

Issues Affecting Successor ESOP Fiduciaries

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*In a prior article, "So You Want To Be A Fiduciary," (link right,) we raised the question of whether a successor fiduciary can be held personally liable for a breach of duty that occurred prior to his or her appointment. In this article, we will question the scope of this duty in the employee stock ownership plan (ESOP) context by looking at two cases in the Ninth Circuit: *Barker v. American Mobile Power Corporation*, concerning the duty to investigate; and *Fernandez v. K-M Indus. Holding Company*, concerning the statute of limitations with which successor trustees must be concerned.*

A REVIEW – THE FUNDAMENTAL FIDUCIARY DUTIES

The standards of conduct for fiduciaries include a duty:

- Of loyalty and prudence;
- To diversify investments; and
- To follow plan documents to the extent they are consistent with ERISA.

The "procedural prudence" standard of the case law under ERISA generally determines whether fiduciary duty has been carried out.

ESOPs and certain other retirement plans designed to invest in employer stock are exempt from the duty to diversify. However, transactions in employer securities raise complex prudence issues involving financial fairness, due diligence, valuation, prohibited transaction, conflict of interest, and other matters. Confusion between corporate roles and actions, and conflicts of interest further complicate these issues. This makes successor trustee liability an especially acute concern in the ESOP arena.

The almost intuitive rule regarding successor fiduciary liability is found in ERISA section 409(b), which provides that if the breach occurs before or after a fiduciary's tenure, then the fiduciary is not accountable for the breach or malfeasance. However, this is only the general rule. There are situations in which a successor trustee may be liable for the uncorrected acts of a predecessor where the federal common law of trusts imposes an affirmative duty to correct a breach. Furthermore, there is the issue of when and whether a fiduciary has a duty to investigate a predecessor's actions.

WHAT THE COURTS HAVE TO SAY

There are many cases that have dealt with liability for the breach of duty by a co-fiduciary. However, relatively few cases deal with the fiduciary responsibility of successor fiduciaries. In the Ninth Circuit, for example, there are no cases on point (as of the date of this article) directly addressing the successor fiduciary issue.

In one of the leading cases, *Silverman v. Mutual Benefit Life Insurance Company*, the Second Circuit reviewed a situation where the plan trustees had embezzled funds from plan assets before transferring plan assets to the successor trustee. The case also dealt with salary deferral contributions that were not forwarded to the successor trustee by the original trustees because the money was being used to try to avoid corporate bankruptcy. The plan sponsor eventually did go bankrupt. The court stated that the successor trustee would be liable for failing to act if the plaintiff could have proved that (i) the successor trustee had knowledge of the breach by its predecessors, (ii) the successor trustee failed to make reasonable efforts to remedy the breach, and (iii) the plan's loss resulted from that failure.

The common law of trusts found in the Restatement of Trusts Second (Restatement), which was cited by the court, states the general rule that, "A trustee is liable to the beneficiary for breach of trust, if he (a) knows or should know of a situation constituting a breach of trust committed by his predecessor and he improperly permits it to continue; or (b) neglects to take proper steps to compel the predecessor to deliver the trust property to him; or (c) neglects to take proper steps to redress a breach of trust committed by the predecessor."

So...what IS knowledge, and what is a SEPARATE breach? Is it safe to assume that the courts will simply "know it when they see it?"

WHAT DO YOU KNOW, AND EXACTLY WHAT DID THEY TELL YOU?

There are examples found in the Restatement which appear to predicate liability on knowledge of an actual breach that is apparent and continuing. In each illustration in the Restatement, the successor has assumed the role as trustee subject to the apparent breach, which either was known as a condition of accepting the trust assets or which became apparent upon delivery of the trust assets (i.e., the trustee received the assets, and voila!, there was the breach).

The cases provide scant discussion of the fundamental issue of what constitutes "knowledge of a breach" which, if imputed to a successor trustee, raises the specter of liability. Arguably, knowledge of a breach should be distinguished from "mere assertions" (i.e., by a third party, like either the DOL or a plan participant) that one has occurred. Assertions may simply amount to suspicions, and may or may not create a duty of inquiry. By extension, assertions that a breach may have occurred, if not made by a fiduciary or someone with firsthand knowledge of the facts, might not constitute knowledge of a breach.

In contrast, for example, assertions that a prohibited transaction has occurred by someone with firsthand knowledge of the occurrence might constitute knowledge of a breach (even if not otherwise apparent to the fiduciary when reviewing the trust assets) because prohibited transactions are per se breaches of fiduciary duty under title I of ERISA.

The Silverman case and the Restatement also suggest that there must be a causal link between the fiduciary breach of a successor fiduciary and the loss to the plan. That is, the successor's own breach due to inaction must cause the plan to suffer a loss or a further loss. Without the causal link, there is no liability to the successor fiduciary.

DO YOU KNOW WHAT YOU DON'T KNOW?

It would be interesting to see the case law evolve such that a successor trustee has an affirmative obligation to exhaustively investigate the actions of a predecessor prior to appointment to determine the existence of, or dispel the rumors of, the existence of any breach, as opposed to the actual knowledge of a fiduciary breach. This has yet to happen. It may never come down to that.

In contrast to the successor fiduciary cases, in *Barker v. American Mobile Power Corp.*, the Ninth Circuit addressed whether a co-fiduciary had breached ERISA's prudence standards by failing to investigate his suspicions that co-fiduciaries had mismanaged plan funds. The mismanagement had resulted in significant underfunding for the plan.

In *Barker*, the co-fiduciary had "suspicions" that the court felt would lead most "reasonable and prudent individuals" to at least make further inquiries to ascertain whether breaches had occurred. As such, at least in the Ninth Circuit, there appears to be an affirmative obligation on the part of a co-fiduciary to investigate suspected breaches of a co-fiduciary if it would be reasonable and prudent under the circumstances to do so based on the suspicion that there has been (by omission or commission) a breach of duty. The case dealt with an ongoing "cover-up" by a fiduciary of the actions of plan trustees who were then "co-fiduciaries."

Could this standard be applied for successor fiduciaries? So far, it has not. There appears to be a fundamental distinction between the co-fiduciary's affirmative duty to investigate and a successor trustee's duties. As the statute is written, the distinction is that co-fiduciary breach is actually occurring while the other is serving; and per the statute it is his or her breach.

INVESTIGATE BEFORE ACCEPTING?

So, is it better to not investigate and merely accept an appointment? A successor trustee may, of course, elect to review or investigate the actions of a prior trustee prior to accepting the appointment. How practical is this in most ESOP contexts? For professional trustees with the wherewithal to review prior plan and transaction

history, this may be a practical and necessary approach. However, even so, it may be a practical barrier to initiating an engagement in an expeditious fashion.

Certain minimum amounts of due diligence may be necessary. Depending on how the case law evolves, a reasonably prudent initial investigation may suffice to surface concerns, should there be any, or perhaps to even satisfy a duty to investigate whether there is anything to investigate, if the courts impose such a duty. Now, is that ambiguous enough conjecture?

What if the breach is not apparent and a procedurally prudent initial review does not raise assertions or suspicions to a higher level of concern? What is a procedurally prudent level of review? What if the breach is uncovered or the successor's view is simply at odds with the predecessor's?

What if the proposed trustee has not accepted the appointment? Hopefully the appointee in question is careful enough to not have accepted until he or she is satisfied as to the condition of the trust, its assets, and history. Even if they are not so careful (but a predecessor's breach becomes apparent upon appointment), the requirement of causation and damage due to failure to act should be required for the successor trustee to incur liability.

IN THE ESOP CONTEXT – INNUMERABLE FACT PATTERNS AND ISSUES

In a most obvious example when a company's shares are not publicly traded, a successor ESOP trustee faces the possibility that the predecessor trustee breached his or her fiduciary duties as a result of imprudent share valuations – not the only potential source of issues for ESOP fiduciaries.

For example, an ESOP transaction may have involved a purchase price share valuation that resulted in a purchase for allegedly more than the "adequate consideration" (e.g. fair market value) allowed by ERISA (however, the value could actually be lower or higher, depending on the facts). Consequently, the predecessor trustee might have violated duties owed to plan participants and beneficiaries by paying too high a price for the trust's shares. If the price was too high and the ESOP used cash contributions to purchase shares, participants would have too few shares allocated to their accounts.

On the other hand, if the price were too low, participants who are cashed out of their accounts would receive too little for their shares. Combine the two fact patterns and you may have a price that is too high for the ESOP purchase, but too much in benefits paid out to plan participants! In such a case, have the ESOP participants overall received a benefit, or have they been damaged? Has the ESOP suffered "a further loss" which is necessary for a "continuing breach" by a successor trustee? Does the successor trustee have an obligation "to compel the predecessor to deliver the trust property to him," in the words of the Restatement, and recover overpayments to plan participants?

How intensely should the successor trustee examine this possibility? What would be procedurally prudent? Must the entire transaction(s) be reviewed? Would due diligence knowledge of insiders being appointed as successors change the answers to these questions under the "should have known" standard? Conversely, is an outside professional trustee operating only under the "apparent" knowledge of facts standard because the same knowledge should not be imputed to them? Or does this simply change the steps they would take in a procedurally prudent marshalling of the assets?

ESOP valuation issues can become a quagmire of conjecture, expert opinion, due diligence, and disclosure. If nothing on its face suggests an inaccurate valuation, must the trustee, at great expense, reinvent the wheel by hiring a second valuation firm to conduct a forensic accounting of the work done by the first? What precisely are characteristics of a transaction or valuation that should indicate the possibility of inaccurate share price? Would an audit, investigation, or participant complaint be enough to trigger a heightened duty to investigate or revalue shares? When do assertions and accusations become "apparent" or "constructive" knowledge? Will you "know it when you see it?"

STATUTES OF LIMITATION – WHEN DOES THE MADNESS END?

Recent case law revisits the question of when a successor must consider himself or herself in the clear from the hidden perils in the trust's history. The issue was most recently addressed in the Northern District of California. In *Fernandez v. K-M Indus. Holding Company*, the court considered the instance of an institutional trustee taking over from an insider – the former owner of the ESOP company in question – who had conducted transactions with the plan, selling his shares. The transaction alleged to be a prohibited transaction occurred in 1998. The successor trustee was appointed in April 2003. The facts involved underlying company business issues thought to affect the valuations for the 2002 transaction. Of course, the predecessor fiduciary would be the one type of predecessor that could have the highest level of knowledge about the facts in question. The successor trustee would be the type of trustee with the wherewithal to investigate transactions of a predecessor, but the least amount of immediately imputed knowledge when considering the appointment...unless, perhaps, if someone brought sufficient facts to the candidate's attention.

ERISA section 413 provides the statute of limitations for breach of fiduciary responsibility. A suit must be brought by the earlier of six years of the breach (or latest date when the fiduciary could have cured the breach) or three years from plaintiff's actual knowledge of the breach. In the case of fraud or concealment, such action must commence not later than six years after the discovery of such breach or violation.

According to the court in *Fernandez*, the successor could have brought a lawsuit for breaches made in connection with an ESOP transaction (there were others)

until October, 2004 – six years after the October 1998 transaction. The Fernandez case indicates that plaintiffs can sue a successor trustee for not suing the predecessor trustee during the predecessor trustee's limitations period. If the successor breached his duties by not suing, plaintiffs could sue the successor trustee by the earlier of 6 or 3 years of the latest date of the omission; the latest date of the omission of not suing was November 2008. This would give plaintiffs until November 2011, or later, to timely bring a claim against the successor trustee. However, in reality, the successor trustee was appointed after the limitations period expired, so no such claim could be brought for the October 1998 transaction.

In contrast, perhaps an initial investigation with a documented decision to not further investigate, or to not pursue claims, may mark the date from which the statute of limitations against a successor should run. This may shorten the successor's exposure under the statute, if the original limitations period for the predecessor is still open. In other words, the successor's alleged breach would not occur on the last day of the predecessor's statute of limitations, but on the earlier date of concluding its initial investigation or due diligence. (Which gets us back to the scope of investigation issue, above, doesn't it?)

Mind you, Fernandez addresses only the statute of limitations, not the merits of the case. The case does not address the scope of a successor trustee's duty to investigate, if any.

WHAT TO DO?

So where does an ESOP fiduciary appointee draw the line? At a minimum, the appointee should insist on the prior trustee's accounting and asset valuation and work of any co-fiduciaries to be complete and error free. The candidate must grapple with the decision as to the scope of the due diligence, and whether it should come before or after accepting appointment; and negotiate the terms and costs of engagement...carefully. Finally, the appointee should be sure the plan and trust provisions regarding expenses and indemnification are clearly spelled out; and when in doubt, be sure there is fiduciary coverage under applicable policies maintained by the sponsor or the plan itself — just in case something pops up.

Editor's Note: We did the best we could to make sure the information and advice in this article were current as of the date of posting to the web site. Because the laws and the government's rules are changing all the time, you should check with us if you are unsure whether this material is still current. Of course, none of our articles are meant to serve as specific legal advice to you. If you would like that, please call us at (916) 357-5660 or email us at contactus@seethebenefits.com.