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ERISA and Litigation Settlements Involving Employer Securities and Mutual Funds

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ERISA LITIGATION

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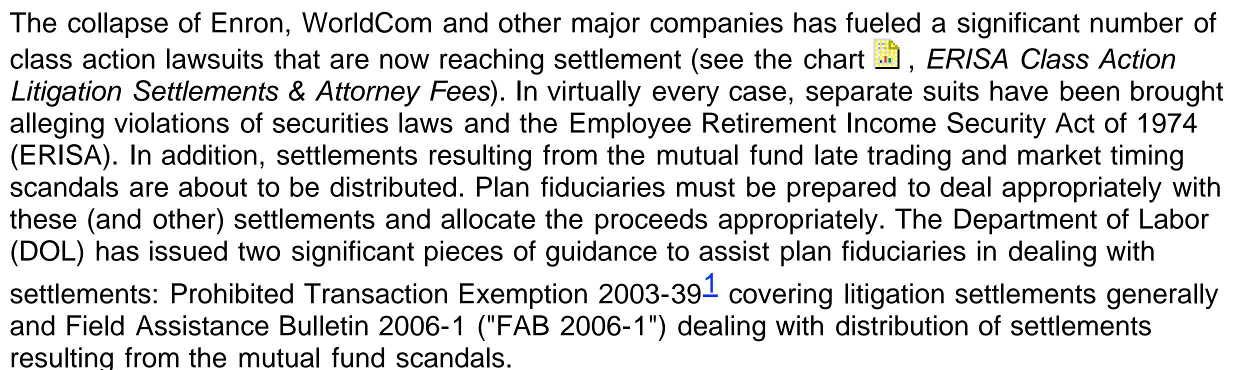
The collapse of Enron, WorldCom and other major companies has fueled a significant number of class action lawsuits that are now reaching settlement (see the chart  , *ERISA Class Action Litigation Settlements & Attorney Fees*). In virtually every case, separate suits have been brought alleging violations of securities laws and the Employee Retirement Income Security Act of 1974 (ERISA). In addition, settlements resulting from the mutual fund late trading and market timing scandals are about to be distributed. Plan fiduciaries must be prepared to deal appropriately with these (and other) settlements and allocate the proceeds appropriately. The Department of Labor (DOL) has issued two significant pieces of guidance to assist plan fiduciaries in dealing with settlements: Prohibited Transaction Exemption 2003-39[1] covering litigation settlements generally and Field Assistance Bulletin 2006-1 ("FAB 2006-1") dealing with distribution of settlements resulting from the mutual fund scandals.

Prohibited Transaction Exemption 2003-39

In broad terms PTE 2003-39 provides relief for releases of litigable claims and associated extensions of credit by plans and plan fiduciaries, subject to a fairly straight forward array of conditions. While the problem addressed by the exemption is nothing new, the wave of securities

and ERISA litigation brought against both corporations sponsoring plans holding large blocks of employer stock and corporate insiders associated with those companies made manifest the need for the exemption.

At the heart of the exemption's conditions, is the requirement that the claims addressed be settled by an independent fiduciary. The role of an independent fiduciary in settling claims against parties in interest can be delicate, especially when the actual or potential defendants are the plan sponsor, and its officers and directors who are directly or indirectly responsible for the independent fiduciary's appointment. However, the independent fiduciary's responsibility is to act solely in the best interests of the participants and beneficiaries of the affected plan(s) and may involve disagreements with both the settling defendants (usually over the scope of the release) and with plaintiffs' counsel (over attorney fees).

This article will analyze both the literal and practical consequences of the exemption. Consistent with DOL's usual practice in issuing an exemption, it declined to opine whether or when a settlement would give rise to a prohibited transaction. [2] Nevertheless, a practical understanding of the exemption requires some discussion of the sorts of transactions where its application might be needed to avoid liability. Relying on our experience with the role of independent fiduciaries settling litigation, we will go beyond merely describing the exemption to offer our views of some of the practical considerations that plan fiduciaries who appoint independent fiduciaries and independent fiduciaries themselves can expect to encounter, particularly in the context of securities fraud and related ERISA allegations.

When is the exemption needed? Relief is provided for two types of transaction:

- releases of claims by a plan or plan fiduciary "against a party in interest in exchange for consideration, given by, or on behalf of, a party in interest to the plan in partial or complete settlement of the plan's or the fiduciary's claim"[3] and
- extensions of credit in connection with such settlements where the party in interest agrees to make payments over time in settlement of such a claim.

By its terms the exemption provides relief retroactive to Jan. 1, 1975, for violations of the prohibited transactions described in sections 406(a)(1)(A), (B) and (D) of ERISA and the excise taxes imposed under the corresponding provisions of the Internal Revenue Code.[4]

As a threshold matter it is fair to ask whether the transactions addressed by the exemption really give rise to prohibited transactions that require the relief offered by the Department. The Department of Labor has held that a prohibited transaction will occur when a plan fiduciary causes a plan to release a claim against a person who is a party in interest at the time of the settlement. In the Department's view, such a settlement involves "an exchange of property (a chose in action) between such [plan] and parties in interest as described in section 406(a)(1)(A)."[5] Similarly, a fiduciary who causes a plan to release claims against himself or his affiliates, or a person with respect to whom the fiduciary has an interest that could affect such person's judgment, will likely be found to have violated section 406(b) of ERISA (the "fiduciary self-dealing violations").[6] Appointment of an independent fiduciary to act for the plan will avoid the fiduciary self-dealing violations without the need for an exemption, so the exemption does not provide relief for fiduciary self-dealing violations. An exemption, however, is necessary to avoid a violation of party in interest violations under section 406(a).

In Advisory Opinion 95-26A, the DOL opined that the statutory exemption for necessary services[7] could, in appropriate circumstances, provide the requisite exemption where the release was granted "solely to resolve claims arising out of the performance of an underlying service arrangement."[8] Implicit in the Advisory Opinion, however, was that the release of some other kind of claims against parties in interest would require an administrative exemption.[9]

Less clear is whether releasing claims that a fiduciary might bring to recover assets for a plan as a

result of breaches of ERISA's fiduciary duties would give rise to a prohibited transaction. If such claims are viewed as the claims of the plan against the party in interest, then the analysis is identical to the release of non-ERISA claims belonging to the plan, as set out above. But, as the DOL acknowledges in the preamble to the Exemption, "ERISA civil actions for breach of fiduciary duty may only be brought by participants, beneficiaries, fiduciaries, and the Secretary of Labor," not by the plan.[10] It is arguable that the release of a fiduciary's right to bring such a claim is not tantamount to the release of a plan's claim.[11] The Secretary of Labor at least would likely argue that she is not bound by such a settlement, and could still bring a claim on behalf of a plan after the fiduciary settled his claim.[12] Nevertheless, where the fiduciary settling the claim was specifically empowered by the governing plan documents to take action on behalf of the plan, a release by a fiduciary might very well bind other fiduciaries and the participants and beneficiaries. This is because these parties can be viewed as suing derivatively for the plan, so a settlement by the plan's fiduciary might well amount to a de facto release of a claim that should be thought of as the plan's claim, even though the plan cannot bring it in its own name. Thus, arguments can be made pro and con as to whether settlement of an ERISA fiduciary breach claims gives rise to a prohibited transaction.

In issuing the exemption, however, DOL has cut this Gordian knot by modifying the final class exemption so that it applies by its terms to the release of claims by both the plan and a plan fiduciary. It has left for another day the question of whether these settlements are prohibited transactions at all. As a practical matter, plan fiduciaries forced by circumstances to take a position on the impending settlement of ERISA claims to recover assets for a plan brought against parties in interest will want to leave this debate to academia and assure that the conditions of the exemption have been met. The goal of settlements is the end of litigation, not the production of new and interesting issues to litigate.

Similarly "interesting" is the question of whether the plan or the participants have securities claims where a 401(k) plan acquires employer stock in a company alleged to have committed securities fraud. It is the premise of the DOL exemption, and indeed its inspiration, that these claims belong in some measure to the plan, and not merely to the individual participants. In the preamble to the proposed exemption the Department explained that "a number of informal inquiries regarding the settlement of class-action securities fraud cases where the plan and/or its participants are shareholders" caused the Department to determine that a class exemption would be appropriate.[13] At least where the participants exercise some control over the acquisition or sale of an interest in employer stock or an employer stock fund in such a plan, it is possible to argue that the participants have standing to assert securities claims, either in lieu of or concurrently with the plan itself. One court decided that a 401(k) plan trustee (rather than each individual participant) could file a claim with the settlement administrator in connection with a settled securities fraud class action that treated each decision by a plan participant to buy into a unitized employer stock fund maintained the plan as a separate purchase within the meaning of the securities laws.[14] The implication of this decision is that the securities claims have a dual character as both the plan's claim and the individual participant's claim.[15] Moreover, where a plan accepts employer stock in satisfaction of a dollar denominated matching obligation, the plan would seem to be purchaser within the meaning of the securities laws. Nothing the Department did or could say in issuing the exemption could answer the fundamental question--who owns, and who has standing to assert, the securities fraud claims with respect to employer stock in 401(k) plans where the participants direct purchases and sales of employer stock or interests in employer stock funds. Plan fiduciaries have an obligation, however, to see that the plan has an opportunity to participate in the settlement, either through a claim for the plan as purchaser of the securities or through a claim on behalf of individual participants. Until the question is resolved, fiduciaries are well advised to file on both bases, so that the plan participants will benefit from the settlement irrespective of which theory prevails.

To the extent that securities claims can be asserted by plans or by plan fiduciaries, the release of these claims is covered by the class exemption. As with the ERISA fiduciary breach claims discussed above, defendants and potential defendants in securities class actions should prefer that the exemption be complied with rather than pinning their hopes for litigation peace on an argument that the settled claim does not belong to the plan such that there is no prohibited transaction when a fiduciary permits a securities class action settlement to go forward.

In class action settlements, where neither the plan nor the plan fiduciary is the named plaintiff, there is also a question of whether a plan fiduciary can be said to have caused the settlement, giving rise to a prohibited transaction violation. In securities fraud class actions, if we assume that the plan is at least a class member, the question is not that difficult. Because these cases are certified pursuant to Fed. R. Civ. P. 23(b)(3), settlements of the cases often, though not invariably, provide an opportunity to opt out after notice is given of the terms of the settlement. By declining to opt out, the responsible plan fiduciary causes the plan to release its claims pursuant to the terms of the class settlement. But the issue is more substantial in a non-opt out class action, which is often the form taken by class actions brought by participants for breach of fiduciary duty under ERISA to recover for a plan, or an opt out class action where the only opportunity to opt out might occur prior to the negotiation of a settlement. Even if we assume that the class settlement binds the plan, there is no obvious point at which it can be said that a plan fiduciary causes a release of the plan's claims or the fiduciary's claims.

In response to comments, the Department declined to opine as to whether the settlement of a non-opt out class would give rise to a prohibited transaction. Instead the Department suggested in the preamble that even in such cases "the fiduciary is unlikely to remain uninvolved," if only because the fiduciary will be a defendant.[16] This discussion by the Department is a bit muddy. The defendant fiduciary is involved in the case as a defendant in his individual capacity, not on behalf of the plan, and in settling the claims against him such a defendant will not, if well advised, purport to act for the plan, but will only act for himself. Likewise, if the plan is named in an ERISA class action, it is named as a rule 19 defendant for the purpose of assuring that complete relief is granted. The plan is not before the court with standing to assert or release its own claims; as noted above, the plan probably has no standing as an ERISA plaintiff in a fiduciary breach case. In the preamble to the exemption, the Department also noted that even if a fiduciary does not cause the transaction with the plan, a prohibited transaction under the Code may still occur if the settlement of the class action produces a transaction between the plan and the disqualified person, so that the disqualified person may need to assure compliance with the exemption to avoid an excise tax.

While the need for the exemption in non-opt out ERISA breach of fiduciary duty cases is less than clear, there is reason to comply with the exemption. Since a plan fiduciary could seek the court's leave to intervene and object to the terms of such a settlement, deciding not to do so could be viewed as causing a release of the plan's claims. This is particularly true if the settlement by the class is ultimately found to have bound plan fiduciaries in their pursuit of the same claims after settlement of the class action. Likewise, the Department is correct that a prohibited transaction may be deemed to have occurred under the Code if an ERISA class action settlement precludes plan fiduciaries from pursuing the same claim. If the decision not to intervene and object is made in compliance with the exemption by an independent fiduciary, uncertainty about whether the settlement can be challenged as a separate and distinct violation of ERISA is eliminated.

In the preamble to the exemption the Department identified two other specific types of transactions for which the exemption would be available. These are settlement agreements relating to an employer's failure to timely remit participant contributions to a plan, and settlements involving failure to remit employer contributions to a single employer plan or to a non-collectively bargained multiple employer plan.[17] No relief was provided for settlements involving delinquent employer contributions to a collectively bargained plan; these settlements are covered by a separate exemption.[18]

What's Required by the Exemption? The Department imposed two sets of conditions on the availability of the exemption, those that apply to all transactions (Section II of the exemption), and those that apply only to settlements entered into after Jan. 30, 2004 (Section III of the exemption). This article will focus only on those conditions applicable to settlements entered into after Jan. 30, 2004.

- **Genuine controversy.** There must be a genuine controvery involving the plan.[19] A genuine controversy will be deemed to exist where the court has certified the case as a class action.[20] If the litigation has not been certified as a class action, an attorney or attorneys retained to advise the plan on the claim must determine that there is a genuine controversy involving the plan.[21] The attorneys can have no relationship to any of the

parties, other than the plan.

- **Independent fiduciary.** The fiduciary that authorizes the settlement has no relationship to, or interest in, any of the parties involved in the litigation, other than the plan, that might affect the exercise of such person's best judgment as a fiduciary.[22] The independent fiduciary must acknowledge in writing that it is a fiduciary with respect to the settlement of the litigation on behalf of the plan.[23]

The proposed exemption had included a requirement from the proposal that an independent fiduciary actually negotiate but the final exemption merely requires that an independent fiduciary authorize the settlement. The Department recognized that where the plan is merely part of a class action, the independent fiduciary would not, at least initially, have any role in negotiating the terms of the settlement. The Department cautioned, however, that "even where negotiation does not take place between the plan and the defendant, a fiduciary will be compelled, consistent with ERISA's fiduciary responsibility provisions, to make a decision regarding the settlement on behalf of the plan, even if that decision is merely to accept or reject a proposed settlement negotiated by other class members."[24]

The Department enlarged on its definition of independence in the preamble. First, the Department rejected concerns expressed by several commenters that institutional fiduciaries chosen by the fiduciaries that had a stake in the settlement to be reviewed could not be relied upon to fairly evaluate settlements. These commenters had suggested that at least prospectively, the exemption should provide participants with input into any settlement that might bind the plan. The Department simply reminded the public that these independent fiduciaries remained subject to 406(b) of ERISA and the general fiduciary responsibility provisions of the Act. That said, the Department was at pains to point out that in many cases the plan's existing independent fiduciary could undertake the task of evaluating the settlement where the "current fiduciary who is not a party to the action and who is not so closely allied with a party (other than the plan) as to create a conflict of interest."[25] Moreover, in the preamble, the Department opined that "the mere fact that a party in interest pays for the independent fiduciary or advisor to the independent fiduciary would not destroy independence, but that compensation paid to the professional fiduciary or advisor by a party in interest should constitute "no more than a small percentage of such professional's annual gross income."[26] Directed trustees that have carefully limited the extent of their discretion in order to control the risk of liability may be reluctant to take on the task of evaluating litigation settlements on behalf of plans. Moreover, the trustee may be a defendant or one of the parties obtaining a release.

In the preamble to the proposal the Department stated that "in some instances where there are complex issues and significant amounts of money involved, it may be appropriate to hire an independent fiduciary having no prior relationship to the plan, its trustee, any parties in interest, or any other parties to the litigation."[27] Although this statement was not repeated in the preamble to the final exemption, it was not contradicted or withdrawn. Thus, we understand that it is still the Department's position.

- **Reasonableness of the settlement.** The settlement must be reasonable in light of the plan's likelihood of full recovery, the risks and costs of litigation, and the value of claims foregone.[28] This is the key determination that the independent fiduciary must make. Factors to be considered are generally similar to the factors the judge must weigh in approving the settlement. Therefore, the parties may wish to submit the independent fiduciary's determination (if favorable) to the court.

- **Arms-length terms and conditions**. The terms and conditions of the transaction are no less favorable to the plan than comparable arms-length terms and conditions that would have been agreed to by unrelated parties under similar circumstances.[29] Here the Department has decided to apply a condition to all transactions that was not included in the original proposal. It is not clear what the Department understood this requirement to add to the "reasonableness" test described above. If it were read to require class action settlement

terms comparable to what the plan could have obtained had it filed its own suit and negotiated individually, this provision might be an impediment to participation in reasonable class action settlements. Opting out of a securities class action is an option that must always be considered, but it should not be considered without regard to its costs and risks. Prudence would suggest that a plan should not undertake substantial litigation expense and litigation risk in the hopes of only slight improvements in settlement terms.

This condition takes on more significance in an ERISA settlement, when only the plan and its participants are involved. The preamble, however, contains language to support the view that the Department meant to require no more than a straightforward cost-benefit analysis. After describing the reasonableness and the arms-length requirements of the exemption, the Department added, "an independent fiduciary could satisfy the authorization requirements under the final exemption by deciding not to opt out of class action litigation if, after a review of the settlement, such fiduciary concludes that the chances of obtaining any further relief for the plan are not justified by the expense involved in pursuing such relief."[30]

- **No collusion.** The transaction is not part of an agreement, arrangement or understanding designed to benefit a party in interest.[31] In the preamble to the proposal, which contained the same requirement, the Department explained that "[t]he intent of this condition is not to deny direct benefits to other parties to a transaction but, rather, to exclude transactions that are part of a broader overall agreement, arrangement or understanding designed to benefit parties in interest."[32] As with the requirement of a "genuine controversy," the Department's concern in promulgating this condition was to preclude collusive settlements.

- **Extensions of credit.** Any extension of credit by the plan to a party in interest in connection with the settlement of a legal or equitable claim against the party interest is on terms that are reasonable, taking into consideration the creditworthiness of the party in interest and the time value of money.[33] This provision was a change from the proposal which recognizes that settlements often provide for a defined stream of payments over time and are not couched in the form of principle and interest. While exhibiting flexibility as to the form of such settlements, the Department insists that in assessing the reasonableness of a settlement and associated extension of credit, the fiduciary recognize that the value of a promised stream of payments must be discounted for the time value of money and the credit risk presented by party making the promise. This provision should have explicitly recognized the value of security for such a promise. Presumably, were the Department asked, it would subsume the availability of security under the rubric of creditworthiness, since the Department in the preamble "encourages fiduciaries to seek security for an extension of credit, wherever feasible, to protect the plan against the risk of default."[34]

- **Delinquent contributions to multiemployer or multiple employer plans.** The transaction cannot be one described in Prohibited Transaction Exemption (PTE) 76-1, A.I.,[35] relating to delinquent employer contributions to multiple employer plans and multiple employer collectively bargained plans). [36] This carve out from the applicability of the exemption was added in the final exemption. PTE 76-1, which, like the present exemption, provides no exemption from §406(b) violations, will continue to apply to settlements of delinquent employer-contributions claims. PTE 76-1 has no condition relating specifically to the use of an independent fiduciary, but does require diligent and systematic attempts to collect the whole amount owing prior to any settlement, and reasonableness requirement similar to the present exemption. Settlements related to delinquent contributions to single-employer plans are covered by PTE 2003-39, since there is no separate exemption.

- **Written settlement agreement or consent decree.** All terms of the settlement must be specifically described in a written settlement agreement or consent decree.[37]

- **Noncash recoveries.** Assets other than cash may be received by the plan from a party in interest in connection with a settlement only if (1) necessary to rescind a transaction that

is the subject of the litigation; or (2) such assets are securities for which there is a generally recognized market, as defined in ERISA section 3(18)(A), which can be objectively valued. [38] In response to comments, this requirement contains far more flexibility than the proposal, which limited the use of non-cash assets to those assets necessary to rescind a transaction. By separately exempting extensions of credit in connection with settlements, effectively allowed the plan to receive even non-marketable debt as part of a settlement. DOL also recognized that stock is often contributed as part of a settlement in securities class actions, and that in ERISA suits involving disputes over qualifying employer securities, the most sensible resolution often involves the contribution of additional qualifying employer securities.

This condition will still create an impediment for more creative settlements that may involve a potentially higher recovery. For example, in the settlement of securities litigation against Lucent which involved that the provisions of warrants to class members,[39] the independent fiduciary was unable to take the warrants and negotiated for substitute compensation. In a situation involving bankruptcy, where the only compensation for equity under the plan of reorganization was warrants, the DOL has granted individual exemptions under its expedited exemption class exemption, Prohibited Transaction Exemption 96-62 ("EXPRO")[40] to permit the plan to accept and hold the warrants.[41]

- **Identifying and valuing noncash assets.** Assets other than cash that are to be received by the plan in exchange for the release of the plan's or the plan fiduciary's claims must be specifically described in the written settlement agreement and valued at their fair market value.[42] Fair market value of non-cash assets must be determined in accordance with section 5 of the DOL's Voluntary Fiduciary Correction (VFC) Program.[43] The methodology for determining fair market value, including the appropriate date for such determination, must be set forth in the written settlement agreement. This VFC valuation methodology allows assets traded on a generally recognized market to be valued at the average value of the asset on such market on the applicable date, but requires an appraisal of any other asset by a qualified, independent appraiser. The requirement is new to the final exemption and may present practical problems for some settlements. Such a promise would have to be valued like any other debt, taking into account the time value of money, creditworthiness of the person making the promise and security for the promise, if any.

Obtaining compliance with the requirement that the value be made an explicit part of the settlement will be particularly difficult in class settlements, where the independent fiduciary for the plan does not negotiate the terms of the settlement. It may be appropriate to ask the Department for a modification of this provision as to class settlements where the plan or plan fiduciary is not the named plaintiff or to negotiate a separate settlement document that values the non-cash assets.

In addition, this condition is unclear as to whether it applies to a promise by a party in interest to make periodic payments as part of a settlement. If so, then permitted extensions of credit to parties in interest would have to be valued like any other debt that might be given as part of a settlement, taking into account the time value of money, creditworthiness of the party in interest, and security, if any, for the promise. Clarification should be sought from the Department regarding the application of this condition to extensions of credit to parties in interest that are permitted by the exemption.

- **Plan changes or future contributions.** The settlement may include a written agreement to: (1) Make future contributions; (2) adopt amendments to the plan; or (3) provide additional employee benefits.[44] Often the settlement of ERISA claims, including claims for relief to the plan includes injunctive relief that benefits plan participants but might not be said to be relief for the plan. A promise to make future contributions falls into a grey area as to whether it amounts to an asset other than cash received by a plan. The Department has not made clear whether such a promise must be valued by an independent appraiser, and the value included in the settlement agreement. We suspect this was not the Department's intent, but the Department should be asked to provide guidance on this point to confirm this reading.

Before the issuance of the exemption, one troubling question was whether a fiduciary is entitled to weigh relief that benefits the participants, but not the plan as an entity, in deciding to release a claim on behalf of a plan. The language of the exemption make clear that such relief is permitted. If value to the participants could nt be taken into account by a fiduciary in assessing the adequacy of a settlement, the terms of the exemption would have needlessly constrain the flexibility of parties in arriving at appropriate settlements.

- **Record retention.** The independent fiduciary must maintain records for six years from which interested parties may determine compliance with the other conditions of the exemption. [45] These records must be available to:

- the Department or the Internal Revenue Service;

- any fiduciary of the plan;

- any contributing employer and any union whose members are covered by the plan,; or

- any participant or beneficiary of the plan.

Confidential financial information or trade secrets is protected from disclosure, except to government agencies. These provisions are the same as those contained in the proposal except that the burden of recordkeeping and disclosure is placed only on the fiduciary that authorized the release of claims.

It is unclear whether the protection for confidential trade secrets or financial information is broad enough. During the course of investigating a settlement, certain persons may be willing to provide information to the independent fiduciary on the condition that it be kept confidential. For example, in our experience we have found it useful to talk to mediators who were involved in settlement negotiations. These individuals would not have been candid with us if they had understood that we might be required to share the substance of what they told us with plan participants. Moreover, in partial settlements, there may be non-settling fiduciaries who remain defendants in the case, and sharing information with them would seem adverse to the interests of participants.

Settlement Issues

Based on our experience with the independent fiduciary role contemplated by the exemption, there are a number of practical considerations that independent fiduciaries appointed to evaluate securities class action settlements and settlements of ERISA claims must take into account in performing their duties. We review some of them here.

Release of ERISA Claims In Securities Class Actions. The most common problem presented by class action settlement of securities claims (and in some ERISA settlements) is the almost automatic inclusion in these settlements of broad release language that cover sclaims other than securities claims, and release claims against non-parties with some connection to the defendants. In the preamble to the exemption, the Department made it clear that such releases are unacceptable unless the plan receives additional consideration for the release of other valuable claims:[46]

> [T]he Department recognizes that, in a number of securities fraud class action settlements, the participants and or plan fiduciaries have successfully objected to the original release and were able to modify the terms of the release to permit the plan to receive its share of the securities fraud settlement without releasing its ERISA claims against the parties in interest. In other instances, fiduciaries have successfully negotiated additional relief for the plan beyond that provided to shareholders who did not have ERISA claims against the defendants. The Department notes that plan fiduciaries should consider whether additional relief may be available for the ERISA claims before agreeing to a broad release.[47]

If the release preserves ERISA claims that have or might be made on behalf of the plan or RISA claims are time-barred, the plan can participate in the securities fraud settlement on the same basis as other class members, provided that the settlement otherwise meets the conditions of the exemption.

We have been successful in obtaining, on behalf of plans, revisions to preliminarily approved securities settlements that contained overbroad release language and failed to provide any additional compensation for the release of plan claims. These negotiations, however, have often been resolved as the deadline for filing objections or opting out of a class action settlement approaches. In ERISA cases, the independent fiduciary is often brought in before the settlement is submitted to the court, so issues can be identified and resolved in advance.

Lawyers handling securities settlements for the employer are often oblivious to the ERISA issues, even where parallel ERISA litigation has been brought. Therefore, in-house fiduciaries and ERISA counsel defending the ERISA litigation should monitor the securities litigation so that an independent fiduciary can be retained before the terms of the settlement are locked in place. While the exemption no longer requires that an independent fiduciary negotiate the settlement, plan fiduciaries may find themselves in an akward position if the class is limited to market purchases, thus disadvantaging participants whose purchases within the plan are netted against sales by other participants, or if a settlement has been negotiated that could release ERISA claims related to the securities purchases. Until appointment of an independent fiduciary, some existing plan fiduciary who is not a defendant in the parallel ERISA class action should monitor to make sure that the interests of the participants and beneficiaries are being protected in the securities litigation, particularly when those interests are not the same as the class representative and should also assess whether the ERISA claims are being appropriately pursued in the parallel ERISA class action.

Settlements limited to "open market purchasers." The securities laws protect purchasers of securities, broadly defined. The protections of these laws are not limited to purchasers on the open market. Plans in particular acquire stock other than on the open market, most commonly through contributions by plan sponsors of employer stock in satisfaction of a matching obligation or an obligation to contribute stock or cash equal to a percentage of compensation. A settlement of securities claims that does not compensate for these non-open market purchases is not adequate from the plan's perspective where it has acquired stock outside of the open market.

Further, many plans allow participants to acquire stock within the plan. This can occur whether the plan maintains a unitized stock fund where the plan nets buys and sell of the fund, or where the plan allocates actual shares to participants' accounts. In either event there is "trading" at the plan level (and injury to defrauded participant purchasers) that is not reflected in open market purchases by the plan. *Kurzweil v. Philip Morris*[48] supports the proposition that a plan trustee may file a claim based on the losses of participants, not just the losses of the plan as a whole based on open market purchases. The independent fiduciary must be mindful of this issue in evaluating the settlement itself to avoid any language that would prejudice the plan's position that claim should be filed on this basis, maximizing recovery for the plan and its participants.

Evaluating the Plan of Allocation. Securities class settlements contain a plan of allocation that that are quite individual to the particular case. Which purchases count and how much, as well as what sales are netted out, and to what extent, will be specified in the settlement, and the parties' resolution may be fair or unfair to class members generally, and may have a particular impact on the plan depending on the plan's and the participants' purchase and sale patterns. The allocation plan needs to be looked at for its fairness to the plan.

The plan of allocation will generally form the basis for allocation of the plan's recovery among the participants. In settlements of ERISA claims, this issue is usually dealt with in the settlement agreement itself and the independent fiduciary reviews the allocation formula for reasonableness as part of the PTE 2003-39 determination. However, in securities class actions, the plan's recovery has to be allocated to participants in some fashion. We have generally followed the formula in the plan of allocation for allocating the recovery to the affected participants, including former participants. However, there may not be sufficient data about participant level transactions or the recovery may be so small that allocations based on historical data is cost prohibitive. The Department of Labor's guidance on allocating mutual fund settlement proceeds, discussed below,

provides useful guidance for what plan fiduciaries should do in those situations.

Opting Out of Securities Class Actions. Where the plan's claim is very large, and the case is very strong, participating in a class action may not be in the plan's interest. Facts peculiar to the individual case, *e.g*., whether distinct misrepresentations were directed to plan fiduciaries, and whether class counsel is the best available counsel will have an impact on whether opting out is in the plan's interest. The plan will have an explicit opportunity to opt out of the class action at the time the class is certified, and often, but not invariably, at the time the case is settled. In some cases, where the class has already been certified and the court does not require a second opportunity to opt out, the plan's only recourse once a settlement has been reached is to file an objection with the court.

From the time a class action is filed, however, plan fiduciaries (whether they appreciate it or not) are making a fiduciary decision about whether to pursue a separate action. If a case justifies a separate action by a plan, often the ideal time to file is relatively early in the life of the litigation, so that the plan can participate in discovery and settlement discussions. Although the class exemption only deals with settlements, the decision not to opt out of a securities class action and bring a case separately on behalf of a plan is typically being made by plan fiduciaries laboring under a serious conflict of interest. The prompt appointment of an independent fiduciary broadly empowered to pursue the plan's claims, when made not long after lead counsel is appointed in the securities litigation, may protect against allegations that the fiduciaries of the plan did not pursue both securities and ERISA claims appropriately.

Usually, however, by inaction or deliberate decision, a plan will not have filed its own action, or opted out in advance of the class settlement. The independent fiduciary has significant leverage in obtaining changes to class settlements where the settlement gives class members the ability to opt out. Often the plan will be the largest claimant, and the settlement itself, or a side letter will stipulate that the defendants can withdraw from the settlement if opt outs represent a specified portion of the class. The defendants want peace, and the prospect that the plan, with substantial resources, might continue the pursuit of the claims provides a powerful incentive to negotiate changes that do not alter the fundamental complexion of the deal. To take advantage of this leverage, however, the independent fiduciary must be empowered to opt out. A decision to opt out effectively commits the plan to file its own action. Even if the terms of the independent fiduciary's engagement do not empower it to take such a step, it must be understood that some fiduciary will have to make that decision in the wake of opting out. A decision not to file suit on behalf of a plan that opts out will be difficult to defend.

Filing the Plan's Claim(s). Once an independent fiduciary has approved the settlement for the plan, submission of the actual claim with the claims administrator for a securities class action settlement need not be made by the independent fiduciary. This is so, at least where, by the terms of the settlement, a fixed amount of money will go to the class, and the division of the proceeds within the class is a matter of indifference to the defendants. Nevertheless, as practical matter, once an independent fiduciary is appointed to deal with the class action, most appointing fiduciaries will want to include complete responsibility for filing the post settlement claim to the fiduciary.

An interesting question exists as to whether the claim can be filed to cover not just acquisitions of stock by the plan as a whole, but acquisitions by each participant. Generally, by filing a claim at the participant level the plan can maximize its recovery because acquisitions and dispositions on behalf of individual participants will be netted out by the plan before the plan acquires stock on the open market. This analysis is complicated somewhat where the participant acquires shares in a unitized company stock fund that contains a small amount of cash, rather than shares of stock.

The issue of whether a plan fiduciary can file a post settlement claim for acquisitions made by each participant is discussed and resolved in the plan's favor in *Kurzweil v. Philip Morris*. Any fiduciary filing a post-settlement claim on behalf of a 401(k) plan should be mindful of this issue and try and submit the claim in the form most advantageous to the plan and its participants.

Attorney Fees. The independent fiduciary must determine whether the requested attorney fees for plaintiffs' counsel are reasonable since fees paid to the attorneys will reduce the plan's recovery. Courts generally award attorney fees in class actions under the common fund principle recognized by the Supreme Court in *Boeing Co. v. Van Gemert*: "a litigant or a lawyer who recovers a

common fund for the benefit of persons other than himself or his client is entitled to a reasonable attorney's fee from the fund itself."[49] Factors to be considered include:

- the magnitude and complexities of the litigation;
- the litigation risk;
- the quality of representation;
- the requested fee in relation to the settlement; and
- the time and labor expended by counsel.

Fees in common fund class action litigation are usually requested as a percentage of the amount recovered.[50] The attached chart shows that attorney fee awards in ERISA class actions generally fall in the range of 20 percent to 33 percent. Fees tend to go down as a percentage of the settlement as the settlement recovery rises.

Many courts examine the reasonableness of the percentage fee requested using the "lodestar multiplier" approach, under which the plaintiff counsels' hours spent on the case are valued at each attorney's customary rate to determine the "lodestar" and the requested fee is divided by the lodestar to determine a multiplier. Multipliers between 1.5 and 3.8 are not unusual, although in some cases plaintiff counsel have received less than their lodestar and in others more than 4 times their regular rates. Since not all courts use the lodestar multiplier, data on multipliers is less available than information on fees as a percentage of the recovery.

In some case, the settlement involves commitments not to decrease contributions for some period of time or plan changes to permit diversification. Assigning a value to these provisions may skew the percentage analysis.

Mutual Fund Trading Settlements

Beginning in 2003, the SEC and state officials brought enforcement actions against two improper trading practices involving mutual funds: late trading and market timing. Late trading involves placing orders to buy or sell after the 4 p.m. (Eastern) close of the markets. Since daily mutual fund transactions are priced at the closing net asset value ("NAV"), the party entering the trade knows whether the mutual fund's value has gone up or down and could buy or sell accordingly. Market timing, on the other hand, involves large trades in and out of a fund in a short period to make quick profits as a result of short-term trends (the functional equivalent of day trading). Late trading is illegal. Market timing, while legal, may violate representations made by the mutual fund that it does not permit large trades in and out within a short time period. Both practices harm the remaining shareholders. Elliot Spitzer, the Attorney General of New York who has brought many of the civil fraud cases, has estimated that such practices have cost mutual fund shareholders over $5 billion.

In many cases, the SEC and state regulators have obtained settlements that require payments, including amounts characterized as penalties rather than compensation, to be paid to the mutual fund shareholders who were harmed by the improper practices. Settlements with securities regulators include:

Mutual Fund Trading Settlements

Advisor or Fund Family	Shareholder Recover	Penalties
AIM	$50 million plus	$30 million penalties

	$15 million annual reduction in fees	(included in shareholder recovery)
Alliance Capital Management	$250 million plus 20% annual reduction in fees for five years	$100 million penalty (included in shareholder recovery)
Banc of America Capital Management	$250 million restitution plus $125 million penalty	$125 million penalty (included in shareholder recovery) $400,000 NASD penalty
Banc One Investment Advisors Corporation	$50 million	$40 million (included in shareholder recovery)
Columbia Management Advisors	$140 million	$70 million
Fleet Boston	$70 million restitution	$70 million penalties
Franklin Templeton	$50 million to shareholders	$20 million SEC penalty (included in shareholder recovery) $5 million Massachusetts fine
Freemont	$2.1 million restitution	$2 million Former CEO fined $127,000
Invesco	$325 million	$110 million penalty (included in shareholder recovery)
Janus Capital Management	$100 million to shareholders plus $25 million annual reduction in management fees for five years	SEC penalties of $50 million (included in shareholder recovery) plus $1.2 million Colorado penalties
MFS	$225 million for market timing plus $25 million annual reduction in management fees for five years	Administrative fine of $1 million, to be used for educating investors, for market timing; $50 million for directed brokerage
Pilgrim Baxter	Adviser to pay $100 million Co-founders to pay $80 million each	Penalties of $20 million each for company and co-founders included in amounts to be distributed to shareholders
PIMCO Advisors Fund Management	$48,383,262	$40 million (included in shareholder recovery)
Putnam	$108.5 million to shareholders and implementation of fund governance measures	Penalties of $50 million (included in shareholder recovery)

RS Investment Management	$25 million	$13.5 million (included in shareholder recovery)
Strong Capital	$40 million for investor losses and $35 million reduction in fees over five years	$40 million in civil penalties Richard S. Strong, former chairman, paid $60 million in penalties and was barred for life from the money management business
State Street Research		$1.5 million

These settlements were put into what the SEC call "fair funds" to compensate investors who were harmed by the violation.[51] For each fair fund, the SEC has appointed an independent distribution consultant (IDC) to establish a plan to distribute the monies from the settlement fund to the shareholders of the relevant mutual fund or series of funds harmed by the late trading or market timing. A proposed distribution plans will be published on the SEC website[52] and there is typically a 30 day comment period following publication. The SEC order approving or disapproving the plan should be entered within 30 days after the end of the final period allowed for comments but the SEC may allo a longer period for good cause shown.[53]

The Assistant Secretary Ann Combs, who heads the DOL's Employee Benefit Security Administration, issued a statement in February 2004 advising plan fiduciaries that they have an obligation to evaluate whether to participate in litigation or settlements arising out of the mutual fund trading scandals.[54] Plan fiduciaries must weigh the potential cost of participating in litigation against the potential and likelihood of recoveries for plan participants. Given the active enforcement activities of state and federal officials, which have yielded settlements for the benefit of investors, and the active plaintiffs' bar,[55] it is likely that plan fiduciaries have only needed to monitor litigation but will have to evaluate the resulting settlements, to ensure that their participants' interests are protected. Plan fiduciaries generally have an obligation to assert claims on behalf of the plan and its participants when these settlement funds are distributed.

On April 19, 2006, the DOL issued Field Assistance Bulletin 2006-1, which provided guidance about the SEC Fair Funds under ERISA. The DOL concluded that the IDC would not be considered fiduciaries for purposes of ERISA. Intermediaries such as trustees and brokerage would be considered fiduciaries if they receive money from a fair fund for their omnibus account and are responsible for allocating the funds among their clients, including ERISA plans. Amounts owed to ERISA plans must be held in trust by intermediaries. Intermediaries who are not otherwise fiduciaries may avoid fiduciary responsibility by declining to receive a settlement distribution on behalf of its omnibus account clients. FAB 2006-1 provided useful guidance to plan fiduciaries about how proceeds from the fair funds are to be allocated:

- If the IDC either makes available or requires a particular method for allocating to plan participants, the plan fiduciaries may follow the procedure laid out in the distribution plan.
- Fiduciaries, including intermediaries, are responsible for determining a prudent allocation method among plans and within plans to participants.
- Where the cost of allocating a recovery is greater than the likely distribution, either to a plan in an omnibus account or to participants, the fiduciaries can establish an objective allocation formula that forfeits small amounts and reallocates them among other eligible accounts or participants.
- If the plan has terminated, the intermediate fiduciary should make efforts to locate the plan sponsor or a responsible plan fiduciary but if a plan fiduciary cannot be located, the intermediate fiduciary may reallocated to other eligible accounts.

- Plan fiduciaries are responsible for ensuring that the allocation method is implemented out in a prudent fashion.

- If distributions to plan participants are not cost-effective, the plan fiduciaries could allocate them to current participants invested in the particular mutual funds or use the recoveries for other permitted purposes, such as plan expenses.

The goal of the allocation methodology should be to allocate the recover to the affected participants, but DOL recognized that there is a cost-benefit analysis in selecting and implementing an allocation method within a plan:

> Prudence ... at a minium, would require a process by which the fiduciary chooses a methodology where the proceeds of the settlement would be allocated, where possible, to the affected participants in relation to the impact the market timing and late trading activities may have had on the particular account. However, prudence would also require a process by which the fiduciary weighs the costs to the plan or the participant accounts and ultimate benefit to the plan or the participants associated with achieving that goal.
>
> ... In deciding on an allocation method, the plan fiduciary may properly weigh the competing interests of various participants or classes of plan participants (e.g., affected versus current participants) and the effects of the allocation method on those participants provided a rational basis exists for the selected method and such method is reasonable, fair and objective. For example, if a fiduciary determines that plan records are insufficient to reasonably determine the extent to which participants invested in mutual funds during the relevant period should be compensated, the fiduciary may properly decide to allocate the proceeds to current participants invested in the mutual fund based upon a reasonable, fair and objective allocation method.

While FAB 2006-1 deals specifically with the allocation of the SEC fair funds, similar principals should apply to distributions from other litigation settlement funds.

To date, only one proposed plan of distribution has been published, for the Pilgrim Baxter Funds.[56] However, others are sure to follow. Plan fiduciaries should have a process in place to monitor the issuance of proposed plans of distributions, comment where necessary and cost-effective, and then monitor the allocation process, both to ensure that the plan receives its appropriate share of each fair fund and that the plan's recoveries are allocated to participants in a reasonable, fair and objective manner.

Fiduciary Counselors is launching http://ERISAsettlements.com, a new website with information on what ERISA plans need to do with respect to class action settlements under ERISA or securities laws. The site also includes information on past ERISA settlements, to help plan fiduciaries and litigators evaluate future settlements.

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[1] Class Exemption for the Release of Claims and Extensions of Credit in Connection with Litigation, Prohibited Transaction Exemption 2003-39, 68 Fed. Reg. 75632-01 (Dec. 31, 2003) ("PTE 2003-39").

[2] *Id*. at 75633.

[3] 68 Fed. Reg. at 75639.

[4] IRC §4975(c)(1)(A), (B), and (D).

[5] DOL Opinion 95-26A, 1995 ERISA LEXIS 38 at *7 (Oct. 17, 1995).

[6] *Id*. at *10.

[7] ERISA §408(b)(2).

[8] *Id*. at *7-*8.

[9] Other situations may already be covered by existing exemptions. The preamble to the exemption lists the correction of a prohibited transaction that complies with §4975(f)(5) of the Internal Revenue Code, reimbursement of a plan without a release of the plan's claim; settlements authorized by the Department pursuant to PTE 94-71 (settlements resulting from an investigation of an employee benefit plan conducted by DOL); and judicially approved settlements where the Labor Department or the Internal Revenue Service is a party pursuant to PTE 79-15.

[10] 68 Fed. Reg. at 75633.

[11] See *Beck v. Levering*, 947 F.2d. 639, 642 (2d Cir. 1991).

[12] *See, e.g. Herman v. S. Carolina Nat'l Bank*, 140 F.3d 1413, 1424-26 (11th Cir. 1998). (Secretary of Labor held not in privity with a class of plan participants, and not bound by their settlement of a fiduciary claim to recover losses for the plan pursuant to §502(a)(2) of ERISA.)

[13] Class Exemption for Release of Claims and Extensions of Credit in Connection with Litigation, 68 Fed. Reg. 6953, 6954 (proposed Feb. 11, 2003).

[14] *Kurzweil v. Philip Morris*, 2001 U.S. Dist. Lexis 83 (S.D.N.Y. Jan. 9, 2001).

[15] The court explained:

There is no artifice in treating the claims of these individual investors 'as a collection of separable, purportedly individual brokerage account actions' (Reply p.4); that, effectively, is what they were

Nor, as this Court held in *In re New York City Housing Development Corp. Bond Redemption Litigation*, 1987 WL 494921 (S.D.N.Y. 1987), is there any valid objection to having these claims filed by Fund trustees who have the documentation to prove them. *See* id. at 7-8. Of course, any individual investors who wish to pursue their claims on their own may do so, provided that no claim filed by the Fund may duplicate a claim filed by an individual investor. *Kurzweil*, 2001 U.S. Dist. Lexis 83, at *9-*10.

[16] 68 Fed. Reg. at 75635.

[17] 68 Fed. Reg. at 75634-35.

[18] PTE 76-1, A.I. (41 Fed. Reg. 12740, March 26, 1976, as corrected, 41 FR 16620, April 20, 1976).

[19]

68 Fed. Reg. at 75639.

[20] *Id*.

[21] *Id*.

[22] *Id*.

[23] *Id*.

[24] 68 Fed. Reg. at 75635-36.

[25] 68 Fed. Reg. at 75635.

[26] *Id.*

[27] *Id.* at 75638.

[28] *Id* at 75639.

[29] *Id.*

[30] *Id.* at 75635.

[31] *Id.* at 75639.

[32] *Id.* at 75638.

[33] *Id.* at 75639.

[34] *Id.* at 75636.

[35] 41 FR 12740 (March 26, 1976), as corrected, 411 FR 16620 (April 20, 1976).

[36] *Id.* at 75639.

[37] *Id.*

[38] *Id.*

[39] Notice of Pendency of Class Action, *In Re Lucent Techs. Inc Sec. Litig.* No. 00-CV-621 (JAP), (D. N.J. Sep. 23, 2003), at http://www.lucentsecuritieslitigation.com/notice.pdf

[40] 61 Fed. Reg. 39988 (July 31, 1996)

[41] EXPRO exemptions were granted to three plans sponsored by Federal-Mogul Corporation to permit the plans, which held stock in the debtor, to receive and hold warrants under the plan of reorganization on the same terms as other equity holders. Prohibited Transaction Exemptions 2005-06E, 2005-07E and 2005-8E (April 8, 2005). The EXPRO exemptions are listed on the DOL website at http://www.dol.gov/ebsa/Regs/expro_exemptions.html.

[42] *Id.* at 75639-40.

[43] 67 Fed. Reg. 15062 (March 28, 2002)

[44] *Id.* at 75640.

[45] *Id.*

[46] If pressed the courts will likely take a similar position. *In re Harnischfeger Indus. Sec. Litig.*, R.R.D. 400, 406 (E.D. Wisc. 2002).

[47] 68 Fed. Reg. at 75637.

[48] *Supra*

[49] 444 U.S. 472, 478 (1980).

[50] *See, e.g.*, *Blum v. Stenson*, 465 U.S. 886 (1984); *Alyeska Pipeline Service Co. v.Wilderness Society*, 421 U.S. 240, 257 (1975).

[51] The SEC Fair Funds are created under a regulation issued by the SEC in 2004 and modified in 2006. 17 C.F.R. §201.1100 available at http://www.sec.gov/about/rulesprac2006.pdf. Individual settlements and fair funds are listed on the SEC website at http://www.sec.gov/divisions/enforce/claims.htm.

[52] 17 C.F.R. §201.1103.

[53] 17 C.F.R. §201.1104.

[54] Fiduciary Responsibilities Related to Mutual Funds: Statement of Assistant Secretary Ann L. Combs on the Duties of Fiduciaries in Light of Recent Mutual Fund Investigations (Feb. 17, 2004), available on the DOL website at http://www.dol.gov/ebsa/newsroom/sp021704.html.

[55] Class action lawsuits involving allegations of late trading and market timing have also been brought against the various mutual fund families, including those in which the regulators have not brought enforcement actions. These class action cases have been consolidated before a multi-district litigation panel of three judges in the U.S. District Court for Maryland. Letter from Judge J. Frederick Motz to Counsel, *In re Mutual Funds Investment Litigation*, No. 04-md-15863 (D. Md.) (Feb. 20, 2004), available at http://www.mdd.uscourts.gov/mdl_litigation/mdldocs/initialletter.pdf.

[56] Notice of Proposed Distribution Plan and Opportunity for Comment, In the Matter of Pilgrim Baxter & Associates, Ltd., Administrative Proceeding File No. 3-11524, available at http://www.sec.gov/litigation/admin/2006/34-54073.htm.

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