The Brattle Group

ISSUE 01 | 2008

Finance

Current Topics in Corporate Finance

About this Newsletter

In this issue of Finance we review the types of pension plans commonly offered and identify risks for plan fiduciaries. We also discuss how to evaluate risks and assess plan performance.

Contents

Introduction

Pension Plans and Their Problems

- Defined Benefit Plan
- Defined Contribution Plan

Corporate- and Union-Sponsored Plans

Litigation Risk for State and Local Pension Plans

Conclusion

For more information about the authors or *The Brattle Group*, please visit **www.brattle.com.**

Copyright © 2008 *The Brattle Group, Inc.*

Lawsuits Stalk Pension Fiduciaries

By **Dennis Logue and George Oldfield**

Introduction

Over the last several years, an increasing amount of litigation surrounding pension plans has originated from a plan's fiduciaries suing other alleged fiduciaries such as investment mangers, advisors, and consultants.

This has been true for all types of pension plans sponsored by corporations, unions, not-for-profit organizations, and state and local governments. As seen in legal actions surrounding Executive Life Insurance Company and Enron, related litigation surely follows financial fiascos like the current subprime mortgage meltdown.

This newsletter reviews plans commonly offered by sponsors and identifies some of the risks for a plan's fiduciaries, highlighted by recent pension-related subprime litigation. It also focuses on the importance of evaluating risks and assessing the performance of a plan's fiduciaries.

Unique features of various pension plans create different types of litigation exposure for the sponsors, overseers, advisors, and managers of the plans. Plan participants are not the only set of plaintiffs. Rather, when there is a problem with a plan, the overseers or the regulator file complaints against the sponsors or the firms that provided technical information or investment services to the plan.

Given the current problems in markets for mortgage instruments, investment managers, advisors, and security underwriters can all expect to be targets of pension-initiated litigation. The suits usually allege some type of failure by the defendants to observe the required level of fiduciary care in dealing with the plan.[1]

The views expressed in this paper are strictly those of the authors and do not necessarily state or reflect the views of *The Brattle Group, Inc.*

Pension Plans and Their Problems

Two main types of pension plans coexist in the United States.

1. Defined Benefit Plan. This is the classic plan design, but is becoming less common for a variety of reasons, including: industrial decline in unionized sectors, demographics, expense, regulation, and litigation exposure.

Many corporations have frozen their existing defined benefit plans for regular employees while they switch to sponsoring other types of plans, primarily defined contribution plans (see Page 3). Some companies, even some with frozen plans, are finding inventive ways to use old defined benefit plans for new compensation purposes (see the box below on deferred executive compensation).

In a defined benefit plan, the sponsoring organization contributes to a pension plan on behalf of participants. Retirees covered by a defined benefit plan receive a specified amount per month upon retirement. Defined benefit plans generally take some time to vest and are usually not portable. Therefore, employees who switch jobs frequently may receive less in retirement benefits than non-switchers with similar wage histories.

The distinguishing feature of defined benefit plans is that the sponsoring organization bears the investment risk associated with the plan, and for plans sponsored in the private sector, government insurance is provided to participants through the Pension Benefit Guaranty Corporation (PBGC).[2]

Accordingly, the PBGC monitors the soundness of private sector plans and has certain requirements for sponsors regarding funding levels. Many old-line American corporations still maintain defined benefit plans, as do many unions.

Currently, the primary providers of defined benefit pension plans are state and local governments. There is no federal regulation or insurance for these plans. Therefore, state and local plans are frequently under-funded and many appear to be mismanaged.

Deferred Executive Compensation Moves into Pension Plans

Interestingly, one exception to the general decline in corporate-sponsored defined benefit pension plans is the movement by sponsors of executives' deferred compensation obligations into existing defined benefit pension plans originally established for regular employees. This has occurred even for some sponsors with plans that are supposedly frozen.

Shifting executives' deferred compensation into an existing employee defined benefit plan creates potential tax benefits for a sponsor. For example, in 2005 Intel Corporation:

- Moved over $200 million in executives' deferred compensation obligations into its employee pension plan
- Contributed about $187 million in cash to the plan
- Took a $65 million tax deduction for the contribution

Moving such executive deferred compensation into an employee defined benefit plan links the financial aspects and accounting standards of defined benefit plans to executive compensation programs and SEC rules on executive compensation disclosure.

The IRS rules limit how much use executives can make of plans designed for regular employees, but there appear to be creative ways to mitigate such limits. See the cover story of *The Wall Street Journal*, August 4, 2008, for a discussion of this trend in executive compensation.

CASE STUDY:
The Lesson of Executive Life

With defined benefit plans, there are several kinds of litigation risk for plans' fiduciaries. For example, during the late 1980s, many corporations terminated their defined benefit plans and purchased plan termination annuities that promised amounts due to the vested participants upon their retirement. This allowed the plans' corporate sponsors to take out surplus pension plan assets, which were those assets in excess of the cost of the termination annuities. Most of these corporations then created defined contribution plans to cover their employees' pension needs.

One prime pension termination annuity provider was Executive Life Insurance Company. Executive Life was also a substantial investor in high yield corporate bonds underwritten by the Drexel Burnham Lambert banking firm.

These so-called "junk bonds" were the 1980's corporate debt version of today's subprime mortgage instruments. Drexel's bankruptcy filing in February 1990 signaled big trouble in the market for junk bonds, much like the demise of Bear Stearns' hedge funds in 2007 flagged looming subprime mortgage problems.

Executive Life was shut down by the California Department of Insurance in 1991 due to its alleged junk bond-driven insolvency. The U.S. Department of Labor, which is the ERISA-designated regulator of corporate-sponsored plans, then filed suits against many companies that had bought plan termination annuities from Executive Life. The complaint against the plan sponsors was breach of fiduciary duty by those who chose Executive Life as a termination annuity underwriter because their investments in low-rated, high yield bonds were supposedly too risky for an insurance underwriter.

Many of these suits were dismissed and others settled. But the lesson from the Executive Life episode is that sponsors of defined benefit plans must be very careful in the process of selecting annuity providers or, for that matter, any other investment manager.

One final note is of interest in Executive Life's ongoing story. Executive Life's junk bond portfolio was sold in a 'fire sale' by the California Insurance Commissioner for $3.25 billion in 1991. The portfolio's value has actually turned out to be substantially higher than the sale price. Litigation over this matter continues.

2. Defined Contribution Plan. This is the most rapidly growing type of plan for corporations and not-for-profit organizations. More pension assets are now in defined contribution plans than in defined benefit plans. In this plan, the participant (and possibly the sponsor) makes a contribution to a retirement account owned by the participant (IRA or 401(k) for corporate-sponsored plans and IRA or 403(b) for non-corporate-sponsored plans).

Upon retirement, an employee who participates in a defined contribution plan can tap into the accumulated savings from the plan. Because these plans are portable, job switching does not affect the accumulation of retirement wealth.[3] In exchange for ownership and portability, participants bear the risk associated with their investment choices. By definition, these plans are always fully funded, absent fraud. However, the risk of poor investment performance is borne entirely by the employee, unless there has been a breach of fiduciary duty by the plan sponsor or investment manager. In this case, the responsible fiduciary may face litigation.

The U.S. Supreme Court recently expanded ERISA coverage to an individual participant in a defined contribution plan by holding the plan's administrator to ERISA's fiduciary standards (*LaRue v. DeWolff, Bloberg & Associates, Inc.*, 128 S. Ct. 1020 (2008)).[4] ■

Corporate- and Union-Sponsored Plans

These days more and more corporations are terminating or completely avoiding defined benefit plans in favor of establishing defined contribution plans. One reason for this is the heavy regulation on defined benefit plans through the PBGC and the Internal Revenue Service. Another reason is the risk of litigation for plan sponsors under ERISA (see *The Lesson of Executive Life* above).

Pension Plan Fiduciaries

Pension plan fiduciaries are named individuals chosen by a plan's sponsoring organization. These individuals are responsible for managing the pension, which may be either a defined benefit plan or a defined contribution plan, in a prudent manner. There are two broad fiduciary duties: the duty of care and the duty of loyalty. The duty of care requires a fiduciary to manage a plan's investments in a prudent fashion. Among other actions, this requires the plan's fiduciaries to:

- *Develop clear and rational investment policies based on appropriate and prudent guidelines, monitor plan investments to insure adherence to the guidelines, block further investments in imprudent alternatives, rebalance investments at reasonable intervals, and commit themselves to continuing education on new investment alternatives and strategies.*

- *Make the plan's investment guidelines available to participants, provide sufficient information to participants so that they can make responsible investment decisions, review plan-wide communications to participants to ensure that the information disseminated is accurate and complete, and assist participants to interpret the information provided.*

The duty of loyalty to the plan is more general. It requires pension plan fiduciaries to:

- *Develop methods of resolving potential conflicts between the plan and its sponsor that are not disadvantageous to the plan, learn as much as possible about plan governance and investments to maintain a high level of competence, and be faithful to the interests of the plan's beneficiaries.*

- *Develop an approach to exercising shareholder rights that works to the advantage of the plan as a shareholder.*

In summary, the duties of a pension plan's fiduciaries require prudence, informed action, faithfulness, and sponsor independence in the management of a plan. A plan's overseers are fiduciaries, but investment managers, advisors, and underwriters may be construed as plan fiduciaries as well. For more details on pension fiduciaries' duties, see *Managing Pension and Retirement Plans: A Guide for Employees, Administrators and Other Fiduciaries* by Baker, Logue, and Rader.

To defend against suits by participants and plan regulators, corporate-defined benefit plan sponsors have often sued their investment advisors, who have deviated from the plan's written investment instructions. In such a case, the damage claim is calculated as the difference between the actual amount in the investment account and the amount that would have been available if instructions had been followed. This can amount to a substantial damage claim by the fund.

Even with corporate-sponsored defined contribution plans, there is litigation risk for the fiduciaries associated with the plans, especially in light of the *LaRue* decision. For example, if the array of investment alternatives has been chosen haphazardly by plan trustees, they and other fiduciaries of the plan may be sued by plan participants for failing to meet their duty of care.

Similarly, if the array of investment alternatives includes the sponsoring company's stock and the company falters, there may be class actions brought by participants who suffered losses. The "poster child" for this sort of litigation is Enron's corporate-sponsored 401(k) defined contribution plan. In the Enron situation, many plan participants lost large portions (or all) of their 401(k) pension wealth as a consequence of having invested heavily in Enron stock through the plan.

Even investment alternatives that appear to be plain vanilla can harbor hidden problems. For example, many apparently straightforward fixed income funds have turned out to be big investors in subprime mortgage-related paper. Any provider of a portfolio that invested in a significant amount of subprime mortgage instruments can expect suits similar to those brought by plan participants against Enron.[5]

Union (Taft-Hartley) plans are more often than not defined benefit plans. As with corporate plans, these plans must be run for the exclusive benefit of the participants. The U.S. Department of Labor is the Taft-Hartley Act designated regulator of union-administered plans. Some union plan overseers have been subject to litigation initiated by the Department of Labor because they pursued investment strategies that put the long-term safety of the plan at risk. For example, some union plans failed to consider diversified investments in common stock. ■

Litigation Risk for State and Local Pension Plans

Litigation risk is associated with the defined benefit plans of state and local governments as well, but the source of litigation is not the participants bringing suit, as one might expect.

Instead, suits arise from one of the biggest problems in the state and local pension arena: most municipal plan investment decision-making is conducted by overseers who are current or former municipal employees. These overseers often appear to have very little background in investment management. Accordingly, plan overseers rely heavily on outside advisors, many of whom may have been selected for political, rather than professional, reasons.

As a result, the advisor group is the target of much litigation, either because the plan's overseers did not understand the advice provided by an actuary, investment advisor, or accountant, or the advice provided was simply wrong. Moreover, because of the high turnover of pension overseers in most state and local plans, new overseers often attack the advisors used by the previous set of overseers. Investment advisors, actuaries, and money managers have been frequent targets of litigation initiated by state and local employees' pension plan administrators.[6] ■

The Brattle Group's Capabilities in Pension Matters

Financial problems in pensions can involve a number of related matters:

- *Transaction execution analysis*
- *Due diligence in underwritings and private placements*
- *Investment strategy*
- *A sponsor's cost of capital and funding decisions*
- *Corporate financial accounting and disclosure*
- *Standards of fiduciary performance*

Our principals have over 30 years of experience with researching, analyzing, and publishing pension-related material on behalf of clients. Most recently, we worked on pension funding and executive compensation disclosure rules on behalf of the U.S. SEC.

Our experts have testified in litigation concerning Executive Life and coauthored a book on financial issues in pensions. We also have worked on litigation involving the performance of a municipal pension plan's overseers.

One specialty of our team includes expertise in the corporate finance aspects of pensions, including: the impact on financial structure, financial accounting and disclosure, and the estimation of damages in securities litigation. Another of our specialties involves evaluating fiduciary performance.

We bring to bear our expertise and industry experience to assist sponsors, overseers, and other fiduciaries in navigating the increasingly complex world of pension planning and pension-related litigation.

CONCLUSION

The recent growth in pension-related litigation means that pension fiduciaries' jobs have become more hazardous due to lawsuit exposure.

Protection for plan sponsors and trustees against the types of litigation discussed herein comes from sound decision-making with robust documentation through the entire decision-making process. Decisions have to be made by plan fiduciaries using all available information. More importantly, procedures must be created and maintained to document that the information gathered was evaluated as carefully as possible by the plan overseers.

It is prudent for pension overseers to engage top quality professionals to provide assistance with actuarial estimates, portfolio investment advice and investment management services, investment performance evaluations, and searches for alternative investment opportunities. The professionals engaged by a fund must adopt robust documentation standards as well, because these professional service providers are frequent targets of litigation by plan overseers.

ENDNOTES

1. A complaint filed in 2007 by Prudential Retirement Insurance and Annuity Company (PRIAC) against State Street Bank and Trust Company and State Street Global Advisors gives an idea of the sort of subprime stimulated litigation already filed against investment managers. PRIAC provides retirement products and services for a wide variety of different pension plans. In its suit against State Street, PRIAC complains of "…State Street's deceptive, imprudent, and incompetent performance as a fiduciary…" in its role as investment manager of a fixed income fund that invested in subprime mortgage instruments and alleges that State Street's conduct caused roughly $80 million in losses in separate accounts maintained by PRIAC for 165 different retirement plans. See the complaint in *Prudential Retirement Insurance and Annuity Company v. State Street Bank and Trust Company and State Street Global Advisors, Inc.*, U.S. District Court for the Southern District of New York, October 1, 2007.

2. The PBGC was created by the Employee Retirement Security Act of 1974 (ERISA). The PBGC is a corporation chartered by the U.S. Congress. It was established to insure, up to specified limits, the benefits owed by private sector-defined benefit pension plans. The PBGC currently covers over 30,000 plans with about 44 million participants. The board of directors of the PBGC consists of the secretaries of the Departments of Labor (chair), Commerce, and Treasury. Another feature of ERISA was the definition of fiduciary standards for pension plan overseers, advisors, and others connected to ERISA covered plans. The U.S. Department of Labor regulates most private sector defined benefit plans. See the Department of Labor website. http://www.dol.gov.

3. Another type of pension plan is called a cash balance plan. It is a hybrid between a defined benefit plan and a defined contribution plan. A cash balance pension plan is a defined benefit plan that defines a participant's benefit in terms of a stated account balance (rather than a stated periodic payment). Investment risks and rewards are borne by the employer. Upon retirement, the participant's accumulated cash balance is converted into an annuity by the plan. Cash balance plans are uncommon.

4. In its *LaRue* decision, the Supreme Court reversed a Fourth Circuit Court decision. The Court ruled that a defined contribution plan participant may recover damages from an ERISA fiduciary's breach of duty even though the breach affected only that individual's 401(k) plan account. Prior to the *LaRue* decision, courts had opined that ERISA Section 502(a)(2) provided a remedy for fiduciary breach claims only for relief sought by a plan as a whole. See the United States Supreme Court Decision in *LaRue v. DeWolff, Boberg & Associates Inc., et al.*, February 20, 2008. The *LaRue* decision will likely engender a large number of future lawsuits against employers that sponsor defined contribution pension plans.

5. In a recent complaint, a securities class action was filed against National City Corporation, a financial holding company headquartered in Cleveland, Ohio. On December 1, 2006, National City acquired Harbor Federal Savings Bank. On that date, National City filed a registration statement with the SEC to offer 2.4 million National City shares to Harbor Bank's employees through the Harbor Bank Employee Stock Ownership and Harbor Bank Stock Incentive Plans. The complaint alleges that National City's registration statement failed to disclose that its loan portfolio was "…dangerously overexposed to risky and impaired CDO's…" backed by subprime mortgages. See the complaint in *Lisa Parker, et al. v. National City Corporation, et al.*, U.S. District Court for the Northern District of Ohio, April 21, 2008. Employee stock ownership plans also come under ERISA. See the Department of Labor website. http://www.dol.gov.

6. For example, the Houston Police Officers' Pension System has filed a suit against State Street Bank and Trust Company and State Street Global Advisors with arguments similar to the PRIAC suit mentioned in endnote 1. The basic allegation is breach of fiduciary duty in the management of a fixed income portfolio due to over-investment in subprime mortgage-backed instruments. See the Civil Action in *Houston Police Officers' Pension System v. State Street Bank and Trust Company and State Street Global Advisors, Inc.*, U.S. District Court for the Southern District of Texas Houston Division.

About the Authors

Senior Advisor

Dr. Dennis Logue is the chairman of the board of directors at Ledyard Financial Group in Hanover, New Hampshire and a professor emeritus at Dartmouth College. He specializes in the areas of pensions, corporate finance, corporate governance, and mergers and acquisitions. He has written six books and numerous articles on various aspects of pension plans and also recently served on a special committee appointed by the governor of the state of New Hampshire to study the New Hampshire Public Retirement System. In addition, Dr. Logue has served as an expert witness in a variety of pension-related legal cases involving the PBGC and the proper management of 401(k) plans.

Dr. Logue holds a Ph.D. in managerial economics from Cornell University, an M.B.A. from Rutgers University, and a B.A. in english from Fordham University.

Phone: +1.617.864.7900 **Email**: Dennis.Logue@dartmouth.edu

Principal

Dr. George Oldfield has worked at the U.S. Securities and Exchange Commission as an economic research fellow specializing in disclosure rules for corporate pensions, executive compensation, and employee stock options. His financial experience includes serving as a managing director in PaineWebber's Capital Markets Division where he managed the dealer's mortgage and asset securitization business. He has spent much of his career in academia, most recently as the Richard S. Reynolds, Jr. Professor of Finance at the College of William and Mary's Mason School of Business. He has also taught at Dartmouth College's Tuck School and Cornell University's Johnson School. Dr. Oldfield has written extensively on pensions, trading strategies, and financial derivatives.

Dr. Oldfield holds a Ph.D. and M.A. in finance from The Wharton School of the University of Pennsylvania and an A.B. in economics from The College of William and Mary.

Phone: +1.202.955.5050 **Email**: George.Oldfield@brattle.com

LATEST FIRM-WIDE NEWS

Finance Experts Michael Cragg and Robert Mudge Join *Brattle* as Principals
Dr. Cragg has extensive research, consulting, and expert witness experience in corporate finance, financial services, and valuation. He has assisted corporations, the U.S. Department of Justice, and the IRS in developing economic and financial testimony in complex litigation.

He recently played a central role in the highly publicized Long Term Capital Management litigation and in the Glaxo transfer pricing dispute.

Prior to joining *Brattle,* Dr. Cragg was a founding partner of Cambridge Finance Partners, LLC.

Mr. Mudge's experience in project finance, M&A, and bankruptcies includes expertise in a wide range of financial structures, degrees of market exposure, technologies, and regulatory environments.

He has advised energy clients in matters involving corporate restructuring, contract terminations or amendments, special capital needs, and acquisitions and divestitures.

Before joining *The Brattle Group*, Mr. Mudge was a principal at CRA International, and an investment banker at Sanwa Bank, ABN AMRO, and Rothschild.

***Brattle* Offers Issue Brief on Litigation Risks of the Expanding Subprime Crisis**
The Brattle Group has published a brief on the increased litigation risks regarding the fallout of the subprime mortgage crisis. This brief offers a view of spreading credit and insurance problems in the finance industry, and discusses litigation risk in light of current uncertainty.

For more information, please go to www.brattle.com.

The Brattle Group

Our Functional Practice Areas

- Antitrust/Competition
- Commercial Damages
- Environmental Litigation and Regulation
- Forensic Economics
- Intellectual Property
- International Arbitration
- International Trade
- Product Liability
- Regulatory Finance and Accounting
- Risk Management
- Securities
- Tax
- Utility Regulatory Policy and Ratemaking
- Valuation

Our Industry Practice Areas

- Electric Power
- Financial Institutions
- Natural Gas
- Petroleum
- Pharmaceuticals, Medical Devices, and Biotechnology
- Telecommunications and Media
- Transportation

About The Brattle Group

The Brattle Group provides consulting and expert testimony in economics, finance, and regulation to corporations, law firms, and governments around the world.

We combine in-depth industry experience, rigorous analyses, and principled techniques to help clients answer complex economic and financial questions in litigation and regulation, develop strategies for changing markets, and make critical business decisions.

We are distinguished by:

♦ *Thoughtful, timely, and transparent analyses of industries and issues*

♦ *Affiliations with leading international academics and highly credentialed industry specialists*

♦ *Clearly presented results that withstand critical review*

The Brattle Group

44 Brattle Street
Cambridge, MA 02138
Voice +1.617.864.7900
Facsimile +1.617.864.1576

www.brattle.com office@brattle.com

Suite 1140
353 Sacramento Street
San Francisco, CA 94111
Voice +1.415.217.1000
Facsimile +1.415.217.1099

Suite 1200
1850 M Street, NW
Washington, DC 20036
Voice +1.202.955.5050
Facsimile +1.202.955.5059

rue Ducale 83
1000 Brussels
Belgium
Voice +32.2.790.35.80
Facsimile +32.2.790.35.81

1st Floor, 198 High Holborn
London WC1V 7BD
United Kingdom
Voice +44.20.7406.1700
Facsimile +44.20.7406.1701