social Security⁸⁹ make it important that employer-sponsored pension plan savings be sufficiently diversified to minimize the risk of loss of adequate retirement income. If a participant has a well-diversified portfolio of retirement savings, her risk from a downturn in

87. Pension plans currently hold over \$4 trillion in assets and provide more than \$300 billion in retirement benefits annually, which is greater than the benefits provided by Social Security. See *Promoting and Expanding Pensions for American Workers: Hearings before the Subcommittee on Employer-Employee Relations of the House Committee on Economic and Educational Opportunities*, 104th Cong. 230 (1996) (testimony of Rita D. Metras, Director of Benefits Policy-Pension and Savings Plans).

88. The rate of savings of Americans is generally so low that such funds are vastly insufficient to afford a comfortable retirement. See, e.g., Lewis Keller, *Sound Investment Policies for an Aging Population*, SAN FRAN. BUS. TIMES, July 19, 1996, available in 1996 WL 10042468 (noting that three in four of today's workers admit their savings are inadequate); Diane E. Lewis, *First Job? Start Socking Away Retirement*, COMM. APPEAL, July 21, 1996, at C3 (reporting a 1995 Rand Corporation study finding that the rate of savings among Americans has dropped to 4% of annual income in 1993 from 6.4% in 1959). The reality is that most workers find it difficult to accumulate personal savings for retirement benefits because "their paychecks are used to meet the demands of day-to-day living expenses." *Democratic Leadership Introduces Clinton's Pension Reform Package*, BNA PENSIONS & BENEFITS DAILY, May 28, 1996, at 23 (quoting Sen. Thomas A. Daschle).

89. See, e.g., *Social Security Advisory Council Report: Hearings before the Senate Finance Committee on Social Security and Family Policy*, 104th Cong. 52 (1996) (testimony of Olivia S. Mitchell) (citing projection of Social Security trustees that Social Security tax revenue will be less than currently-legislated benefits after the year 2013, and that the Social Security trust fund will be depleted by 2030); Kathy M. Kristof, *Candidate Lamm Stressing Social Security Alternatives*, AUSTIN AMERICAN STATESMAN, July 21, 1996, at E5 (reporting the conclusion of a bipartisan congressional panel that, if nothing changes, Social Security will be bankrupt by the year 2029 and the conclusion of the National Taxpayers Union that Social Security will be running such a deficit by 2020 that the government would have to raise employment tax rates by more than 50% to avoid cutting benefits to retirees); Lewis, *supra* note 87, at C3 (reporting a 1995 Rand Corporation study concluding that the Social Security Administration is in such bad shape it might not be around in 50 years). In any event, Social Security alone, which provides an average of 40% of pre-retirement income, does not provide sufficient retirement income. See *Democratic Leadership Introduces Clinton's Pension Reform Package*, *supra* note 87, at 23 (quoting Labor Secretary Robert Reich).

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any single investment is relatively low.⁹⁰ If, instead, a significant portion of retirement savings is concentrated in a single investment, such as employer securities, the overall effect of a downturn in that investment can be devastating.⁹¹

Overinvestment in employer securities by pension plans is even more potentially damaging than a general lack of diversification in an investment portfolio. Significant accumulation of employer securities puts employees at a double risk: If the employer's fortunes decline, employees lose both their current job security and their future retirement security.⁹² Additionally, even if employee ownership translates into higher returns on the employer's securities because of increased productivity (a conclusion I have already shown reason to question), the employee cannot capture any gains until retirement. Not only may productivity gains be temporary in nature, but general economic or other factors may contribute to a decline in the value of an employer securities.⁹³ Therefore, the benefits may not be realized in a long-term

90. Indeed, as one commentator has noted in discussing shareholder diversification, participants generally "may even profit elsewhere in their portfolio as a result of reverses suffered by one of the firms whose stock they own." Ronald M. Green, *Shareholders as Stakeholders: Changing Metaphors of Corporate Governance*, 50 WASH. & LEE L. REV. 1409, 1414 (1993).

91. An employee with a significant portion of her retirement portfolio tied up in her employer's securities can be analogized to a close corporation shareholder. In general, the investment by a shareholder in a close corporation represents a disproportionately large portion of the shareholder's disposable assets. See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271, 273 (1986); Brent Nicholson, *The Fiduciary Duty of Close Corporation Shareholders: A Call for Legislation*, 30 AM. BUS. L.J. 513 (1992) (asserting that close corporation shareholders often "center their financial lives" on the corporation). However, in recognition of the risks imposed on the close corporation shareholder as a result of this concentration of personal assets in a single investment, the law does many things designed to protect the shareholder's investment in the close corporation, including providing means to allow shareholders to participate directly in the management of the close corporation and allowing aggrieved shareholders the means of dissolving a close corporation. See, e.g., CAL. CORP. CODE § 1800 (b)(4) (West 1990) (allowing shareholders to petition for dissolution in case of illegality, oppression or fraud); N.Y. BUS. CORP. LAW § 620(b) (McKinney 1986) (permitting a certificate provision allowing shareholders to manage directly the close corporation); § 1104(a) (allowing shareholders to petition for dissolution for board or shareholder deadlock or because those in control acted illegally, oppressively or fraudulently). Lamentably, except for the very limited protection afforded ESOP participants nearing retirement by I.R.C. § 401(a)(28) (1997), the law does not show the same solicitude for pension plan participants whose retirement eggs are all in one basket.

92. See S. REP. NO. 93-383, at 100 (1973); reprinted in 1974 U.S.C.C.A.N. 4890, 4893 (noting that even if an employer's stock is generally a high grade investment, employer stock acquisition by pension plans adds a "substantial risk factor" from employees' standpoint because declining firm fortunes jeopardize both current job and future pension benefit).

93. A General Accounting Office ("GAO") study of ESOPs between 1981 and 1987 demonstrated the risk inherent in linking retirement security to the performance of an employer's stock. The GAO found a wide range of account balances, some of which were nearly worthless. It also found a higher than expected termination rate among ESOPs, raising questions about whether current ESOP plan participants would receive significant retirement benefits. See *Participants' Benefits Generally Increased, But Many Plans Terminated*, GAO/HRD 91-28 (Dec. 10, 1990). The report noted that the risks are especially significant "at the many companies where the ESOP is the only company retirement plan available to employees." *Id.*; see also S. REP. NO. 101-249 (1990), available in 1990 WL 263545 (LH), at *215 (noting that because "the value of a company's shares can fluctuate over a wide range in

investment such as a pension plan.

For employees whose employer maintains a defined benefit pension plan that offers meaningful retirement benefits, diversification is not a significant concern. As already discussed, the general fiduciary standards imposed by ERISA include a duty to diversify the investments of such a plan "so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so,"⁹⁴ and, in any event, employer securities held by defined-benefit pension plans may not exceed 10% of the fair market value of the plan's total assets.⁹⁵

Historically, defined benefit plans were the dominant form of pension plan, meaning that plan investments in employer securities did not create a significant problem of lack of diversification.⁹⁶ However, while there are still some employers who maintain only defined benefit pension plans or who maintain both a defined benefit and a defined contribution plan,⁹⁷ a defined contribution plan is the sole source of employer-sponsored pension income for many employees.⁹⁸ As a result of both increased regulation of defined benefit pension plans and the change in the American workforce away from a career model of employment,⁹⁹ the trend is away from the establishment of defined

response to the employer's fortunes, an ESOP cannot be considered a secure primary retirement vehicle for participants").

94. 29 U.S.C. § 1104(a)(1)(C) (1994). Courts are often quite lenient when faced with challenges to a fiduciary's fulfillment of this duty, *see, e.g.*, *Leigh v. Engle*, 727 F.2d 113, 116, 129 (7th Cir. 1984) (accepting a fiduciary's position that investing 30% of assets in three common stocks was sufficiently diversified); *Sandoval v. Simmons*, 622 F. Supp. 1174, 1199, 1208 (C.D. Ill. 1986) (accepting that a plan holding 18% of its equity assets in a single stock and 32% in three stocks was sufficiently diversified).

95. *See* 29 U.S.C. § 1107(a)(2) (1994).

96. *See* RICHARD A. IPPOLITO, *PENSIONS, ECONOMICS AND PUBLIC POLICY* 81 (1986).

97. *See* Report of the General Accounting Office to the House Committee on Government Reform and Oversight, GAO/GGD 97-1, *available in* 1996 WL 581458, at *6 (Oct. 3, 1996) [hereinafter GAO Report] (in 1993, 3% of employers sponsoring single-employer private pension plans offered both defined benefit and defined contribution plans, although a higher percentage of larger employers offered both types of plans); Nancy C. Pratt, *The Road to Retirement*, 28 *COMPENSATION & BENEFITS REV.* 14, *available in* 1996 WL 9950847, at *4 (Jan. 1, 1996) (citing a Hewitt Associates survey of 1034 companies that found that about 80% of major employers offer both types of plans).

98. *See* GAO Report, *supra* note 97, *available in* 1996 WL 581458, at *6 (reporting that in 1993, 88% of private employers with single-employer pension plans sponsored only defined contribution plans, in contrast to 68% offering only defined contribution plans in 1984); Adam Bryant, *Betting the Farm on Company Stock*, N.Y. TIMES, Apr. 16, 1995, § 3, at 2 (noting a study showing that between 1980 and 1986, 9700 companies switched from defined benefit to defined contribution plans). This is an important point. It would be a mistake to view 401(k) plans as a supplemental plan providing a tax-deferred investment for affluent employees. For many employees, their 401(k) plan is their only meaningful source of retirement income.

99. *See* GAO Report, *supra* note 97, *available in* 1996 WL 581458, at *20 (suggesting several reasons for employers' preference for defined contribution over defined benefit plans, namely the increasingly complex government regulation of defined benefit plans, an increase in the number of employer-terminating defined benefit plans used to acquire capital assets, and the increasing desire of employees to have portability of pension benefits).

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benefit plans and toward that of defined contribution plans.¹⁰⁰ Since that trend can be expected to continue,¹⁰¹ the way of the future is 401(k) plans and ESOPs, neither of which is subject to any limit on holdings of employer securities,¹⁰² and which even today hold the vast bulk of the employer securities in pension plans.¹⁰³

Participant-directed 401(k) plans give the appearance of offering significant diversification options. In order for employers to minimize the risk that they will be subject to liability for participant losses, plans must have a wide range of investment options to choose from.¹⁰⁴ However, the reality is that participants in plans offering an employer security option invest a disproportionate portion of their plan account balances in that investment choice. Although investment advisers generally recommend investing no more

100. The balance between defined benefit and defined contribution plans has shifted substantially in recent years. See GAO Report, *supra* note 97, available in 1996 WL 581458, at *6 (asserting that employers are increasingly providing retirement benefits through defined contribution plans and that the growth in defined contribution plans between 1984 and 1993 occurred without regard to size or kind of business); Pratt, *supra* note 97, available in 1996 WL 9950847, at *4 (noting that defined contribution plans, such as 401(k)s, are the most frequently available retirement plan types and are steadily gaining in popularity); Bryant, *supra* note 97, § 3, at 2. The shift from defined benefit plans to defined contribution plans worries many people. While defined contribution plans offer greater portability, the risk of loss is shifted from the employer to the plan participant (since the plan participant is entitled at retirement only to the value of his account). At the same time, investment decisions are being made by unsophisticated employees rather than professional asset managers. See, e.g., Vanessa O'Connell, *Market Bumps Rattle Nerves at 401(k)s*, WALL ST. J., Aug. 23, 1996, at C1 (citing a case in which 401(k) plan investors responded to a downturn in the market by dumping shares of stock funds when the market was down and then purchasing the shares again after stock prices rose); *The Long Haul, Investing in Your Retirement Plan*, THE RECORD, May 12, 1996, at B1 (stating that ordinary workers do not know enough to invest wisely, "regularly moving from cold investments to hot investments, just as the hot investments are turning cold"). In addition, defined contribution plans do not have the advantage of being insured by the Pension Benefit Guaranty Corporation, as do defined benefit plans. See 29 U.S.C. § 1321(b)(1) (1994) (exempting individual account plans from ERISA's Title IV insurance program).

101. The reasons for the shift remain, making it unlikely that employers will begin shifting back toward defined benefit plans.

102. See 29 U.S.C. § 1107(b)(1) (1994) (exempting eligible individual account plans from the 10% limit); 29 U.S.C. § 1108(e) (1994) (exempting ESOPs from the 10% limit); 29 U.S.C. § 1104(a)(2) (1994) (providing that the diversification requirement of section 404 of ERISA is not violated by eligible individual account plan's acquisition of employer securities).

103. See *supra* note 23.

104. Since an employer has control over the arrangements of the plan and usually bears the ultimate responsibility for its administration, the employer is a fiduciary. Section 404(c) of ERISA provides a limited exception to the strict fiduciary liability rules in cases where the participant or beneficiary exercises independent control over the plan assets. See 29 U.S.C. § 1104(c) (1994). Section 404(c) states that while a participant or beneficiary who exercises control over the plan assets will not be a fiduciary, the plan fiduciary will not be responsible for losses resulting from the participants' actions in the exercise of control. See *id.* The Department of Labor has issued detailed regulations that describe when 404(a) will apply. See 29 C.F.R. § 2550.404c-1 (1997). The regulations provide that for a participant to be exercising control over the plan assets, the participant must be able to (1) choose from a broad range of investments, consisting of at least three diversified investment alternatives; (2) give investment instructions with whatever frequency is necessary; (3) diversify investments among stated alternatives; and (4) receive sufficient information to make informed investment decisions. See *id.*

than 5% to 15% of an investment portfolio in any single stock,¹⁰⁵ participants in defined contribution plans offering an employer stock option invest an average of 33% in company stock.¹⁰⁶ The obvious implication of the word "average" is that there are plans with significantly higher levels of investment in employer stock.¹⁰⁷ For example, until 1991, Idaho Power Co. offered only employer stock as an investment option. Partly as a result of employee requests, the company began to offer a range of investment options. However, three years after the plan was changed, 90% of the plan's assets were still invested in employer securities.¹⁰⁸

A number of explanations have been offered for the heavy 401(k) plan investment in employer securities. One is direct or indirect employer influence. Such influence may take the form of employers, letting it be known that they look kindly upon employees' investing in employer securities. Alternatively, many employers actively promote employee stock accumulation by making 401(k) matching contributions solely in the form of employer securities¹⁰⁹ or by offering stock to employees at a discount.¹¹⁰ A

105. See Jonathan Clements, *Portfolio Pushups*, PITTSBURGH POST-GAZETTE, Feb. 5, 1996, at B6 (suggesting that no more than 10% of equity investment should be riding on any one stock); Charles A. Jaffe, *Just Say No to These Retirement Options*, CHI. TRIB., June 5, 1996, at 5 (explaining that financial advisers suggest holding no more than 15% of an investment portfolio, including both retirement and taxable accounts, in individual stocks or sector funds); Christine Philip, *Company Stock Stays at Top of Heap*, PENSIONS & INVESTMENTS, Apr. 17, 1995, at 30 (explaining that investment advisers recommend investing no more than 5% of a portfolio in a single stock). Many of these investment advisers also suggest that investors should be even more conservative with investments in employer securities, since if the employer experiences a downturn, the employee faces unemployment as well as loss of retirement savings. See Clements, *supra*; Jaffe, *supra*.

106. See Philip, *supra* note 104, at 30 (explaining that high employer stock allocations in defined contribution plan accounts are common in publicly held companies of all sizes and citing data from *Pensions & Investments'* directories of the largest U.S. pension funds showing that defined contribution plans among the largest 200 and the next 800 employers have held between 21% and 25% of total plan assets in company stock for the past five years, with little difference between the allocations of large and small companies); see also Gordon, *supra* note 32, at 23 (stating that "disturbingly," almost half of the equity investment in 401(k) plans is in employer securities).

107. See Philip, *supra* note 104, at 30 (citing examples of Proctor & Gamble Co. with 91% of plan assets invested in employer securities, Ford Motor Co. with 65%, Bell Atlantic Corp. and Southwestern Bell Corp. with 68% and 67%, respectively, J.C. Penney Co., Inc. with 73%, and Kimberly-Clark Corp. with 90%); Ellen Schultz, *Blunders Can Sink 401(k) Plans*, CHICAGO SUN-TIMES, June 9, 1996, at 80 (citing examples of Abbott Laboratories with 92% of plan assets invested in employer securities, Amoco Corp. with 70%, Walt Disney Co. with 63%, Dominion Resources with 75%, Westvaco Corp. with 90%, and Weyerhaeuser Corp. with 65%).

108. See Bryant, *supra* note 97, § 3, at 2. At the time Color Tile, Inc., a national retail chain, filed for bankruptcy in January of 1996, 83% of the company's 401(k) plan assets were invested in 44 Color Tile stores, some of which were closed as a result of the bankruptcy. See *Retirement Policy*, *supra* note 12, at 3. Similarly, when Carter Hawley Hale entered bankruptcy, 92% of its employees' 401(k) plan assets were invested in employer securities. See *Id.*; Stephen Green, *Cracks in the 401(k) Nest Egg: Lawmakers Want More Safeguards*, S. D. UNION-TRIB., July 16, 1996, at C2 (citing the example of an employee of a Carter Hawley Hale subsidiary whose retirement fund plummeted from \$88,000 to \$9,200).

109. See Jim Davenport, *When All the Eggs Are in the Company Basket*, CHI. TRIB., Aug. 14, 1995, at 3 (reporting finding of Buck Consultants that 18% of all companies surveyed, and 40% of the largest companies surveyed, matched contributions with employer stock); Richardson, *supra* note 22, at

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second explanation is that many employees feel a sense of loyalty to their employers and investing in employer securities is a way of demonstrating that loyalty.¹¹¹ Finally, many employees invest in their employer's stock out of a misplaced sense of confidence; they are overly optimistic about their own company's performance and feel that an investment in their employer's securities is less risky than investments in other stocks.¹¹² Regardless of the reasons, many plan participants are so heavily invested in a single stock that their retirement portfolios are insufficiently diversified.

ERISA does nothing to prevent this lack of diversification in 401(k) plans. Normally, exercising control over investment of pension plan assets makes one a fiduciary, and thus subject to fiduciary standards.¹¹³ However, section 404(c) of ERISA explicitly provides that participants who exercise control over the assets of their individual accounts in defined contribution plans are not deemed to be fiduciaries by reason of such exercise¹¹⁴ and that no person who is otherwise a fiduciary to the plan shall have any liability for any loss which results from the participants' exercise of control.¹¹⁵ Thus, ERISA's fiduciary standards of prudence and diversification do not operate here. Although heavy plan investment in a single security potentially violates

31 (showing that more than half of companies surveyed used company stock for their employer match). In some 401(k) plans, employer securities are the only investment option. See Toddi Gutner, *Commentary: A One Stock 401(k) is Too Fragile a Nest Egg*, BUS. WK., Dec. 9, 1996, at 175 (stating that "some 2000 of the nation's 200,000 corporate 401(k) plans . . . offer company shares as their only investment option. In an additional 40,000 plans, matching contributions are made only in company stock").

110. See Gordon, *supra* note 32 (suggesting that one of the reasons so much 401(k) money is invested in employer securities is that employers often offer stock to employees at a discount).

111. See Lewis Braham, *Institutional Asset Management: The Growing Number of Options in Qualified Plans is a Boon for Planners in the Short Run But Could Spell Trouble in the Long*, FIN. PLAN., July 1, 1997, available in 1997 WL 10306217, at *7 (explaining that despite lack of diversification, employees over-invest in employer securities because "often even the most sophisticated employees remain doggedly loyal to their mother company"); Bryant, *supra* note 97, § 3, at 1 (stating that for many employees, the issue is emotional; employees invest heavily in employer securities even though they say they would never advise a relative to be so heavily invested in a single stock); *Company Stock Overview: Will Employer Stock Put an End to the 401(k) Honeymoon*, DEFINED CONTRIBUTION PLAN INVESTING, Aug. 27, 1996, available in 1996 WL 11658331 (noting that employees are naturally loyal to their employers and express their faith in the future of the company by investing in employer securities).

112. See Jim Gardner, *ESOP Fables Sometimes Lack a Happy Ending*, S.F. BUS. TIMES, Feb. 7, 1997, available in 1997 WL 7731803, at *3 (noting that the risk of lack of diversification of investment in employer securities is magnified by the fact that employees "tend to have rosier views of the prospects for their companies than might be warranted"); Jeffrey M. Laderman, *More Gold for Your Golden Years*, BUS. WK., July 3, 1995, at 63 ("[Employees] don't think employer securities are risky because they understand the company. They think the stock market is risky because they don't understand it.").

113. See 29 U.S.C. § 1002(21)(A)(i) (1994).

114. See 29 U.S.C. § 1104(c)(1) (1994). A participant exercises control over the assets in her individual account for purposes of section 404 when she receives adequate information concerning investments, is given the opportunity to make independent investment decisions, and has access to a broad range of investment alternatives. See 29 C.F.R. § 2550.404c-1 (1997); see also *supra* note 104.

115. See 29 U.S.C. § 1104(c)(2).

both ERISA's prudence and diversification standards, the effect of section 404(c) is that no one is liable for the violation. The failure to impose any standards on 401(k) investment choices makes it particularly troubling that there is no limit on how much of a participant's account may be invested in employer securities.

ESOPs, by definition, are not diversified; they are formed to invest primarily in employer securities. Despite the fact that Congress never intended ESOPs to be an employee's sole or primary means of receiving retirement income,¹¹⁶ ESOPs often do not represent additional benefits, but are given to employees in lieu of other benefits.¹¹⁷ Thus, ESOPs can significantly affect the diversification of a retirement portfolio.

The lack of diversification of ESOPs is particularly dangerous since courts have been slow to impose the same fiduciary standard of prudence on ESOP trustees as they impose on trustees of other plans.¹¹⁸ Since an ESOP, by definition, exists to invest in employer securities, and the ESOP documents direct the plan to purchase employer securities, courts often do not question the prudence of a trustee's purchase of such securities even if an investment in those shares would not seem to be a wise investment for a third party.¹¹⁹

116. See *supra* note 37 and accompanying text.

117. For example, United Airline employees agreed to reduce salaries and benefits by \$3.3 billion over five years in exchange for an ESOP holding a majority of the company's shares. See INVESTOR'S BUS. DAILY, May 18, 1995, at A5. Polaroid's ESOP, established in 1988 as part of the company's "Total Quality Ownership" program, resulted in a 10% reduction in pay and benefits. See GIBLIN et al., *supra* note 23, at 42; see also *Perry v. P*I*E* Nationwide, Inc.*, 872 F.2d 157, 158 (6th Cir. 1989) (showing that the establishment of ESOPs involved a 15% salary reduction); Mercedes M. Cardona, *Northwest Air Employees May Get Windfalls*, PENSIONS & INVESTMENTS, Nov. 13, 1995, at 43 (stating that Northwest Airline Corp.'s ESOP was established when employees traded wage concessions for part ownership of the company); *LTV and Steelworkers Seek Approval of Employee Buyout at Alabama Plant*, 12 Pens. & Ben. Rep. (BNA) 1749, 1750 (Dec. 16, 1985) (describing an ESOP proposal which would include a \$5 per hour cut in pay and benefits).

Congress has become increasingly concerned that companies appear to be terminating their defined benefit plans and replacing them with ESOPs. See S. REP. NO. 101-249 (1990), available in 1990 WL 263545 (LH), at*205; see also 29 U.S.C. § 1104 (1994). However, it is not uniformly the case that ESOPs provide replacement income. For many employers, an ESOP is offered as an added benefit and does not replace existing employee benefit programs. See James E. Ahern, *Beware of How ESOPs Can Impact Shareholder Value*, CORP. LEGAL TIMES, Aug. 1992, at 10 (indicating that a majority of firms responding to a 1990 questionnaire said their ESOP did not replace any other employee benefit program); Bill Sing, *Raising Stakes for Workers: Stock Plans Strengthen Loyalty When Employees Get Real Control*, L.A. TIMES, Sept. 18, 1988, (Special Section), at 8 (maintaining that two-thirds of firms forming ESOPs give shares to workers as a supplemental benefit, not as a replacement for an existing pension plan).

118. While section 408(e) of ERISA purports to exempt ESOP fiduciaries from the prohibitions of sections 406 and 407 of ERISA in connection with the acquisition or sale of ESOP shares, see 29 U.S.C. § 1108(e) (1994), the general fiduciary standards of section 404 apply to the activities of an ESOP trustee.

119. See *Maniace v. Commerce Bank*, 40 F.3d 264, 267-68 (8th Cir. 1994); *Ershick v. United Mo. Bank*, 948 F.2d 660, 666, 668 (10th Cir. 1991); *Donovan v. Cunningham*, 716 F.2d 1455, 1473 (5th Cir. 1983); *Barud v. Acme Elec. Co.*, 591 F. Supp. 238, 247-48 (D. Ala. 1984). But see *Fink v. National Sav. & Trust Co.*, 722 F.2d 951, 955 (D.C. Cir. 1985) (noting that although ESOP fiduciary is relieved from duty of diversification, he still is responsible for determining that the investment decision is

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Likewise, courts are not likely to impose liability on an ESOP trustee who fails to sell ESOP shares when the value of employer stock falls, even if a third party would sell the shares at that time.¹²⁰

There is some protection from the lack of diversification of ESOPs for employees nearing retirement. In 1986, Congress added a provision to the Code giving plan participants who have attained age fifty five and completed ten years of participation in the plan the right to direct the investment of 25% (and, in the year preceding retirement, 50%) of their ESOP accounts into other investments.¹²¹ Thus, in the years nearing retirement, a participant can diversify a portion of her ESOP portfolio. While this lessens the problem somewhat, it does not eliminate the diversification problem. First, the provision does nothing to protect participants from serious downturns in the employer's business, including bankruptcy, that occur prior to the time an employee reaches the age of fifty five. Second, the investment of even 50% to 75% of a participant's account balance in employer securities is too much if the ESOP represents the sole or a significant piece of an employee's retirement portfolio.

B. Addressing the Diversification Problem

The lack of adequate diversification of defined contribution plan assets is a problem that must be addressed. The recent attention that has been given to the issue of employee investment education¹²² poses the obvious first question

prudent and in the best interests of plan participants); *Eaves v. Penn*, 587 F.2d 453, 459 (10th Cir. 1978) (ruling that in deciding whether or not a plan's assets should be invested in employer securities, an ESOP fiduciary is governed by the "solely in the interest" and "prudence" tests of ERISA).

Even though courts do not question the wisdom of the purchase itself, they carefully scrutinize whether the fiduciary paid more than adequate consideration for the shares. *See, e.g., Eyler v. Commissioner*, 88 F.3d 445, 457 (7th Cir. 1996) (holding a majority shareholder liable for engaging in prohibited transaction for failing to show that the price paid by a newly established ESOP for his shares represented fair market value); *Reich v. Valley Nat'l Bank of Ariz.*, 837 F. Supp. 1259, 1281-85 (S.D.N.Y. 1993) (concluding that the amount paid by an ESOP for shares was in excess of adequate consideration).

120. *See, e.g., Kuper v. Quantum Chem. Corp.*, 66 F.3d 1447, 1458-59 (6th Cir. 1994) (holding that ESOP fiduciaries did not breach fiduciary duty by failing to sell employer securities during an 18 month period when the value of the stock declined 80%); *Maniace*, 40 F.3d at 264, 267-68 (holding a trustee not liable for failing to act when the value of the stock held by ESOP declined).

121. *See* I.R.C. § 401(a)(28) (1997).

122. Although employers have long recognized the need to educate employees making 401(k) plan investment decisions, the fear of being deemed to be giving investment advice—thus creating potential liability as a fiduciary under ERISA and as an investment adviser under the Investment Advisors Act of 1940 (the "Advisors Act")—has made some employers hesitant to provide such advice. *See DOL Issues Draft Guidance for Participant Investment Education*, WATSON WYATT INSIDER, Feb. 1996, at 4. Sensitive to this concern, the Department of Labor has issued an interpretive bulletin explaining how employers can offer investment-related educational information without being considered to be giving investment advice within the meaning of ERISA, which gives rise to fiduciary status and potential liability for a participant's investment choices. The guidelines provide a safe harbor for certain types of information that can be given, including plan information, general financial and investment information, asset allocation models, and interactive investment materials. *See* Department of

whether employee education is likely to lead employees to invest their 401(k) assets less heavily in employer securities.¹²³

Given the growth of 401(k) plans and the fact that more employees are directing the investment of what will be the primary source of their retirement income, efforts by employers to provide meaningful investment education to employees should be encouraged. There is no question that employers should attempt to educate employees about the importance of diversification and to provide them with suggested asset allocation models reflecting different goals, time horizons and risk profiles.¹²⁴

However, it is unlikely that such education will affect employees' decisions with respect to investment in employer securities. Employers have, in fact, increasingly been providing employees with investment education, yet employees continue to invest unwisely.¹²⁵ There are several explanations for the failure of education in this area. First, as discussed above, employees' decisions to invest in employer securities are frequently based on emotional and psychological factors, such as loyalty to the employer and an overinflated sense of confidence in the employer.¹²⁶ There is evidence that employees with such feelings overinvest in employer securities despite the fact that they are generally sophisticated and appreciate in general terms that excessive investment in any single stock is unwise.¹²⁷ It should come as no surprise that employee investment education is insufficient to overcome such emotional

Labor Interpretive Bulletin 96-1, 29 C.F.R. § 2509.96-1 (1997). Additionally, the Securities and Exchange Commission's division of Investment Management has advised the Department of Labor that employers who provide information within the guidelines' safe harbors would not be subject to registration or regulation under the Advisors Act. See *DOL Issues Draft Guidance for Participant Investment Education*, *supra*, at 5.

123. Education is obviously not a solution to an ESOP's lack of diversification, since employee choice has nothing to do with an ESOP until the years just before the employee's retirement.

124. These are the types of things covered by the safe harbor recently created by the DOL. See *supra* note 122.

125. See Gordon, *supra* note 32, at 15 (stating that there has been more investment education activity carried on by employers in the last several years, yet employees continue to "underweight the equity allocation in their portfolio," even though they have knowledge of the return differentials between fixed income and equity investments); Ellen Benoit, *Too True to Be Good*, CFO, MAG. FOR SENIOR FIN. EXECUTIVES, Aug. 1, 1997, available in 1997 WL 8300230, at *4 (stating that employees continue to invest heavily in employer securities despite the fact that employers have "stepped up efforts to provide investment education, especially since the adoption of rule 404(c) in 1992"); Lynn Brenner, *Crossing the Line*, CFO, MAG. FOR SENIOR FIN. EXECUTIVES, Oct. 1, 1996, at 61 (claiming that although employees have received various forms of investment education for several years, their plan investment decisions have not improved).

126. See *supra* notes 111-112 and accompanying text. This may be particularly true of women, who make up a growing part of the workforce. As one financial planner put it, "women invest with their souls and their hearts rather than their pocketbooks alone." Debora Vrana, *Investing With Cash, Hearts and Souls*, L.A. TIMES, Feb. 25, 1997, at A1 (quoting financial planner Esther Berger).

127. See *supra* note 111. Even very knowledgeable executives can make bad decisions when it comes to employer securities. See Braham, *supra* note 110, available in 1997 WL 10306217, at *7 (describing a GM executive who, despite having "participated in all the conference calls, every analyst activity in the company," insisted on investing enormous amounts in GM stock as the stock was falling; by the time the stock finished plummeting, he lost \$160,000 of his retirement money).

bases of decisionmaking given the failure of education to change behavior in such wide-ranging areas as diet,¹²⁸ smoking¹²⁹ and wearing of motorcycle helmets.¹³⁰

Second, employees do not appear to be an easy group to educate. Although employers are making investment information available to employees, “[m]any employees just want to be told how to invest their retirement accounts. They don’t want to invest time or money in a soup-to-nuts examination of their entire financial picture.”¹³¹ Given employers’ fears about potential fiduciary liability under ERISA, an employer is not going to be willing actually to make an investment decisions for its employees or even to give specific individually-tailored advice to employees.¹³²

In addition, educating employees about employer securities poses particular difficulties for employers because of the potential conflicts of interests created by the fact that the employer has a fiduciary obligation to plan participants but also wants its stock in friendly hands. As one consultant explains, “A lot of managers are wary of addressing the issue [of employer securities], so it gets short shrift. It’s hard for a company to say, ‘We have a very good company and good stock, but don’t buy too much of it.’”¹³³ Finally, educating employees will obviously have no effect on accumulations of employer securities that result from employers’ matching employee contributions with employer securities.

Since education is not likely to be effective, the law should place limits on the amount of a participant’s retirement savings that can be invested in employer securities. In June of 1996, Senator Boxer introduced a bill, the

128. See Barbara M. Houle, *People: Low-Fat Doesn't Mean You Have to Sacrifice Taste*, TELEGRAM & GAZETTE, Feb. 28, 1996, at C1, available in 1996 WL 2381866 (estimating that two-thirds of American adults eat more than 130% of the recommended limit for fat calories and noting that despite recommendations by the USDA and the U.S. Department of Health and Human Services, many Americans still eat lower levels of vegetables and fruits than are recommended).

129. See Susan MacDonald, *I'm Popping Outside for a Puff*, TIMES (London), Aug. 28, 1997, available in 1997 WL 9225667 (claiming that despite continuing dissemination of information about hazards of smoking, smoking among students and recent graduates is not diminishing as much as had been expected); William H. Redmond, *Product Disadoption: Quitting Smoking As a Diffusion Process*, J. PUB. POL'Y & MARKETING, Mar. 1, 1996, at 87 (reporting that despite the fact that publicity about the health hazards of smoking “has generated broad awareness of the connection between smoking and negative health outcomes,” the rate of decline in smoking prevalence has slowed and, in some groups, smoking is increasing).

130. See Abigail Trafford, *Second Opinion: Mystique and Mistakes*, WASH. POST, Aug. 20, 1996, at Z6 (estimating that despite decades of research that helmets protect motorcycle riders from serious head injuries, only about 50% of riders wear helmets voluntarily).

131. Brenner, *supra* note 124, at 61; see also Braham, *supra* note 110, available in 1997 WL 10306217, at *6 (stating that employees attend investment seminars conducted by major corporations, yet come out of such sessions failing to understand simple concepts such as “equity”).

132. See Brenner, *supra* note 124, at 61. The DOL safe harbor from fiduciary liability does not protect individualized investment advice. See Department of Labor Interpretive Bulletin 96-1, 29 C.F.R. § 2509.96-1 (1997).

133. See Benoit, *supra* note 124, available in 1997 WL 8300230, at *3 (quoting an Institute of Management and Administration representative).

401(k) Pension Protection Act, which would limit investment in employer-related assets by employer-directed plans funded with employees' pre-tax contributions.¹³⁴ The bill resulted in the enactment in August 1997 of section 407(b)(2) of ERISA, which prohibits such plans from investing more than 10% of assets in company securities or company-owned real estate.¹³⁵ However, because the bill only applies to 401(k) plans in which the employer and not the employee directs investments, it would affect a very small number of pension plans.

The recently enacted change is on the right track, but it does not go far enough. ERISA should be amended to prevent accumulations of 401(k) plans beyond a certain percentage of a participant's account value without regard to who is actually making the investment decision. What should that percent be? The 10% limit on plan asset investment currently applied to defined benefit plans conforms to general recommendations of investment advisers about the percentage of an investment portfolio that should be invested in a single stock.¹³⁶ My proposal is simple: Impose a similar 10% limit on 401(k) plans. The law should provide that employees cannot invest more than 10% of their individual account balances in employer stock.¹³⁷ Such a rule would significantly divorce a participant's future retirement security from the fortunes of a participant's employer.

It is true that my proposal limits individual decision-making in a way that section 407(b)(2) does not. However, there are many instances in which limiting individual choice through ERISA¹³⁸ and other laws¹³⁹ is perceived as the best mean of achieving a desired goal. Generally, we feel more comfortable limiting individual choice if we do so for the sake of broader social concerns in addition to protecting individuals from themselves. This claim can be made easily in the present circumstance. The individual participant is not the only one harmed by poor plan investment decisions. Ultimately, society as a whole will be burdened by a retirement age population with insufficient resources to maintain an adequate standard of living. Since it does not appear that we can succeed in reducing employee overinvestment in employer securities through education, there is merit in restricting the amount of a participant's individual account that can be invested in employer

134. See 401(k) Pension Protection Act, S. 1837, 104th Cong. (1996) (enacted).

135. See 29 U.S.C. § 1107(b)(2) (1997).

136. See *supra* note 105.

137. With respect to diversification, the only concern is the percent of a participant's assets invested in the employer. The percentage of the employer's stock held by the plan is not relevant.

138. For example, ERISA's anti-alienation clause prevents a participant from voluntarily or involuntarily assigning her interest in a retirement plan. See 29 U.S.C. § 1056(d) (1994). Similarly, ERISA's vesting and other minimum design standards for pension plans may not be contractually altered by employers even with employee consent. See, e.g., 29 U.S.C. §§ 1053, 1054 (1994).

139. For example, many state laws require motorcyclists to wear helmets, because it is clear that despite evidence that helmets protect riders from serious head injuries, many riders will not voluntarily wear them. See *supra* note 130.

securities. Given the severity of the harm created by lack of diversification and the absence of alternative means to address the problem, the intrusion on individual decision-making is warranted.

I recognize that the proposal is potentially overbroad in that some 401(k) plan participants do have significant non-plan retirement savings. However, requiring employers to apply a limit to some participants' investment choices and not to others would require employers to inquire into employees' personal finances, which would be both intrusive and burdensome.

The final argument that should be stressed about the limit I propose with respect to 401(k) plans is that it still allows employees to make a significant plan investment in employer securities—up to one-tenth of an employee's account balance. I have earlier suggested that the evidence linking employee ownership and worker productivity has flaws. Even if one accepts the link, however, there is no evidence of a direct relationship between stock ownership and productivity gains. Therefore, nothing suggests that employees whose holdings of employer securities will decline as a result of my proposal will suffer reduced productivity. Additionally, if employers are concerned about the limit on plan investments, they can offer employees more employer securities outside of their pension plan through stock options or bonus stock grants. They can also encourage employees to purchase non-plan employee shares at a discount.

ESOPs, by definition, are vehicles for investment in employer securities, meaning that they will invariably have all or most of their assets invested in employer securities. Thus, one cannot simply impose the kind of limit on ESOPs that I propose for 401(k) plans. Since employers have many non-retirement goals in adopting ESOPs, they should not be prevented from offering such plans. However, employers should not be permitted to mislead employees into thinking that they are providing a stable source of retirement income by adopting an ESOP. I propose that ERISA be amended to prohibit an employer from offering an ESOP as its only retirement plan. Only if an employer already provides meaningful retirement benefits backed by a diversified investment portfolio should the employer be able to offer a non-diversified ESOP. This would allow employers to achieve their non-retirement goals without jeopardizing their employees' retirement security¹⁴⁰ and conforms with Congress's view that ESOPs should not serve as a primary

140. Although this proposal comes close to violating ERISA's acceptance of the notion that pension plans should remain voluntary, it does not cross the line. No employer must offer a retirement plan. However, if an employer for whatever reason wants to adopt an ESOP, giving employees a belief that they have received some retirement security, the employer should be forced to provide that security in the manner suggested herein. Those opposed to this solution on the grounds that ESOPs should be viewed primarily as corporate finance vehicles or as mechanisms to serve other employer concerns should think about the treatment of ESOPs under the Code and ERISA and about how such vehicles would fare without the benefit of the "retirement plan" rules currently applied to ESOPs.

vehicle for retirement savings.¹⁴¹

IV. Entrenchment Impact of Plan Investments in Employer Securities

Employers often adopt ESOPs and include employer stock funds as 401(k) investment options with the goal of placing large blocks of shares in friendly hands.¹⁴² Employers believe that employees will be more concerned with the “immediate benefits of job security than with the potential increase to the value of their future retirement benefits” and thus will make voting and tender decisions that preserve the status quo.¹⁴³

141. See *supra* note 37 and accompanying text.

142. See Gen. Couns. Mem. 39,870 (Apr. 7, 1992); see also Susan Chaplinsky & Greg Niehaus, *The Role of ESOPs in Takeover Contests*, 49 J. FIN. 1451, 1451, available in 1994 WL 13301274 (noting that the role of takeovers involving companies with ESOPs is about half that of companies without ESOPs); Sangsoo Park & Moon H. Song, *Employee Stock Ownership Plans, Firm Performance, and Monitoring By Outside Blockholders*, FIN. MGMT, Dec. 22, 1995, at 52, available in 1995 WL 10376037 (finding that most ESOPs are adopted as a response to a takeover announcement); Susan P. Serota, *Employee Benefit Plans in Corporate Acquisitions and Dispositions: Company Stock Held by Employee Plans*, 20 REAL PROP. PROB. & TR. J. 1075, 1076-79 (1985) (describing several instances of utilization of ESOPs and other employee benefit plans as an anti-takeover strategy).

So long as an ESOP is adopted or a proposal by a board of directors to adopt an ESOP exists prior to a takeover attempt, courts will permit the use of an ESOP as an anti-takeover device. See, e.g., *Danaher Corp. v. Chicago Pneumatic Tool Co.*, 635 F. Supp. 246, 249 (S.D.N.Y. 1986) (holding that the creation of an ESOP was valid because it had been repeatedly discussed prior to the takeover bid); *Shamrock Holdings v. Polaroid Corp.* 559 A.2d 257, 270 (Del. Ch. 1989) (upholding Polaroid’s decision to create an ESOP with the goal of increasing productivity since there was no prior board determination of the impact of the takeover bid on the corporation). While courts grant directors wide latitude in their decision to adopt an ESOP, they have invalidated ESOPs that were clearly motivated by self-interest. A particularly egregious example of the use of ESOPs as an anti-takeover strategy was the adoption by NCR Corporation of an ESOP to attempt to thwart a hostile takeover attempt by AT&T. Among the facts that came to light when NCR sought a declaratory judgment that its ESOP was valid and enforceable was that the company’s director of employee benefits believed that NCR’s compensation package was satisfactory and competitive and that, from a benefits perspective, an ESOP was unnecessary. Additionally, in contrast to the usual procedure of benefit proposals, going through the company’s benefits or human resources department, the ESOP was structured by NCR’s financial officers. Based on that evidence, a district court determined that the primary purpose of the ESOP was to entrench management and not to provide benefits to employees. Thus, the court invalidated the ESOP and enjoined it from voting on the tender offer. See *NCR Corp. v. AT&T*, 761 F. Supp. 475, 492-98 (S.D. Ohio 1991); see also *Norlin Corp. v. Rooney*, Pace 744 F.2d 255, 266 (2d Cir. 1984) (granting an injunction against voting of ESOP shares by management where it was clear that the “ESOP was created solely as a tool of management self-perpetuation.”).

143. See Michael J. Nassau et al., *ESOPs After Polaroid—Opportunities and Pitfalls*, 15 EMPLOYEE REL. L.J. 347, 348 (1989).

In terms of an employer’s anti-takeover goal, the amount of stock held by pension plans assumes even more significance when combined with holdings by officers and directors through stock option or stock bonus plans or otherwise. Some companies set aside 10% of their stock for stock options and bonus grants for senior officers. See Capell, *supra* note 1 (giving examples of Toys ‘R’ Us, Inc. and Pfizer, Inc.); Robert A.G. Monks, *Stock Options Don’t Work*, FORTUNE, Sept. 18, 1995, at 230 (reporting that 97% of options go to the top 15 people in the company). Some companies reserve even higher amounts. See Capell, *supra* note 1 (citing Morgan Stanley & Co.’s request for shareholder approval to allocate 55% of outstanding shares for its 1996 stock option plan); see also Giblin et al., *supra* note 23, at 42 (citing projection of Joseph R. Blasi, professor at Rutgers University School of Management and Labor Relations, that by the year 2000, one quarter of all public companies will be

While unwanted takeovers are, almost by definition, viewed negatively by the management of a corporate employer and are sometimes undertaken by short-term profit seekers, takeovers also perform useful functions.¹⁴⁴ Perhaps most importantly, takeover activity tends to keep corporate managers reasonably responsive to shareholder interests. Corporate managers cannot be relied upon always to act in the best interests of shareholders and the corporation.¹⁴⁵ The threat of a takeover performs the monitoring of corporate managers that a large and diverse group of shareholders may not be able to perform¹⁴⁶ or may not have an incentive to perform.¹⁴⁷ That threat is removed

more than 15% employee-owned); Corey Rosen & Susan Prolman, *Harnessing Employee Ownership in 401(k)s*, PENSIONS & INVESTMENTS, Apr. 17, 1995, at 12 (stating that in addition to \$350 billion in corporate equity owned by employees through ESOPs and 401(k) plans, employees own at least another \$100 billion through stock option and other stock ownership plans); David Stamps, *A Piece of the Action*, TRAINING, Mar. 1, 1996, at 64, available in 1996 WL 9820885 (citing National Center for Employee Ownership figures that some 15 million American workers now own \$500 billion worth of employer stock). Since many states have anti-takeover statutes that require supermajority approval for combinations not approved by directors, see, e.g., DEL. CODE ANN. tit. 8, § 203 (1988) (prohibiting an interested shareholder from combining with its target within three years of becoming a 15% shareholder unless the interested shareholder owns 85% of the outstanding shares at the time the transaction commenced or the board approves the transaction in which the shareholder becomes an interested shareholder), the total shareholdings by officers, directors and employees can effectively block an unwanted takeover.

144. See Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981) (arguing that defensive techniques permit management entrenchment and avoidance of responsibility at shareholders' expense); *Corporate Finance: Do Mergers Work?*, ECONOMIST, Dec. 17, 1988, at 76 (noting that hostile bids let managers know they must be careful to handle the company efficiently); *State Developments*, Antitrust and Trade Reg. Rep. (BNA) No. 1226, at 235 (Aug. 1, 1985) (citing Federal Trade Commission statement that acquisitions shift assets to higher-valued uses, allow companies to realize economies of scale, and provide an incentive for managerial excellence); *Witnesses Dispute Need for Regulation of Hostile Takeovers*, Antitrust & Trade Reg. Rep. (BNA) No. 1213, at 739 (May 2, 1985) (asserting that the benefits of takeovers include ousting incompetent management, disciplining entrenched management, and providing shareholders an opportunity to sell their shares).

Opponents of unwanted acquisitions argue that takeover battles waste capital resources that could be spent improving industrial productivity and developing new technologies. See, e.g., Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 110 (1979).

145. See, e.g., Paul Mallette & Karen L. Fowler, *Effects of Board Composition and Stock Ownership on the Adoption of "Poison Pills"*, 35 ACAD. MGMT. J. 1010, 1016 (1992) (suggesting that directors sometimes act in ways that benefit management and themselves rather than shareholders).

146. See MICHAEL E. PORTER, *THE COMPETITIVE ADVANTAGE OF NATIONS* 529 (1990) ("Investors exercise little real influence on managements, and are rarely represented on boards of directors. The only mechanism left to discipline poorly performing managements is takeovers or mergers."); Harold Demsetz, *Financial Regulation and the Competitiveness of the Large U.S. Corporation*, FED. RESERVE BANK OF ST. LOUIS REV., Mar. 1993, available in LEXIS, News Library, Asapii File (noting that takeovers provide a way to concentrate diffuse ownership structures); Dwight Lee, *The Market for Control*, CORP. BOARD, Jan. 1990, available in LEXIS, News Library, Asapii File (discussing the fact that it is impossible for a large and diverse group of shareholders to have any meaningful impact on management).

147. See ROBERT C. CLARK, *CORPORATE LAW* 390-93 (1986) (asserting that shareholders only become involved if expected benefits outweighs costs and that they cannot easily free-ride on the actions of the few informed shareholders); Stephen M. Bainbridge, *Independent Directors and the ALI Corporate Governance Project*, 61 GEO. WASH. L. REV. 1034, 1055 (1993) (suggesting that shareholders have insufficient incentive to gather the information necessary to become actively involved

when a large enough percentage of a company's securities is removed from objective decisionmakers and placed in the hands of those who will invariably vote in management's interest.¹⁴⁸

Tender offers are one way of dealing with opposition to existing management.¹⁴⁹ Although tender offer activity is generally not perceived to be as widespread today as during the 1980s, hostile acquisition attempts have again become "a regular feature of the business landscape."¹⁵⁰ In addition, the increased concentration of shareholdings in publicly held corporations¹⁵¹ has resulted in increased shareholder activism. This activism has manifested itself in proxy battles where shareholders' aim has been not necessarily to oust existing management but rather to promote some policy not supported by the management.¹⁵² In the words of a prominent mergers and acquisitions attorney, "[t]he takeover entrepreneurs of the '80s have latched on and

in monitoring corporate affairs since the cost of such activity is high and most shareholders' holdings are too small to have a significant impact on the outcome).

148. A high enough concentration of employer securities in the hands of officers, directors, and employees makes it impossible to undertake an acquisition that is not approved by the target company and its board.

149. A tender offer involves "an invitation to the shareholders of the target corporation by the acquiring party to submit, or 'tender' their shares for purchase." RICHARD T. McDERMOTT, *LEGAL ASPECTS OF CORPORATE FINANCE* 594 (1985).

150. Carol B. Swanson, *The Turn in Takeovers: A Study in Public Appeasement and Unstoppable Capitalism*, 30 GA. L. REV. 943, 945-46 & n.6 (1996) (citing as examples of some recent sensational bids AT&T's \$6 billion bid for NCR in 1991 and Matsushita's \$6.6 billion acquisition of MCA in 1991).

151. A significant percentage of U.S. equity securities are now held by institutional investors. See *The Business Week 1000*, BUS. WK., Mar. 28, 1994, available in 1994 WL 2711197 (showing that in 1994, institutions held 56% of shares of the 1,000 largest U.S. corporations).

152. See *Harman International Bars Option Repricing*, 22 Pens. & Ben. Rep. (BNA) 593 (Mar. 6, 1995) (stating that Harman International Industries, Inc. had changed its incentive plan to forbid option repricing in response to a shareholder proposal); Mark S. Porter, *Institutional Investors Make Voices Heard*, MERGERS & ACQUISITIONS REP., June 10, 1996, available in 1996 WL 8301682 (noting that shareholders submitted at least twice as many shareholder proposals relating to corporate governance issues in the 1995 annual meeting season compared to 1994 and that the 1996 season was at least as active as 1995). During recent years, shareholders have introduced numerous proposals on issues that run counter to the interests of management, such as proposals to repeal classified boards, restrict executive compensation, provide for cumulative voting, redeem poison pills, and require independent directors. See WILLIAM L. CARY & MELVIN ARON EISENBERG, *CORPORATIONS* 249 (1995) (presenting a table of 1994 shareholder proposals compiled by the Investor Responsibility Research Center). Interestingly, pension funds have been very active in putting forth shareholder proposals in companies other than the employer in which the plan has invested. See *CalPERS Proposes Boise Cascade 'De-Stagger' Terms of Directors*, 22 Pens. & Ben. Rep. (BNA) 936, 936 (Apr. 17, 1995) (citing several examples of shareholder proposals put forth by the California Public Employees' Retirement System).

Another manifestation of shareholder activism involves management's willingness to meet and negotiate with institutional investors on corporate governance matters, thus rendering a shareholder proposal unnecessary. See INSTITUTIONAL SHAREHOLDER SERVICES, *SPECIAL REPORT: THE 1994 PROXY SEASON* 7, 14 (1994), quoted in CARY & EISENBERG, *supra* note 152, at 253-54; see also Emily Otani, *Firms Feel Interfaith's Moral Might*, SACRAMENTO BEE, June 12, 1996, at D1 (describing Kimberly-Clark's sale of its tobacco-related business in response to shareholder campaign by the Interfaith Center on Corporate Responsibility).

become the proxy entrepreneurs of the '90s."¹⁵³ Significant plan holdings of employer securities have the same potential impact on shareholder proposals as they do on unwanted tender offers.

A. *Legal Standards Applicable to Voting and Tender Decisions*

In order to understand the entrenchment impact of pension plan investments in employer securities, it is necessary to start by considering the standards applicable to voting and tender decisions made by pension plans.

Since 1988, the Department of Labor ("DOL"), the agency responsible for interpreting and enforcing the fiduciary responsibility provisions of ERISA,¹⁵⁴ has taken the position that the decision on how proxies are voted is a fiduciary act of the plan's management.¹⁵⁵ Courts have taken the same position with respect to both voting¹⁵⁶ and tender decisions.¹⁵⁷ Thus the standards generally applicable to fiduciary decisions discussed earlier also apply to voting and tender decisions. As the following sections illustrate, both the courts and the DOL have elaborated how those general statements of fiduciary duties and prohibited transactions play out in the context of voting and tender decisions with respect to employer securities.

1. *Voting and Tender of Employer Securities in Defined Benefit Plans*

Two questions readily present themselves regarding the voting and tender of employer securities by defined benefit plans. The first question is whether prudence and loyalty dictate that a plan fiduciary accept an offer to purchase

153. Porter, *supra* note 152 (quoting Martin Lipton).

154. See 29 U.S.C. § 1135 (1994).

155. See Department of Labor Opinion Letter to Helmuth Fandl, Avon Products, 15 Pens. Rep. (BNA) 391 (Feb. 23, 1988). The Department of Labor views proxies as assets of the plan. Therefore, fiduciaries are responsible for the management of proxies as they are for all other plan assets. See Department of Labor Opinion Letter to Robert A.G. Monks, Institutional Shareholders Services, Inc., 17 Pens. Rep. (BNA) 244 (Jan. 23, 1990); Department of Labor Interpretive Bulletin 94-2, 29 C.F.R. § 2509.94-2 (1994).

In general, proxy voting has been a long-standing issue of interest to the Department of Labor. The Department's interest in proxy voting stems from the fact that "the exercise of the vote can influence the value of the shares held by the plan and, therefore, has to be appropriately managed as a plan asset. Responsible proxy voting is also important because of the role that employee benefit plans play as major institutional investors. Institutional shareholders, including pension funds, mutual funds and other institutions, now control more than 60% of outstanding shares in U.S. corporations, and how they exercise their franchise may have a significant impact on the management of corporations and share values. See Department of Labor, Pension and Welfare Benefits Administration, Proxy Project Report at 1 (released February 1996). The proxy project was initiated following the release of Interpretive Bulletin 94-2 to determine whether fiduciaries of employee benefit plans were complying with their responsibilities as corporate shareholders. See *id.*

156. See, e.g., Newton v. Van Otterloo, 756 F. Supp. 1121, 1126 (N.D. Ind. 1991); O'Neill v. Davis, 721 F. Supp. 1013, 1015 (N.D. Ill. 1989); see also Myers v. Pink, 191 N.E.2d 659, 663 (Ill. App. Ct. 1963); Babcock v. Chicago Rys Co., 155 N.E. 773, 778 (Ill. 1927).

157. See Evans v. Bexley, 750 F.2d 1498, 1500 n.3 (11th Cir. 1985) (using "prudent man" standards to evaluate tender decision); Norlin Corp. v. Rooney, 744 F.2d 255, 267 n.13 (2d Cir. 1984).

the employer's securities at a price that is in excess of the prevailing market value of the shares. The DOL and the Treasury Department addressed this very question in a Joint Statement on Pension Investments issued in 1989. The Joint Statement states that the fiduciary standards of loyalty and prudence do not require a fiduciary to accept a tender offer merely because it represents a premium over the prevailing market price of the shares held by the plan.¹⁵⁸ Instead, a fiduciary should

weigh a tender offer against the underlying intrinsic value of the target company, and the likelihood of that value being realized by current management or by a possible subsequent tender offer. It would also be proper to weigh the long-term value of the company against the value presented by the tender offer and the ability to invest the proceeds elsewhere.¹⁵⁹

The Joint Statement suggests that the same reasoning applies to voting decisions.¹⁶⁰ However, the exclusive benefit provisions of both ERISA and the Code would be violated if a trustee were to consider non-financial employment-related factors in the tendering, voting and handling of securities.¹⁶¹

158. See Joint Department of Labor/Department of Treasury Statement of Pension Investments (Jan. 31, 1989), 16 Pens. & Ben. Rep. (BNA) 215 (Feb. 6, 1989) [hereinafter Joint Statement].

159. Joint Statement, *supra* note 158. Law and economics theorists would argue that the distinction between long-term and short-term value is meaningless, suggesting that in an efficient capital market, the market price accurately reflects long-term prospects because it "represents the market's best estimate of the company's future returns properly discounted for the time value of money and risk." Robert A. Ragazzo, *Unifying the Law of Hostile Takeovers: Bridging the Unocal/Revlon Gap*, 35 ARIZ. L. REV. 989, 1020 (1993); see Dale Arthur Lesterle, *The Negotiation Model of Tender Offer Defense and the Delaware Supreme Court*, 72 CORNELL L. REV. 117, 144 (1986); Jonathan R. Macey, *State Anti-Takeover Legislation and the National Economy*, 1988 WIS. L. REV. 467, 481. *But see* Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 203 (1991) (criticizing the efficient capital market theory); Louis Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 COLUM. L. REV. 249, 254 (1983).

160. "A similar process should lead to the fund's decisions to support or oppose a proposed merger." Lowenstein, *supra* note 159.

It is interesting that this clarification by the DOL and the Department of Treasury occurred at around the same time as some courts suggested that a corporation's board of directors is justified in considering factors other than short-term shareholder wealth maximization in evaluating tender offers. See, e.g., *Paramount Comm., Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1990); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985). However, while corporate law may also allow directors to consider the impact of the takeover on non-shareholder constituencies, see, e.g., N.J. STAT. ANN. § 14A:6-1 (West 1992); N.Y. BUS. CORP. LAW § 717(b) (McKinney 1992); 15 PA. CONS. STAT. ANN. §§ 1715-16 (West 1992), an ERISA fiduciary may consider only the interests of plan beneficiaries. See *infra* note 161 and accompanying text.

161. In Gen. Couns. Mem. 39,870 (Apr. 7, 1992), the IRS considered a plan provision that provided that in addition to relevant financial factors, the trustee should consider relevant non-financial factors, such as the continuing job security of participants as employees of the company and its subsidiaries, conditions of employment, employment opportunities and other similar matters, before acting on a tender offer. The General Counsel's Memorandum notes that the DOL expressed to the IRS

Pension Plan Investments in Employer Securities

The second question with respect to defined benefit plans is whether a decision made by an interested trustee is reliable. This question was addressed by one of the more famous ERISA fiduciary duty cases, the Second Circuit decision in *Donovan v. Bierwirth*,¹⁶² which involved a tender decision made by the fiduciaries of a defined benefit pension plan.

The *Bierwirth* case arose out of an unsuccessful hostile tender offer by LTV Corporation for the shares of Grumman Corporation.¹⁶³ At the time of the tender offer, the Grumman pension plan owned approximately 525,000 shares of Grumman common stock. The trustees of the pension plan were three individuals, all of whom were officers of Grumman.¹⁶⁴

Grumman's management, including the plan trustees, opposed the tender offer and spent a significant amount of time and energy to repel it. Not only did the trustees refuse to tender the 525,000 Grumman shares held by the plan,¹⁶⁵ but they also had the plan purchase additional shares while the tender offer was outstanding. The plan purchased an additional 1,158,000 shares at an average price of \$38.27 per share, a price significantly inflated by LTV's tender offer.¹⁶⁶ After the tender offer was enjoined, the DOL brought suit alleging that the trustees' decision not to tender and their decision to have the plan purchase additional shares was a violation of fiduciary duties.

The court refused to rule that it was a per se conflict of interest for a corporate officer to act as a plan fiduciary during the pendency of a takeover attempt,¹⁶⁷ although it accepted that by "looking at the matter realistically," it was difficult to see how the trustees could have made a decision with respect to the plan different from the position they took as officers.¹⁶⁸ However, it did find that the trustees had violated their duty to act in the interests of plan

its opinion that the plan provision violated the fiduciary provisions of ERISA and concluded that the provision also violated the exclusive benefit provision of the Code. A "trustee's sole object and aim must be to satisfy all liabilities to the employees under the trust . . . [a]llowing the trustee to consider non-financial employment-related factors constitutes a purpose that goes beyond satisfying the liabilities of the plans." *But see* John S. Welch, *Fiduciary Aspects of Employee Stock Ownership Plan Investments in Employer Securities*, 23 REAL PROP., PROB. & TR. J. 575, 588 (1988) (arguing that the special nature of leveraged ESOPs may make consideration of the risk of lost employment appropriate).

162. 680 F.2d 263 (2d Cir. 1982).

163. LTV's offer was to purchase up to 70% of Grumman's common stock and securities representing or convertible into common stock at \$45 per share, conditioned upon the tender of a minimum of 50.01% of such securities. Prior to the announcement of the tender offer, Grumman's shares were trading at between 23 7/8 and 27 1/4 per share. *See id.* at 266.

164. Historically, banking institutions had served as trustees of Grumman's pension plan. However, beginning in 1973, it was Grumman's policy to have its own officers or affiliates serve as trustees. At the time of the tender offer, the trustees were the chief executive officer of Grumman, Grumman's chief financial officer, and the treasurer of a Grumman affiliate, with the associate general counsel of Grumman acting as their counsel. *See id.* at 267.

165. *See id.* at 264.

166. *See id.* at 264, 266.

167. The court did not see the need to go so far as to accept the Department of Labor's position that once the tender offer was announced the trustees should have immediately resigned in favor of a neutral trustee since there was adequate evidence that the trustees violated their duties. *See id.* at 272.

168. *See id.*

participants and beneficiaries, emphasizing the inadequacies of the trustees' process of decision making.¹⁶⁹ The trustees made no attempt to inform themselves adequately by, for example, seeking independent legal advice, nor did they do a thorough job in ascertaining facts about LTV's pension plans and LTV's intentions with respect to the Grumman plan. Even if the trustees honestly believed that the acquisition by Grumman of LTV would not be beneficial to plan participants,

they should have realized that, since their judgment on this score could scarcely be unbiased, at the least they were bound to take every feasible precaution to see that they had carefully considered the other side, to free themselves, if indeed this was humanly possible, from any taint of the quick negative reaction characteristic of targets of hostile tender offers displayed [at the trustees' meeting to consider the tender offer].¹⁷⁰

So, while *Bierwirth* declined to impose a bright line rule that trustees must always resign during the pendency of a tender offer, it did acknowledge that it may not be possible for a fiduciary to act in the best interest of the plan when a corporation takes a position with respect to the tender. At the least, a fiduciary has a duty to avoid placing itself in a position when its acts as an officer and director that will prevent it from functioning with complete loyalty to plan participants and beneficiaries.¹⁷¹ And while the court did not expressly impose a requirement that related fiduciaries must always seek the advice of independent counsel, it did suggest that such a course of action would have been preferable.¹⁷²

The other significant aspect of *Bierwirth* was the court's statement that the exclusive benefit rule was not violated if another party was "incidentally" benefited by the trustee's actions,¹⁷³ a significant departure from a literal understanding of ERISA's prohibited transaction rules.¹⁷⁴ The court stated that

169. *See id.* at 271-273.

170. *Id.* at 276.

171. *See id.* at 271.

172. *See id.*

173. *See id.* This is consistent with the IRS's interpretations of the analogous Code language. *See Central Motor Co. v. United States*, 583 F.2d 470, 490 (10th Cir. 1978) (holding that the Code's requirement that the plan be operated for the exclusive benefit of employees should not be interpreted literally); Rev. Rul. 69-494, 1969-2 C.B. 88 (stating that as long as the primary purpose of a transaction is to benefit the trust, incidental benefits may accrue to others); James D. Hutchinson & Charles G. Cole, *Legal Standards Governing Investment of Pension Assets for Social and Political Goals*, 128 U. PA. L. REV. 1340, 1348-49, 1359-60 (1980). However, the standard imposed by the Taft-Hartley Act with respect to the administration of union funds have been interpreted more strictly by the courts. *See NLRB v. Amax Coal Co.*, 453 U.S. 322, 333-34 (1981) (interpreting the Act's requirement that union funds be administered for the sole and exclusive benefit of employees to mean that the trustee owes to the trust and its beneficiaries a duty of complete loyalty to the exclusion of all other interests).

174. *See supra* notes 63-65 and accompanying text.

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“officers of a corporation who are trustees of its pension plan do not violate their duties as trustees by taking action which, after careful and impartial investigation, they reasonably conclude best to promote [sic] the interests of participants and beneficiaries simply because it incidentally benefits the corporation or, indeed, themselves”¹⁷⁵ This “incidental benefit” notion introduced by *Bierwirth* has been accepted and adopted by other courts.¹⁷⁶

2. *Voting and Tender of Employer Securities in Defined Contribution Plans*

With respect to defined contribution plans, both courts and the DOL have taken the position that passing voting and tender decisions through to participants is permissible and does not constitute a violation of ERISA.¹⁷⁷ However, pass-through voting is inappropriate when the exercise thereof conflicts with fiduciary obligations. At a minimum, a fiduciary is responsible for assuring that participants receive necessary and accurate information to allow them to make fully informed decisions on how to vote or whether to tender shares.¹⁷⁸ Additionally, the DOL takes the position that a trustee must ignore participant instructions if the trustee is aware that participants did not render an independent decision absent pressure from the employer.¹⁷⁹

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

176. *See, e.g., Donovan v. Walton*, 609 F. Supp. 1221, 1245 (S.D. Fla. 1985), *aff'd sub nom. Brock v. Walton*, 794 F.2d 586 (11th Cir. 1986) (noting that usually a transaction will benefit both parties and that ERISA does not prohibit parties other than a plan's participants and beneficiaries from getting some benefit); *Bing Management Co. v. Commissioner*, 36 T.C.M. (CCH) 1633, 1636 (1977) (noting that investments by a trustee in employer securities are not automatically precluded despite benefit to the employer). *But see Central Trust Bank, N.A. v. American Avents Corp.*, 771 F. Supp. 871, 874 (S.D. Ohio 1989) (holding that a trustee has a fiduciary duty to administer plan solely in interest of participants).

177. *See Central Trust Bank, N.A. v. American Avents Corp.*, 771 F. Supp. at 874 (finding that pass-through voting and tender decisions are not improper per se); Department of Labor Opinion Letter to Thobin Elrod, Citizens and Southern Trust Company, 16 Pens. Rep. (BNA) 390 (Feb. 23, 1989).

178. *See Shoen v. AMERCO*, 885 F. Supp. 1332, 1350 (D. Nev. 1994) (noting that an ESOP administrator has a duty as an “election monitor” in pass-through voting situations and must ensure that participants get accurate and sufficient information and that information forwarded to participants is not false nor misleading); *Central Trust Bank, N.A. v. American Avents Corp.*, 771 F. Supp. at 875 (stating that participants must receive enough information to make an informed decision). For example, the fiduciary must give all participants the material information given to other shareholders by the tender offeror and the target employer, it must make efforts to ensure that the information actually reaches participants, and it must not distribute information known to be misleading. *See Welch, supra* note 161, at 594. *But see McGinn v. DeSota, Inc.*, No. 90 C 4481, 1990 U.S. Dist. LEXIS 16794, at *10 (N.D. Ill. 1990) (finding that to prevail on a claim of nondisclosure in pass-through voting situation plaintiff must demonstrate that the fiduciary breached its duty by failing to disclose and that absent the non-disclosure the vote would have been different).

179. *See Memorandum of the Secretary of Labor as Amicus Curiae Regarding Issues Presented by Motion for Summary Judgment, Harris v. Texas Air Corp.*, No. 87-2057, 1987 WL 49665 (D.D.C. 1987). The Department of Labor used to apply a more burdensome standard, imposing on fiduciaries an affirmative duty to determine that participants are not subject to coercion or undue influence and that they in fact have rendered an independent decision without pressure from the employer on how to vote

Even then, a fiduciary may not blindly or automatically follow employee wishes. The fiduciary must make a determination that the instructions received from participants are proper and not contrary to ERISA. That is, pass-through voting does not relieve a fiduciary of the duty to determine whether a voting or tender decision is prudent or otherwise satisfies ERISA standards.¹⁸⁰ To encourage such independent determinations, courts will not uphold indemnification agreements that encourage fiduciaries not to make independent decisions.¹⁸¹

Plans that provide for pass-through voting also must make provision for the voting or tender of shares as to which no instructions are received by participants and, in the case of ESOPs, the voting or tender of unallocated shares.¹⁸² With respect to a participant's failure to convey instructions, a plan commonly will provide that shares as to which no instructions are received will not be voted or tendered. That is, the failure to convey instructions is treated as a decision not to vote or not to tender.¹⁸³ With respect to unallocated shares, plans commonly provide that such shares will be tendered or voted in the same proportion as allocated shares.¹⁸⁴

The DOL has long been opposed to treating a participant's failure to convey instructions as a decision not to tender or not to vote. Its position is

shares. See Department of Labor Opinion Letter to John S. Welch, Latham & Watkins, 11 Pens. & Ben. Rep. (BNA) 633 (April 30, 1984).

180. See *Central Trust Bank, N.A. v. American Avents Corp.*, 771 F. Supp. at 875-76 (upholding a trustee's decision to tender ESOP shares without complying with pass-through voting provision in trust agreement); *Danaher Corp. v. Chicago Pneumatic Tool Co.*, 635 F. Supp. 246, 250 (S.D.N.Y. 1986) (holding that a trustee must not put aside his personal judgment in favor of carrying out wishes of plan participants).

181. See, e.g., *Martin v. Nationsbank of Georgia*, 16 Employee Benefits Cas. (BNA) 2138 (N.D. Ga. 1993), available in 1993 WL 345606, at *3 (holding that an indemnification provision that provides broader indemnification for liability incurred in responding to tender offers for trustees following participant directions than for trustees who did not follow participant instructions violates ERISA by creating a financial incentive for the trustee to put aside its own independent judgment as required by ERISA and instead substitute the wishes of plan participants).

182. See William P. Wade, *Employee Benefit Plans in Control Contests: An Analysis of Participant 'Pass Through' Arrangements*, 17 Pens. Rep. (BNA) 1290 (July 23, 1990) (noting that usually a substantial block of stock is unallocated and held in suspense pending repayment of the ESOP loan). Since a newly created ESOP will have a large number of unallocated shares, how those shares are to be voted is an important issue.

183. Alternatives would be to have the trustee vote or tender in its discretion, have the trustee vote the unvoted shares proportionately to the voted shares, or have a management committee vote the shares.

184. To take a simple example, assume an ESOP with a total of 500,000 shares, 100,000 of which have been allocated to participants. If participants holding 75,000 of the shares elect to tender and the remaining elect not to tender, the trustee will tender a total of 375,000 shares (the 75,000 shares with respect to which participants made an election and 75%, or 300,000, of the 400,000 unallocated shares) and will not tender a total of 125,000 shares (the 25,000 shares with respect to which participants determined not to tender and 25%, or 100,000, of the 400,000 unallocated shares).

With respect to non-public companies, section 409(e)(5) of the Code provides that the plan trustee will vote all allocated and unallocated employer securities held by the ESOP in proportion to the results of the votes cast on the issue by the participants. I.R.C. § 409(e)(5) (1994). The Code provision covers only voting and not tender decisions.

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that the participant's silence is ambiguous and may be a result of the fact that a participant did not receive the proxy or tender materials or that the participant simply forgot to vote.¹⁸⁵ Therefore, the DOL believes that a trustee must vote such shares in its discretion.¹⁸⁶ While earlier cases seem to oppose this position,¹⁸⁷ there has been recent judicial support for it. For example, in *Reich v. Nationsbank of Georgia, N.A.*,¹⁸⁸ which dealt with Polaroid's use of its ESOP to block a tender offer, the court reasoned that

the only way to ensure that participants, as named fiduciaries, are well-informed and are actually directing trustees on investment decisions, is to interpret § 403(a)(1) as requiring affirmative direction. Without an affirmative act, it is impossible to determine if a participant's silence is actually a direction or a failure to direct due to unforeseen circumstances.¹⁸⁹

As a result, the court held that when a trustee does not receive an affirmative direction from plan participants regarding allocated shares, the trustee must make an independent decision whether to tender the shares.¹⁹⁰

The DOL position with respect to unallocated shares is less clear. In an opinion letter to the trustee of Polaroid's ESOP, it took the position that plan trustees must make an independent decision whether to tender unallocated ESOP shares.¹⁹¹ The DOL has argued that a plan may permit participants to vote or tender only stock allocated to their accounts; that participants cannot become "named fiduciaries" of shares not so allocated because they cannot be

185. See Department of Labor Opinion Letter to John S. Welch, Latham & Watkins, 11 Pens. & Ben. Rep. (BNA) 633 (April 30, 1984). The Department also argues that making an inference from silence ignores the language of section 403(a)(1) of ERISA, which states that a trustee's exclusive authority to manage and control plan assets can be subject only to a "direction" from a named fiduciary. See 29 U.S.C. § 1103(a)(1) (1994). It is the Department's position that a failure to vote or tender is a non-direction or a failure of direction. See *Reich v. Nationsbank of Georgia*, 19 Employee Benefits Cas. (BNA) 1345 (N.D. Ga. 1995), available in 1995 WL 316550, at *6.

186. There is an argument that the Department of Labor's position puts ERISA and the Code in conflict in situations where section 409 of the Code requires pass-through voting. See Welch, *supra* note 161, at 596 (arguing that section 409 makes no provision for a trustee to vote shares that a participant fails to vote, and pointing as an analogy to Treas. Reg. § 1.46-8(d)(8)(iv), forbidding a trustee to vote shares in tax credit ESOPs upon which the participants have not returned voting instructions).

187. See, e.g., *Smachlo v. Birkelo*, 576 F. Supp. 1439 (D. Del. 1983) (rejecting an attempt to void a pass-through provision providing, inter alia, that a failure to instruct shall be deemed to be a decision not to tender); cf. *Martin Marietta Corp. v. Bendix Corp.*, No. 82 CIV 6135, 1982 WL 1379, at *1 (S.D.N.Y. Sep. 22, 1982) (denying an application to modify an order directing a trustee to tender all shares as to which no withdrawal instructions had been received where plan allowed participants to direct the trustee to withdraw shares from a tender, accepting the assumption that nonresponse was an election to maintain an earlier decision to tender).

188. *Reich v. Nationsbank of Georgia*, 19 Employee Benefit Cas. (BNA) at *1.

189. *Id.* at 6.

190. See *id.*

191. See Department of Labor Opinion Letter to Thobin Elrod, Citizens and Southern Trust Company. 16 Pens. Rep. (BNA) 390 (Feb. 23, 1989).

held accountable for decisions regarding such shares.¹⁹² Courts have adopted the DOL's view expressed in *Polaroid*, holding that decisions with respect to unallocated shares must be made by the trustee and not in proportion to the votes received with respect to allocated shares.¹⁹³ However, more recently, the DOL has suggested that "a trustee must follow the plan provisions which require unallocated and non-directed shares to be voted in accordance with participant instructions unless the trustee can articulate well-founded reasons" why doing so would violate ERISA.¹⁹⁴

B. *Impact of Current Legal Standard on Attempts to Oust Management*

Despite the fact that ERISA's fiduciary duties require that a fiduciary act prudently and in the best interests and for the exclusive benefit of plan participants, voting and tender decisions with respect to employer securities favor existing management. There are several reasons why this is the case.

First, ERISA explicitly allows an employer or someone related to the employer to serve as a plan fiduciary, and many pension plans take advantage of that permission.¹⁹⁵ Section 406 of ERISA provides that certain transactions between a plan and a party in interest to a plan are prohibited.¹⁹⁶ However, section 408, which contains exemptions from ERISA's prohibited transaction rules, provides that nothing in section 406 shall be construed to prohibit any fiduciary from "serving as a fiduciary in addition to being an officer, employee, agent, or other representative of a party in interest."¹⁹⁷ This means that the person being asked to make a decision with respect to the voting or tender of employer securities is often someone who, in her capacity as officer

192. See *Reich v. Nationsbank of Ga.*, 19 Employee Ben. Cas. (BNA), at *3.

193. See *Danaher Corp. v. Chicago Pneumatic Tool Co.*, 635 F. Supp. 246, 249 (S.D.N.Y. 1986); *Reich*, 19 Employee Ben. Cas. (BNA), at *1. The courts' adoption of the DOL's view on this issue is consistent with the standards laid down by the Supreme Court in *Chevron, U.S.A. v. Natural Resources Defense Council*, 467 U.S. 837, 842-43 (1984). See also *British Printing & Comm'n Corp. v. Harcourt Brace Jovanovich, Inc.*, 664 F. Supp. 1519 (S.D.N.Y. 1987) (holding that an agreement between ESOP trustees and New York Stock Exchange that unallocated shares would be voted for or against shareholder proposals in the same proportion as allocated shares was not binding and that trustees were required to tender unallocated shares if it would be in the best interests of beneficiaries).

194. Department of Labor Opinion Letter to Ian Lanoff (Sept. 28, 1995), in Kenneth C. Edgar, Jr. et al., *Employer Securities Issues: Voting, Tender & Passthrough Issues; Termination of an ESOP with Unallocated Shares*, PENSION PLAN INVESTMENTS (PLI) (1996).

195. See Mark J. Roe, *The Modern Corporation and Private Pensions*, 41 UCLA L. REV. 75, 91 (1993) (noting that half of all corporate pension plans have in-house pension managers).

196. See 29 U.S.C. § 1106 (1994).

197. 29 U.S.C. § 1108(c)(3) (1994). In addition, both DOL regulations and IRS regulations state that it is not an absolute requirement that an ESOP be represented by an independent fiduciary. See Treas. Reg. § 54.4975-7(b)(2)(ii) (1996); 29 C.F.R. § 2550.408b-3(b)(2) (1997). The view of Congress in enacting ERISA was that merely functioning as both an officer and a fiduciary did not itself create a conflict of interests. See *Donovan v. Cunningham*, 716 F.2d 1455, 1466 (5th Cir. 1983) (explaining that in ERISA, "Congress departed from the absolute common law rule against fiduciaries' dual loyalties" in allowing a fiduciary to be an officer or employee of the company whose securities he purchases on behalf of the plan).

or employee of the employer, has an interest in the outcome of the vote. The assumption behind ERISA is that the fiduciary can separate her “fiduciary hat” from her “employer hat” and make a fiduciary decision subject to ERISA’s standards without regard to the fiduciary’s interests in her other capacities.

This assumption of separation of functions is a necessary byproduct of allowing officers and directors to act as fiduciaries, which itself is probably an indispensable element of a legal system that makes the decision whether to offer a pension plan a voluntary one.¹⁹⁸ Because not every act undertaken by an officer who is a fiduciary to a pension plan will be a fiduciary act, there must be a concept of separation of such officer’s fiduciary functions from her nonfiduciary functions and a corresponding assumption that the officer will be capable of acting in the best interest of plan participants when making plan-related fiduciary decisions, although he need not act so when making corporate decisions that are not plan-related.

This assumption is extraordinarily unrealistic in the context of a tender offer. A pension plan trustee who is an officer or director may face loss of salary and other benefits resulting from her corporate position if a hostile takeover is successful. In addition, the officer or director, in her corporate capacity, may very well be telling shareholders, to whom the officer or director also owes a fiduciary duty, not to tender their shares. Subject to satisfaction of state corporate law standards,¹⁹⁹ there is nothing improper about this. However, it is hard to imagine how a corporate officer who in her corporate capacity is urging shareholders not to tender can, in her capacity as plan fiduciary, come to any conclusion other than that a plan should not tender. It is hardly possible to expect a pension trustee to come to a decision with respect to the plan that is different from the decision the trustee has reached as an officer and director of the corporation. While *Bierwirth* acknowledged this difficulty, the court refused to create a bright line rule requiring a trustee to resign under such circumstances.²⁰⁰ Other courts have taken the same position.²⁰¹

198. See *infra* text accompanying notes 235-236.

199. In a tender offer situation, the actions of officers and directors are judged by a standard more stringent than the business judgment rule generally applicable to management actions. Decisions taken by directors in response to a tender offer are judged based on whether the tender offer presented a threat to the corporate enterprise and whether the directors’ actions were reasonable in relation to the threat posed. See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954-55 (Del. 1985) (enunciating the foregoing test for judging a board’s response to a takeover); see also *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 181 (Del. 1986) (noting that only actions that maximize shareholder value will be permissible in the sale of corporate control).

200. See *Donovan v. Bierwirth*, 680 F.2d at 271.

201. See, e.g., *Martin v. Feilen*, 965 F.2d 660, 670 (8th Cir. 1992) (holding that the rule requiring resignation of ERISA fiduciaries facing conflict of interest would conflict with congressional intent); *Gruby v. Brady*, 1994 U.S. Dist. LEXIS 17649, at *16-17 (S.D.N.Y. Dec. 9, 1994) (holding that conflict of interests does not require resignation).

The conflict of interest in decisionmaking is in one respect worse in defined benefit plans, in which the trustee itself makes the voting or tender decision, than in defined contribution plans, in which such decisions are passed through to plan participants. Whatever pressures a trustee feels to vote in a way consistent with management's wishes are more likely to affect the actual decision in a defined benefit plan.

On the other hand, the problem with decisions that are not in the best interest of plan participants is not eliminated by pass-through voting.²⁰² While most plan participants, if asked, would probably acknowledge that adequate retirement income is important, it does not necessarily follow that these same participants will actually vote or make a tender decision in their best interests as participants. In *Donovan v. Bierwirth*,²⁰³ employees and retirees overwhelmingly approved the trustees' decision to oppose the tender offer and purchase additional shares on behalf of the plan, although this course of action did not appear to have been in their best interest as plan participants.²⁰⁴ It is easy to surmise that current employees were motivated by either loyalty to their employer or a concern that the acquisition by LTV of Grumman would cost them their jobs. Retirees were presumably concerned with reports of the underfunding of LTV's plans.²⁰⁵ While the court determined that fears about the effect of LTV's underfunding on the Grumman plans were unfounded,²⁰⁶ it may not be reasonable to expect retirees to be able to make the same

202. The assumption that pass-through voting eliminates the problem of conflict of interest has an analog in trust law. A corporate trustee may find itself a trustee of a trust estate that holds as one of its assets shares of the corporate trustee. This is because, even though as a general matter a bank or trust company serving as trustee cannot purchase shares of its own stock for the trust estate, the trust estate may already hold such shares at the time the bank or trust company takes on the role of the trustee, in which case the shares may be retained or authorized by the terms of the trust, either specifically or pursuant to a general authorization to retain investments received from the settlor of the trust. See 2A A.W. SCOTT & W.F. FRATCHER, *THE LAW OF TRUSTS*, § 170.15, at 371-75 (4th ed. 1987). Moreover, purchase by a trustee of such shares is proper if expressly or implicitly authorized by the terms of the trust. See *id.* § 170.15, at 369. Due to the potential for self-dealing, corporate and bank trustees are generally prevented by statute from voting such shares unless the trust provides for pass-through voting. That is, the actual voting decision must be made by the donor or the beneficiary of the trust. See *id.* § 170.15, at 367-69 & n.3.

203. 680 F.2d 263 (2d Cir. 1982).

204. See *id.* at 265, 267. According to an affidavit submitted by a plan participant, Grumman employees at all levels spontaneously and within days after the suit was commenced circulated petitions expressing approval of the trustees' actions. As of the date of the affidavit, 17,000 of 22,000 employees who were plan participants had signed the petitions. See *id.* at 265. There was further evidence that the "overwhelming attitude of the retirees was 'what is good for Grumman is good for retirees.'" *Id.* at 267. Similarly, when Martin Marietta corporation attempted a hostile takeover of Bendix Corporation, more than 90% of participants did not tender their plan shares. See Serota, *supra* note 142, at 1077.

205. This was not an unreasonable concern. LTV's pension plans were "chronically underfunded," and by the time LTV filed for bankruptcy in July 1986, its defined benefit plans had unfunded liabilities of almost \$2.3 billion. See *Pension Benefit Guar. Corp. v. LTV Corp.*, 496 U.S. 633, 640 (1990).

206. See *Donovan*, 680 F.2d at 273-74. The court found that a number of LTV's plans were funded quite well and that LTV had indicated that it did not intend to touch the Grumman plan. See *id.* at 272-74.

evaluation. In *Danaher Corp. v. Chicago Pneumatic Tool Co.*,²⁰⁷ the court also expressed doubt that participants could make decisions in their own best interests.²⁰⁸

Such pro-employer decisions by current employees and retirees, while not in their best economic interests in their capacity as future or current pension benefit recipients, may have other, less tangible benefits to such employees and retirees. They may very well have strong feelings of identification with the employer and derive psychological or emotional benefit from making decisions they perceive to be in the best interests of current management. However real or significant such intangible factors are, they have no place in plan-related decisionmaking. As the issue here concerns the primary form of retirement income for a significant number of employees, voting and tender decisions must be made with an eye toward the best interests of the plan and of participants in their capacity as participants.

Unlike private trusts, which generally benefit one or a small number of related individuals,²⁰⁹ ERISA plans almost invariably have numerous unrelated beneficiaries. This creates the possibility of conflict among beneficiaries, particularly between younger active workers and older employees nearing retirement or retirees currently receiving benefits from a plan.²¹⁰

207. 635 F. Supp. 246, 249 (S.D.N.Y. 1986).

208. *See id.* at 250 (It is a fair assumption that a number of the plan participants, particularly the higher-salaried, larger presumptive participants, regard the possibility of a successful takeover and merger as casting doubt on their continued employment Furthermore, those presumptive participants who have a deep personal interest in the failure of Danaher's takeover are the bosses of the remainder of the participant group.); *see also* Fischel & Langbein, *supra* note 46, at 1140-41 (discussing *Bierwith* and *Danaher*).

209. *See* Jonathan R. Macey, *Private Trusts for the Provision of Private Goods*, 37 EMORY L.J. 295, 317 (1988) ("the residual claimants of a private trust often are a small group of easily identified people"); Robert B. Smith, *Reconsidering the Taxation of Life Insurance Proceeds Through the Lens of Current Estate Planning*, 15 VA. TAX REV. 283, 362-63 (1995) (noting that "beneficiaries of nearly any private trust are likely to be members of the donor's family who will often comply with the donor's wishes" regarding the disposition of trust property). Note that pension plans do not always have multiple beneficiaries. For example, individual retirement accounts (IRAs) are subject to certain rules of the Internal Revenue Code that are similar to ERISA's fiduciary rules, *see* I.R.C. § 4975 (1997), but these do not give rise to the same types of problems. There have not been any Internal Revenue Service enforcement actions alleging that an IRA fiduciary has violated the prohibited transaction rules of § 4975 of the Code.

210. The same problem does not tend to arise in the context of private trusts even when such trusts have multiple beneficiaries because there is usually no concern about younger beneficiaries' interests being pitted against older beneficiaries' interests as they are for ERISA plans. Also, even where such a conflict might be present, trust law contains specific rules for dealing with successive beneficiaries. *See* John H. Langbein, *The Contractarian Basis of the Law of Trusts*, 105 YALE L.J. 625, 660 (1995) (discussing various trust law principles for dealing with multiple and successive beneficiaries).

As a general matter, there does not appear to be much litigation concerning the voting actions of trustees of private trusts. Perhaps an explanation is that trustees in such instances are either corporate trustees, who tend to be very conservative, or private trustees who are family members. One commentator has suggested that "the only [private] trusts that become the subject of litigation are those

Conflicts between younger and older workers may arise in different ways. At the most basic level, younger and older workers are likely to have different views as to what percentage of total compensation should be paid in the form of retirement benefits versus current income, with younger workers preferring more current disposable income and older workers generally favoring increased retirement income.²¹¹ More directly relevant to voting and tender decisions is the fact that younger workers are more likely to favor voting plan shares in a manner that promotes their current interests as employees rather than their future interests as retirees. For example, they might use votes to ward off a tender offer that might risk their current job security.²¹² In contrast, a retired worker will more likely be tempted by a high premium offered in a tender offer because that worker is only likely to be concerned more with plan assets than with the employer.²¹³

Even among retirees, there may be conflict. A retiree with a long life expectancy may have a different interest than a retiree who expects to receive benefits only for several years. The former may be more interested in preserving the employer as a going entity if he believes that future employer contributions are necessary to the continued well-being of the plan or believes that the employer is more likely to provide for cost-of-living adjustments to plan benefits than the acquirer. There also may be conflicts among employees, regardless of age, based on whether an employee is single or has a family, with employees who have families having a greater concern about the effect of a change in management on welfare benefits, such as insurance.

This conflict among beneficiaries makes it difficult for a fiduciary to meet her duty to act in the exclusive interest of all beneficiaries in a tender offer situation since a particular decision may benefit one group of beneficiaries over another. A decision to tender may be potentially dangerous to younger employees, for example, when the takeover would jeopardize future plan contributions. Yet the same tender, with a high premium, would be beneficial to retirees, whose primary concern is that there be sufficient funds to pay their benefits.²¹⁴

It is difficult to see how such conflict among beneficiaries can be avoided.

that have been artlessly crafted by lawyers." Macey, *supra* note 209, at 313-14. Professor Macey also suggested that private trusts do not frequently become the subject of litigation because the settlor, the real party in interest, "generally is dead when problems arise" and the "trustee has no direct economic interest in seeing that the settlor's trust be used in one way over another." *Id.*

211. See Fischel & Langbein, *supra* note 46, at 1120.

212. That employees might vote to ward off a takeover bid does not mean that defending against it is necessarily in their best interests because the defense will involve a significant expenditure of corporate funds that could have been used for other purposes, such as increasing the current employees' wages. Nevertheless, an employee's perception and reality will not necessarily converge.

213. See Fischel & Langbein, *supra* note 46, at 1141.

214. As a general matter, a takeover will not jeopardize current retirees, but may have devastating consequences to future plan beneficiaries (that is, current employees).

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In *Danaher Corp. v. Chicago Pneumatic Tool Co.*,²¹⁵ the court suggested this conflict should be dealt with by the trustees, evaluating the “best interests of beneficiaries in the abstract as beneficiaries,”²¹⁶ a suggestion that is less than completely helpful as a practical matter. The court did not elaborate on how one determines the best interests of beneficiaries in the abstract, and it seems neither possible nor desirable to determine “best interests” without regard to the individual beneficiaries themselves.²¹⁷

As previously discussed, the exclusive benefit rule is not violated when a decision or action by a trustee creates an incidental benefit to someone other than the plan.²¹⁸ While the incidental benefit notion may be consistent with the construction of the Code’s exclusive benefit analogs to ERISA,²¹⁹ one should pause before using this notion to evaluate voting and tender decisions.

Whenever one introduces the idea of allowing an incidental benefit to someone other than plan participants, there is the problem of trying to decide how much of a benefit constitutes an incidental benefit. In the context of tender and voting decisions, the “incidental” benefit to management and the fiduciary is likely to be quite significant. Management will always benefit from the failure of an unwanted tender offer. The same will often be true in voting matters because shareholder proposals tend to involve issues on which shareholders disagree with the management.²²⁰ If all *Bierwirth* intended to say was that the fact that management might benefit from the defeat of a tender offer did not mean that a trustee automatically violated the exclusive benefit rule by refusing to tender, the decision is not bothersome. A trustee may, in fact, determine that tendering is not in the best interests of plan participants. However, if the court intended more and meant to suggest that it is permissible for a fiduciary to make decisions with an “incidental” benefit to the employer in mind, the decision is very troubling.

Finally, when the plan fiduciaries are related to management, it is difficult to evaluate voting and tender decisions made by such fiduciaries with respect to employer securities. ERISA requires that the fiduciaries’ actions be judged at the time a decision is made.²²¹ Decisions are not judged by looking at the results of a fiduciary’s actions; if a fiduciary’s act constitutes a violation of the general fiduciary standards contained in section 404 or of the prohibited transaction rules of section 406, ERISA is violated even if the act turns out to

215. 635 F. Supp. 246 (S.D.N.Y. 1986).

216. *Id.* at 250.

217. One commentator has suggested that what *Danaher* means is that “only the basic goal of plan asset maximization [should] inform the trustee’s decision.” See Susan S. Ressel, Note, *Tender is the Right: Responsibility for Tendering ESOP Shares Under ERISA*, 6 VA. TAX REV. 561, 575 n.64 (1987).

218. See *supra* notes 173-176 and accompanying text.

219. See *supra* note 57.

220. See *supra* note 152 for examples of matters on which shareholders have submitted proposals in recent years.

221. See cases cited *supra* note 53.

have been neutral or beneficial to plan participants and beneficiaries.²²²

How does one evaluate the fiduciary's decision at the time it was made? One cannot look to motive. It is difficult to assess motive other than by relying on perceptions, or the existence of, a conflict of interests. Once ERISA permits a fiduciary related to management, it will be impossible to judge such a fiduciary's motive in voting in accordance with the management's wishes.

C. *Impossibility of Eliminating Entrenchment Problems by Other Means*

The previous section suggested that significant accumulations of employer securities in pension plans promote entrenchment of existing management. Before concluding that this problem should be addressed by decreasing pension plan holdings of employer securities, other alternatives should be considered.

1. *Requiring Independent Fiduciaries*

The most obvious suggestion for ensuring that proxy and tender decisions are made in the best interest of plan participants and beneficiaries is to amend ERISA to require the appointment of independent fiduciaries for pension plans. This could be accomplished through the simple expedient of eliminating from the statute section 408(c)(3), which provides that no prohibited transaction occurs when a fiduciary is an officer, employee, agent or other representative of a party in interest.²²³ This would make the appointment of such a fiduciary a "furnishing of goods, services, or facilities between the plan and a party in interest,"²²⁴ and, therefore, a prohibited transaction.²²⁵

222. See, e.g., *Donovan v. Cunningham*, 716 F.2d 1455, 1467 (5th Cir. 1983) (stating that the test focuses on the conduct of the fiduciary, not the performance of the investment); *Marshall v. Glass/Metal Ass'n & Glaziers & Glassworkers Pension Plan*, 507 F. Supp. 378, 384 (D. Haw. 1980) ("The application of ERISA's prudence standard does not depend upon the ultimate outcome of an investment, but upon the prudence of the fiduciaries under the circumstances prevailing when they make their decisions and in light of the alternatives available to them."). This formulation of the test is necessary to further the aim of deterring bad behavior.

223. See I.R.C. § 408(c)(3) (1997). Assuming that an independent fiduciary provides a benefit, that statutory change should be sufficient because persons other than officers and directors, who might not be independent for other reasons, would likely be parties in interest to a plan and, therefore, precluded from serving as a fiduciary by virtue of ERISA's prohibited transaction rules. See 29 U.S.C. § 1106(a), (b) (1994). For example, the DOL has taken the position that "when a significant portion of plan assets consists of the securities of one issuer, it is not possible for a plan trustee to act 'solely in the interest of the [plan's] participants and beneficiaries' in conformity with ERISA section 404(a)(1) if he, the trustee, is simultaneously in his nonfiduciary capacity a substantial secured creditor of the issuer of those securities." Op. DOL No. 76-32 (Jan. 13, 1976).

224. 29 U.S.C. § 1106(a)(1)(C) (1994).

225. Absent section 408(c)(3), the appointment of a related fiduciary would also arguably constitute a violation of section 406(b) of ERISA at least in the context of a tender offer, because the fiduciary would be acting on behalf of both the plan and a party with an interest adverse to that of the plan. See 29 U.S.C. § 1106(b) (1994).

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There is great appeal in the suggestion that once a position of dual loyalties is permitted,

it can be very difficult to determine: (1) if a fiduciary has stepped over the line and breached his or her duty of loyalty to plan beneficiaries (an ERISA violation) or, (2) if the fiduciary has merely made a mistake in judgment or simply made a reasonable investment or taken a reasonable action which did not turn out as intended (probably not an ERISA violation).²²⁶

Therefore, the idea of requiring an independent fiduciary has some appeal.²²⁷

The requirement of an independent fiduciary would also bring ERISA closer to the requirements of traditional trust law in which ERISA has its origins.²²⁸ Trust law also imposes on trustees of private trusts the duty of loyalty to the beneficiaries of the trust.²²⁹ The trustee's duty to administer the trust solely in the interests of trust beneficiaries results in the trust law's imposition of a prohibition against a trustee's holding a position that has interests conflicting with the interests of the trust of which the trustee is a fiduciary.²³⁰

226. Laurence B. Wohl, *Fiduciary Duties Under ERISA: A Tale of Multiple Loyalties*, 20 U. DAYTON L. REV. 43, 47 (1994).

227. The suggestion is appealing for the same reason that a number of reformers respond to allegations of corporate management abuse by proposing independent outside directors as a solution. See, e.g., AMERICAN BAR ASS'N, CORPORATE DIRECTOR'S GUIDEBOOK 15-16 (2d ed. 1994); AMERICAN LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 3A.01 (1994); Martin Lipton & Jay W. Lorsch, *A Modest Proposal for Improved Corporate Governance*, 48 BUS. LAW. 59, 67 (1992). However, there is substantial disagreement among commentators as to whether corporate abuses would be eliminated by requiring outside directors. See, e.g., John W. Byrd & Kent A. Hickman, *Do Outside Directors Monitor Managers? Evidence from Tender Offer Bids*, 32 J. FIN. ECON. 195, 196 (1992). The "managerial hegemony theory" argues that even independent boards of directors are powerless to control corporate management, because of biases in the nomination and selection process for outside directors, constraints on the ability of outside directors to monitor management and weak incentives to monitor. See Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898, 912-17 (1996).

228. See *supra* note 46.

229. "One of the most fundamental duties of the trustee is that he must display throughout the administration of the trust complete loyalty to the interests of the beneficiary, and must exclude all selfish interest and all consideration of the interests of third parties." GEORGE G. BOGERT & GEORGE T. BOGERT, *THE LAW OF TRUSTS AND TRUSTEES* § 543, at 375-98 (revised 2d ed. 1980 & Supp. 1993). The various aspects of the duty of loyalty, including the common law prohibition against dealing with the assets of a trust in the trustee's own interest, representing persons with an interest adverse to the trust in a transaction with the trust, and receiving consideration from a party dealing with the trust, were the basis for the prohibitions contained in section 406(b) of ERISA. See 29 U.S.C. § 1106(b) (1994).

230. See *City Bank Farmers Trust Co. v. Cannon*, 51 N.E.2d 674, 675 (N.Y. 1943) ("The standard of loyalty in trust relations does not permit a trustee to create or occupy a position in which he has interests to serve other than the interest of the trust estate."); see also *Fulton Nat'l Bank v. Tate*, 363 F.2d 562, 571 (5th Cir. 1966) (holding that the trust law rule is one of undivided loyalty and that a fiduciary may not allow himself to be placed in a position where his personal interest might conflict with that of beneficiary). However, the settlor has the power to modify that rule. See *Bartlett v. Dumaine*, 523 A.2d 1, 7 (N.H. 1986) (stating that general fiduciary trust principles apply unless settlor imposes

However, there are several problems with the independent fiduciary solution. First, given the shift from defined benefit toward defined contribution plans, increasing amounts of employer securities will be held by defined contribution plans, which generally provide for pass-through voting of shares.²³¹ An independent fiduciary would have no effect on voting in such plans.

Second, it is not clear that an independent fiduciary would really guarantee independent decisionmaking. Independent trustees generally have some business or other relationships with management of the company of whose pension plan the trustee is a fiduciary, thus creating the risk that the trustee will fear making pension plan decisions opposed to the employer's interest.²³² Even in cases in which no such preexisting relationship exists, the trustee may be interested in keeping her job, which may color her voting and tender decisions.²³³ In sum, an independent fiduciary may not be immune from pressure (overt or subtle) to vote in a manner advantageous to management.²³⁴

Finally, there is a risk that requiring an independent fiduciary for all plans will cause some employers, particularly smaller ones, to hesitate in offering defined contribution plans. Keeping pension plans voluntary was one of Congress's fundamental requirements in enacting ERISA. No employer is forced to provide its employees with a pension plan unless it has contractually

different constraints on trustee); Kerper v. Kerper, 780 P.2d 923, 929 (Wyo. 1989) (holding that the settlor has the right to modify the fiduciary duties that ordinarily govern the administration of a trust); Neuhaus v. Richards, 846 S.W.2d 70, 74 (Tex. 1992) (holding that the settlor may relieve trustee of duties imposed by statute); Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 429 (1993) (characterizing the trust law rule that an express provision in the trust instrument governs over the duty of loyalty in the event of conflict as one of the cornerstones of trust law).

231. See *supra* notes 41-44.

232. See S. REP. NO. 100-265, at 1126 (1987) (noting that since independent fiduciaries rely on corporations for their business, they often felt compelled to vote with management). In the analogous corporate arena, concern is sometimes expressed that outside directors may view their board seats as a vehicle for securing business relationships with the corporation. The directors, therefore, may be reluctant to make decisions that could jeopardize those relationships. See Lin, *supra* note 227, at 920.

233. See Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 842 (1993) (explaining that outside investment managers "understand the power of appointment"). In the overwhelming majority of cases, the corporation's board of directors chooses the ESOP trustee. See BLASI, *supra* note 25, at 306 n.37. That being the case, it would not be surprising if an independent trustee felt he was serving at the pleasure of the employer, much in the way many independent, disinterested directors "feel they are serving at the pleasure of the CEO-Chairman." JAY W. LORSCH & ELIZABETH MACIVER, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARD 17 (1989) (reporting results of a survey of outside directors of S&P companies).

234. See Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L. J. 445, 469 n.80 (1991) (arguing that employers have a tendency to pressure pension plan investment managers into voting for proposals that further the employer's interest); Bruce Nussbaum & Judith H. Dobrzynski, *The Battle for Corporate Control*, BUS. WK., May 18, 1987, at 102 (citing letters from CEOs involved in proxy contests appealing to other CEOs to instruct their pension managers how to vote). Commentators have also questioned the effectiveness of independent board members in monitoring corporate management. See *supra* note 227.

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obligated itself to do so. The requirement that all pension plan fiduciaries be independent of the employer would impose an additional cost on plan administration. If the cost is too high, the requirement may discourage the adoption and retention of pension plans.²³⁵

The cost factor assumes a particular significance in defined benefit plans, in which investment risk is borne by the employer. In contrast to a defined contribution plan, in which the participant's entitlement is measured by the value of the participant's individual account, a defined benefit plan promises a fixed benefit, which must be paid regardless of how well or how poorly pension fund investments do. If there is a shortfall, the employer must make up the difference. Since the employer bears the cost, the employer would prefer to have the opportunity to control the management of the plan. Insisting that an employer bear the cost of bad decisions, without having control over such decisions, will likely decrease the adoption of new defined benefit pension plans by small employers.²³⁶

If one believes that there is merit in independent fiduciary decisionmaking in contests for corporate control, an intermediate approach is possible. As already discussed, current law not only allows the appointment of a fiduciary related to the employer, but also permits a fiduciary to remain even when a conflict of interests arises.²³⁷ The law could continue to allow for the appointment of fiduciaries related to the employer, but require the resignation of the related trustee and the appointment of an independent fiduciary when a

235. This concern was expressed at the time ERISA was adopted. See S. REP. NO. 93-383 (1974), reprinted in 1974 U.S.C.A.N. 4890, 4904 (arguing that because pension plans are voluntary and because both the adoption of pension plans and increases in benefits depend on employer willingness to adopt or expand plans, regulation must take into account the effect of additional costs from the employer's standpoint); 120 CONG. REC. 29,945 (1974) (statement of Sen. Long) ("We know that new pension plans will not be adopted and that existing plans will not be expanded and liberalized if the costs are made overly burdensome, particularly for employers who generally foot most of the bill.").

When the DOL included an independent fiduciary requirement in its 1991 proposed regulations under section 404(c) of ERISA, the proposal was met with great resistance by employers, who argued that the requirement would be too costly. See, e.g., Research Inst. of America, *Pension Benefits*, 6 DOL Official Discusses Comment Letters on Proposed ERISA § 404(c) Regulations, EXECUTIVE COMPENSATION ALERT, June 12, 1991, at 6, 6; *Section 404(c) Rules Receive Mixed Reviews at Labor Department Hearings*, 18 Pens. & Ben. Rep. (BNA) 1194 (July 15, 1991). The final section 404(c) regulations enacted in 1995 do not include an independent fiduciary requirement. See 29 C.F.R. § 2550.404c-1 (1997).

236. See Fischel & Langbein, *supra* note 46. While competition and the need to attract and retain workers may require an employer to offer some form of pension plan, employers will be less likely to offer a defined benefit plan. The shift away from defined benefit plans is not necessarily a positive one. See *supra* note 100.

The cost factor could be minimized by requiring an independent fiduciary only for pension plans established by public companies of a certain size, on the assumption that they are the most likely takeover candidates. While it would lessen the disincentive, cost is still something employers will factor in when deciding whether to offer a defined benefit plan. Such a proposal would also allow managements of smaller companies to continue operating without the check that would be there if shares were more widely dispersed among more unrelated, objective shareholders.

237. See *supra* notes 197-201 and accompanying text.

potential for conflict arises — for example, when a tender offer is announced or a proxy battle commenced.²³⁸ Alternatively, even if the related trustee does not resign, the voting or tender decision could be made by an independent fiduciary when a potential for conflict arises. As already discussed, this possibility was raised by the court in *Donovan v. Bierwirth*.²³⁹ It was raised more directly in *Danaher Corp. v. Chicago Pneumatic Tool Co.*,²⁴⁰ where Judge Leval, after hearing oral argument on an application to remove an independent fiduciary, suggested to the parties that, given the plan fiduciary's status as president of a target corporation, it was inappropriate for him to continue as the plan trustee during the fight for corporate control.²⁴¹

The intermediate approach has some appeal because it does not require employers to undertake the additional cost of having an independent fiduciary unless a conflict of interests arises. However, it is not problem-free. First, it requires that a new fiduciary, unfamiliar with the company and the plan, make a decision within a short period of time. Second, because the company or the existing fiduciary will be making the selection of the independent trustee at the time a conflict of interests situation has already arisen, the appointment decision itself is likely to be challenged. That is exactly what happened in *Danaher*, when the DOL brought a challenge against the appointment of trustees chosen to take the place of the resigning president.²⁴²

Of course, neither requiring an independent fiduciary under all circumstances nor adopting the intermediate approach addresses the difficulties created by the fact that plans have multiple beneficiaries with potentially different interests.

2. Requiring Reliance on Independent Advisers

An alternative to requiring the appointment of independent fiduciaries would be requiring that a related fiduciary obtain the advice of an independent adviser before making a voting or tender decision with respect to employer securities, and to render decisions consistent with that advice. The law does not currently mandate that pension trustees seek the counsel of outside

238. See Elizabeth J. Buck, Comment, *Making a Prudent Response to a Tender Offer: The Corporation Trustee's Dilemma Under ERISA*, 32 AM. U. L. REV. 839, 864 (1983) (suggesting that corporate trustees should resign during a tender offer).

239. See 680 F.2d at 271.

240. 635 F. Supp. 246 (S.D.N.Y. 1986).

241. See *id.* at 247. Judge Leval offered the parties a recess to give the fiduciary an opportunity to withdraw as the trustee before the court acted on the application to remove him. The fiduciary accepted the court's invitation to submit his resignation. See *id.*; see also *McMahon v. McDowell*, 794 F.2d 100, 110 (3d Cir. 1986) (holding that under certain circumstances, the duty a trustee owes to plan participants may "require the fiduciary to step aside in favor of a neutral referee").

242. See *Danaher Corp. v. Chicago Pneumatic Tool Co.*, 635 F. Supp. 246, 248 (S.D.N.Y. 1986); see also *Ressel*, *supra* note 217, at 590 ("A seemingly independent fiduciary appointed by interested parties during a takeover battle may be tainted by the latter's conflict of interest.").

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experts, although there was a suggestion in *Donovan v. Bierwirth*²⁴³ that the trustees in that case should have sought legal advice from “someone above the battle”²⁴⁴ and there are cases holding that a trustee can meet its fiduciary obligations by soliciting the advice of outside advisers.²⁴⁵

There are other contexts in which the law recognizes the value of reliance on independent advisers. To take an example from the corporate arena, New York law provides that, generally, the board of directors, acting by a quorum consisting of directors who are not party to an action, may vote for indemnification of directors or officers upon a finding that the statutory standard for indemnification has been met.²⁴⁶ However, the statute also provides that, in a situation in which it is not possible to obtain a quorum of independent directors, the board also may vote to indemnify upon the opinion in writing of independent legal counsel as to satisfaction of the statutory standard.²⁴⁷ In the context of voting and tender decisions, we could require trustees to obtain opinions from attorneys or financial advisers, as the case may be, and to render decisions consistent with those opinions.

Requiring reliance on independent experts would provide greater degree of comfort that the decision reached was made in the best interest of plan participants.²⁴⁸ However, any kind of meaningful opinion doubtless would be quite costly. Additionally, there are questions of enforcement. How do we

243. 680 F.2d 263 (2d Cir. 1982).

244. *Id.* at 273; *see also* *Salovaara v. Eckert*, No. 94-C3430, 1996 U.S. Dist. LEXIS 323, at *6 (S.D.N.Y. Jan. 10, 1996) (“Where a fiduciary is also a corporate officer, conflicts of loyalties should be adjudicated on a case-by-case basis as they arise, with officer-fiduciaries seeking independent advice as necessary.”); *Andrade v. Parsons Corp.*, 12 Employee Benefits Cas. (BNA) 1954, 1961 (C.D. Cal. 1990) (finding that the decision of an interested committee based on advice of independent legal and financial advisers satisfied the duty of loyalty).

245. *See Gruby v. Brady*, 92-C3888, 1994 U.S. Dist. LEXIS 17649, at *20 (S.D.N.Y. Dec. 9, 1994). However, while reliance on an independent adviser helps against a charge of a breach of the duty of loyalty, it does not necessarily satisfy the prudence requirement. *See Donovan v. Mazzola*, 716 F.2d 1226, 1234 (9th Cir. 1983) (holding that relying on counsel’s advice, without more, cannot be a complete defense to the charge of imprudence); *United States v. Mason Tenders Dist. Council of Greater New York*, 909 F. Supp. 882, 888 (S.D.N.Y. 1995) (holding that bad advice from counsel does not shield a trustee from liability under ERISA).

246. *See* N.Y. BUS. CORP. LAW § 723(b)(1) (McKinney Supp. 1997).

247. *See id.* § 723(b)(2)(A). The role of the outside adviser suggested here is somewhat different from the role in the New York statutory scheme. There, the lawyer is reviewing decisions made by a director to see if the director acted in good faith and for a purpose the director reasonably believed to be in the corporation’s interest. *See id.* § 722(a). Here, the independent adviser would actually be making the voting or tender decision in place of the related trustee. Depending on the facts, the role of the outside adviser could be more or less difficult than the role envisioned by the New York statutory indemnification scheme. Still, the point is the same with both: A decision or evaluation by an independent party is used to cure what would otherwise be an interested or tainted decisionmaking process.

248. To get that comfort, the requirement would have to be that the fiduciary’s decision must be consistent with the advice of the outside adviser. It would not be enough merely to require the fiduciary to solicit outside advice if the fiduciary were then free to ignore the recommendation.

ensure that fiduciaries actually follow the advice of their outside advisers?²⁴⁹ Finally, like the proposal to appoint an independent fiduciary, this approach would do nothing for pass-through voting plans and does not address the problem of varying beneficiary interests.²⁵⁰

3. *Imposition of a Modified Business Judgment Rule*

A different suggestion has been advanced by Professor Wohl.²⁵¹ Based on the inadequacies of measuring fiduciary decisions by motives or results, he suggests a process-based approach. Professor Wohl advocates the adoption of a modified business judgment rule,²⁵² which he calls the "ERISA Judgment Rule,²⁵³" that would look to the adequacy of the process by which an ERISA fiduciary makes decisions. The rule "is a variable one which requires evidence that the fiduciary utilized appropriate procedures sufficient to safeguard the interests of the plan and the plan's participants and beneficiaries."²⁵⁴ While this proposal has some appeal, it has several flaws. First, despite being borrowed from the corporate arena, the proposal is inconsistent with the requirement that heightened rules applied in conflict of interests situations. The business judgment rule's focus on process assumes no conflict of interests on the part of the board of directors receiving the protection of the rule.²⁵⁵

249. If the adviser were outside counsel, as it may be in many circumstances, checking whether such advice was being followed would probably raise attorney-client privilege issues.

250. Although not directly addressing voting and tender issues, Professors Fischel and Langbein have proposed to resolve problems with the operation of ERISA's exclusive benefit rule by explicitly imposing on ERISA fiduciaries a duty of impartiality. See Fischel & Langbein, *supra* note 46, at 1159. Their recommendation derives from trust law, which requires trustees to be impartial when there are two or more beneficiaries of a trust, because beneficiaries may not have identical interests. See RESTATEMENT (THIRD) OF TRUSTS § 183 (1992). The trustee must also deal impartially with successive beneficiaries, that is, with beneficiaries whose interests follow one another. See *id.* § 232. In such a situation, the trustee must manage the trust to provide income for the life beneficiary and preserve the trust corpus for the remainder beneficiary. See *id.* Fischel and Langbein's proposal is based on the idea that the exclusive benefit rule "makes no sense when the interests of some beneficiaries conflict with the interests of others." Fischel & Langbein, *supra* note 46, at 1159. However, while Fischel and Langbein are correct that ERISA has no express analog to the conventional trust law duty of impartiality, they recognize that the "duty of impartiality inheres in the logic of pension trusts." *Id.* at 1159-60. Courts have also recognized such a duty. See, e.g., *Morse v. Stanley*, 732 F.2d 1139, 1145 (2d Cir. 1984); *Struble v. New Jersey Brewery Employees' Welfare Trust Fund*, 732 F.2d 325, 333 (3d Cir. 1984); *Winpisinger v. Aurora Corp.*, 456 F. Supp. 559, 569 (N.D. Ohio 1978). Therefore, it is not clear what, if anything, would be gained by explicitly spelling out the duty legislatively or otherwise.

251. See Wohl, *supra* note 226.

252. The business judgment rule is a presumption that the corporate director has acted in an informed and good faith manner. The usual standard of review of a decision coming under the business judgment rule is that it only be rational. See, e.g., *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (discussing the protection of the business judgment rule which, absent abuse, will be respected by courts); *Kamin v. American Express*, 383 N.Y.S.2d 807 (Sup. Ct. 1976) (noting that directors are entitled to use business judgment in acting on information), *aff'd*, 387 N.Y.S.2d 993 (App. Div. 1976).

253. Wohl, *supra* note 226, at 87.

254. *Id.* at 91.

255. Application of the business judgment rule first requires that the duty of care in information gathering, monitoring, and supervision be satisfied. Once this has been met, the subsequent evaluation of

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Along the same lines, the proposal arguably would involve lowering standards, since ERISA fiduciaries start with a standard already higher than the business judgment rule, which, in the corporate arena, is the lowest standard applicable to the decisions of fiduciaries.²⁵⁶

Professor Wohl implicitly acknowledges this by suggesting that the rule requires a higher level of scrutiny of procedures when there is a conflict of interest. If he is not arguing for a lowered standard but merely advocating an approach that looks to the process of decisionmaking, that is not a real change. Courts already employ a procedural focus in resolving breach of fiduciary duty claims.²⁵⁷ For example, the *Bierwirth* court's focus was on the inadequacies of the decisionmaking process employed by the trustees.²⁵⁸

None of the foregoing alternatives addresses the problem of pass-through voting. Because it makes little sense to impose fiduciary liability on employees for poor voting and tender decisions, the only possibility for addressing that problem, short of the solution proposed by this Article, is to eliminate pass-through voting altogether. The former clearly would be undesirable. It would be both harsh and unfair to employees, who may not be very sophisticated in investment matters and the statutory standards established by ERISA.²⁵⁹ Eliminating pass-through voting would merely magnify the aforementioned problems regarding defined benefit plan voting and tender decisions.

D. *Minimizing the Entrenchment Impact of Pension Plan Employer Securities Holdings*

The prior discussion suggests that tender and voting decisions made by pension plans are invariably suspect. Whether the voting or tender decision is being made by a single fiduciary, as in the case of a defined benefit plan

the substantive decision will be less stringent. *See Aronson*, 473 A.2d at 812 (noting that the business judgment rule presumes that directors are acting in good faith and in the best interest of corporation, but will not apply when a director's self-interest is proven); *Kamin*, 383 N.Y.S.2d at 812 (noting that a declaration of a dividend is essentially a matter of business judgment and that a court should not interfere with directors' "discretion" unless they have acted in bad faith).

256. *Cf.* GEORGE G. BOGERT & GEORGE T. BOGERT, *THE LAW OF TRUSTS & TRUSTEES* § 543, at 262-63 (rev. 2d ed. 1980 & Supp. 1993) (comparing trust law fiduciary duties with corporate directors' more lenient standard, which is satisfied by full disclosure and a showing of fairness and good faith).

257. *See, e.g.,* *Gochnauer v. A.G. Edwards & Sons, Inc.*, 810 F.2d 1042, 1050 (11th Cir. 1987) (examining the process of a fiduciary's selection of an investment); *Donovan v. Cunningham*, 716 F.2d 1455, 1467 (5th Cir. 1983) (focusing on "a review of the fiduciary's independent investigation of the merits of a particular investment, rather than on an evaluation of the merits alone"); *Donovan v. Bierwirth*, 538 F. Supp. 463, 470 (E.D.N.Y. 1981) (reviewing a fiduciary's investigation under the test of prudence); *Jones v. O'Higgins*, 11 Employee Benefits Cas. (BNA) 1660 (N.D.N.Y. 1989) (examining whether a fiduciary employed proper methods to investigate, evaluate, and structure an investment).

258. *See* sources cited *supra* notes 169-170 and accompanying text.

259. For a discussion of the fiduciary standards imposed by ERISA, see *supra* notes 48-60 and accompanying text. In any event, it is unlikely that courts would enforce such liability against employees.

holding employer securities, or is being passed through to plan participants, as in the case of a 401(k) plan or an ESOP, the likely outcome is that the decision will be made with less of an eye toward the interests of employees as retirees than toward other interests. Whoever is making the decision, it is likely to favor existing management. Because it is very difficult to eliminate this bias through the appointment of independent fiduciaries or other means, a desirable course of action would be to minimize the role pension plans play in tender and voting decisions.

Recall that the current restrictions applicable to defined benefit plans operate in two ways. The law limits both the percentage of a plan's assets that can be invested in employer securities²⁶⁰ and the percentage of an employer's stock that can be held by the plan.²⁶¹ It is the second type of restriction that directly impacts management entrenchment. As already noted, neither limit applies to defined contribution plans.²⁶² The result is that the overall percentage of an employer's securities held by its defined benefit and defined contribution plans (in the case of employers maintaining multiple plans) or by defined contribution plans alone can have a significant effect. For instance, approximately 1500 companies with ESOPs are majority-owned by employees and approximately 500 companies with ESOPs are 100% owned by employees, according to recent statistics provided by the ESOP Association, the national trade association for companies with ESOPs.²⁶³

If decisions made by pension plans cannot be trusted to be independent of management, the most direct solution is to limit the percentage of an employer's stock that can be held by all pension plans maintained by the employer, without distinguishing between defined contribution and defined benefit plans. While imposing such a combined limit introduces a new element of pension plan regulation, it is a relatively simple form of regulation, unlike many of the other changes that have been made in the laws affecting pension plans. Imposing this additional layer of regulation seems a small price to pay for minimizing management entrenchment promoted by the current legal approach.

Choosing what the combined plan holdings limit should be in percentage terms is more difficult, as almost any percentage chosen has an element of arbitrariness. Recognizing that other numbers could arguably be defended, I

260. See 29 U.S.C. § 1107(a)(2) (1994).

261. See 29 U.S.C. § 1107(f)(1) (1994). Under the current limit, defined benefit plans can invest in employer securities only if no more than 25% of the outstanding stock of the same class is owned by the plan and at least 50% of the outstanding stock of the same class is owned by persons independent of the issuer.

262. See *supra* notes 31-32 and accompanying text.

263. See *The ESOP Association President J. Michael Keeling's Statement on the Office of Investigations Services ESOP Proposal*, PR Newswire, June 12, 1995, available in WL, PRWIRE Database. U.S. corporations with majority ownership include United Airlines, Publix Supermarkets, Avis and Wierton Steel. See Tseo & Ramos, *supra* note 70, at 25.

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would amend ERISA to provide that the total percentage of an employer's securities held by all pension plans maintained by the employer combined may not exceed 15% of any class of voting securities.²⁶⁴ Furthermore, I propose that a pension plan may not make an investment in employer securities if such investment would result in less than 67% of any class of the employer's voting securities being held by persons independent of the employer.

I choose these limits for several reasons. First, current law limits defined benefit plans to no more than 25% of a class of the employer's securities and requires that at least 50% of the class be owned by persons independent of the employer.²⁶⁵ The 25% limit is consistent with the approach of several other federal statutes, where an entity is viewed to "control" another entity when it holds 25% of a class of that entity's voting securities.²⁶⁶ However, it ignores the fact that in addition to employer securities held by pension plans sponsored by the employer, officers and directors often hold significant holding of shares and options to purchase shares.²⁶⁷ Limiting plan holdings to 15% should ensure that, even taking into account shares held by officers and directors directly, the bias in favor of management created by plan voting and tender decisions is minimized.

Second, the requirement that 67% of a class of voting shares be held by independent shareholders allows dissident shareholders to approve certain actions requiring a supermajority vote under state corporate law without management and those voting in management's interest being necessarily able to block the vote. Finally, the proposed limit continues to allow companies to get the benefit of giving employees some meaningful stake in the company's growth through its pension plan, without concentrating too high a percentage of the employer's securities in so-called friendly hands.

Conclusion

Aligning the interests of employees with those of shareholders has appeal in motivating employees and allowing them to share in the growth of their employer. However, there are reasons why it is not desirable to encourage significant accumulations of employer securities in pension plans. First, pension plan investment in employer securities puts an employee's current job security and future retirement security in the same basket: Declining

264. Presumably, there would be no entrenchment danger if an employer allowed plan investment in a class of non-voting securities.

265. See 29 U.S.C. § 1107(d)(5), (f)(1) (1994).

266. See, e.g., 12 U.S.C. § 1467(a)(2)(A) (1994) (defining "control" for purposes of the Savings and Loan Holding Company Act as holding more than 25% of the voting shares of an association); 12 U.S.C. § 1841(a)(2)(A) (1994) (defining "control" for purposes of the Bank Holding Company Act as controlling the power to vote 25% of any class of voting securities of a bank or a bank holding company).

267. See *supra* note 143.

prosperity of the employer threatens both the employee's job *and* the value of her pension assets. Because for many employees an employer-sponsored pension plan represents their primary source of retirement income, lack of sufficient diversification of pension plan assets can have a devastating effect. Second, significant accumulations of employer securities in pension plans help entrench management by putting shares into friendly hands. Management becomes immune not only to hostile takeovers, but also to shareholder proposals that may be good for the company but that run counter to the management's current views. While there are those who would view immunity from unfriendly takeovers as positive, the threat of takeover acts as an important monitor on the actions of officers and directors, whose interests are not always identical to the interests of shareholders. Fear of an unfriendly tender offer or proxy fight forces management to be responsive to shareholder interests.

These negative outcomes are not a necessary consequence of a desire to foster some holding of employer securities by employees. If an employer wants to encourage employee stock ownership, stock could be made an element of current compensation or employee stock purchase programs could be established.

The approach of current law towards limiting only holdings of employer securities by defined benefit pension plans is indefensible given the fact that defined contribution plans now dominate the universe of pension plans, and that the form they most frequently take is 401(k) plans or ESOPs. Placing limits on holdings of employer securities by both defined contribution and defined benefit plans is necessary and appropriate. Congress should amend ERISA to limit both the percentage of an employer's securities that can be held by pension plans and the percentage of a pension plan's assets that can be invested in employer securities in the manner proposed in this Article. The limits I suggest would promote greater diversification of retirement assets and would make management less immune to the threat of a takeover, while still allowing for some investment of retirement funds in employer securities.

While there are many areas of the law that cry out for less regulation, the issue of pension plan investments in employer securities is not one of them. Only by placing meaningful limits on the acquisition of employer securities by pension plans will such plans have as their real purpose the provision of adequate retirement income to employees.