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21St Century Pensions: The Risk, the Hedge and the Duty to Consider

Martin Rosenburgh

Andrew C. Spieler

21ST CENTURY PENSIONS: THE RISK, THE HEDGE AND THE DUTY TO CONSIDER

Martin Rosenburgh & Andrew C. Spieler**+*

INTRODUCTION

Among the most significant of the damages to result from the recent market turmoil may be those suffered by U.S. pension plans and their participants. In a period of little more than a year, defined benefit ("DB") plans have been taken from fully-to-over-funded status to historically large deficit levels.[1] Furthermore, many of these underfunded plans are sponsored by companies facing drastic deterioration in financial health (and in some cases potential bankruptcy); and the Pension Benefit Guaranty Corporation ("PBGC"), the agency responsible for insuring DB plans, is itself experiencing significant and rising deficits.[2] The result may likely be a rising uncertainty as to the status and future of benefits for a large number of pension plan participants.[3]

Perhaps what is most troubling about this development is that it occurred "under the watch" of one of the world's most robust legal and

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* Martin Rosenburgh, Esq. is an independent legal consultant specializing in securities and financial laws.

** Andrew C. Spieler, Ph.D., CFA, FRM, Associate Professor of Finance, Frank G. Zarb School of Business, Hofstra University, Hempstead, New York.

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[1] In a recent report by Mercer, "funded status" (defined as the ratio of assets to liabilities) for the S&P 1500 companies declined from 104% in 2007 YE to 75% in 2008 YE. The pension funding deficit for the same group is estimated to be $409 billion as of 2008 YE. In addition, U.S. pension related expenses are estimated to increase from approximately $10 billion in 2008 to $70 billion in 2009. Published by Mercer on January 7, 2009, reported by Pension & Benefits Daily on January 8, 2009.

[2] The PBGC is currently experiencing $11.2 Billion deficit. *See* "PBGC Premium Boost - Outgoing PBGC chief Millard pushes to strengthen agency's financial footing", Pension & Investments, January 20, 2009.

[3] *See* Note 1.

regulatory frameworks, designed to protect against this very harm – that of the Employee Retirement Income Security Act of 1974 ("ERISA").[4] With ERISA provisions governing virtually every aspect of pension plan entitlement and operation, and administrative and enforcement responsibility shared by three U.S. agencies (i.e., the U.S. Department of Labor ("DOL"), the U.S. Treasury and the PBGC), three questions immediately come to mind: i) how is such significant DB plan risk exposure (and consequential large losses) permissible under ERISA? (in short- how could this sort of thing happen?), ii) are there safeguards available which could have been (or could be in the future) implemented?, and iii) if so, is someone responsible for failing to take them?

The answers to these questions are found in a review of the applicable law governing the investment of pension plan assets, as well as in consideration of industry practices and available investment solutions. In summary, we find the following:

> 1. Notwithstanding the fact that plan investment decision-makers are "fiduciaries" under ERISA, subject to a number of stringent standards regarding conduct and decision-making (e.g., the statutory duty of the "Prudent Man Standard of Care"), plan fiduciaries have been afforded a great deal of freedom under ERISA in their choices regarding plan investment strategy.
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> 2. Pension solutions experts offer safeguards against the forms of defined benefit plan-related risk experienced during the past year, in hedging-based investment strategies called "Liability Driven Investing" ("LDI").
>
> 3. Although applicable law is sparse and uncertain, it does appear plausible for ERISA fiduciary liability to arise in connection with a failure to adopt such safeguards,

[4] As amended. ". . . that owing to the inadequacy of current minimum standards, the soundness and stability of plans with respect to adequate funds to pay promised benefits may be endangered; that owing to the termination of plans before requisite funds have been accumulated, employees and their beneficiaries have been deprived of anticipated benefits; and that it is therefore desirable in the interests of employees and their beneficiaries, for the protection of the revenue of the United States, and to provide for the free flow of commerce, that minimum standards be provided assuring the equitable character of such plans and their financial soundness." 29 U.S.C. § 1001(a), ERISA § 2(a) Congressional findings and declaration of policy.

> particularly where the decision-making process involved in choice or monitoring of investment strategy is found to be inadequate.

I. HOW IS SUCH SIGNIFICANT DB PLAN RISK EXPOSURE, AND CONSEQUENTIAL LARGE LOSSES, PERMISSIBLE UNDER ERISA? (I.E, HOW COULD THIS SORT OF THING HAPPEN?)

For the groundwork of understanding of what is, and is not, permissible with respect to plan investment decision-making, one must begin with a review of the ERISA statute itself and interpretive DOL regulations, ending with remedies available under ERISA and common law.

A. ERISA Section 404(a) "Prudent Man Standard of Care"

ERISA sets forth a "Prudent Man Standard of Care" governing all fiduciary behavior, including investment decisions.[5] Fiduciaries are required to act

> "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."[6]

Viewed generally by courts as adoption of the "prudent person" standard from the common law of trusts, these and the other provisions of ERISA §404 are interpreted under a significant and growing body of federal common law of ERISA.[7]

In addition, a fiduciary is required to "discharge his duties with respect to a plan solely in the interest" of the plan participants, for the "exclusive purpose" of providing benefits and "defraying reasonable expenses" of plan administration.[8] Investment decision-making is also subject to a diversification

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[5] ERISA § 404(a).

[6] ERISA § 404(a)(1)(B).

[7] *See* Donovan v. Mazzola, 716 F.2d 1226 (9th Cir. 1983). *See also* Varity v. Howe, 516 U.S. 489(1996).

[8] ERISA § 404(a)(1)(A). Sometimes referred to as the "exclusive benefit" rule, this has been viewed as incorporating a trust law "duty of loyalty".

requirement "so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so", [9] and must also be made "in accordance with the documents and instruments governing the plan."[10]

DOL Regulation 2550.404a-1, referred to by courts as the "prudence rule",[11] provides guidance for what is deemed a "prudent" discharge of duties under ERISA Section 404(a) with respect to an "investment" or "investment course of action".[12] Such requirements are deemed satisfied

> "if the fiduciary. . . has given *appropriate consideration* to those facts and circumstances that, given the scope of such fiduciary's investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action involved, including the role the investment or investment course of action plays in that portion of the plan's investment portfolio with respect to which the fiduciary has investment duties; and . . .has acted accordingly" *(emphasis added).*[13]

The regulation defines "appropriate consideration" as including (but not limited to) the following two components:

> A. A determination by the fiduciary that the particular investment course of action is reasonably designed, as part of the portfolio. . .to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain (or other return) associated with the investment or investment course of action, and
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> B. Consideration of the following factors as they relate to such portion of the portfolio:
>
> i. The composition of the portfolio with regard to diversification;

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[9] ERISA § 404(a)(1)(C).

[10] ERISA § 404(a)(1)(D).

[11] California Ironworkers v. Loomis Sayles & Co., 259 F.3d 1036, 1043 (9th Cir. 2001).

[12] DOL Reg. 2550.404a-1. The DOL is the U.S. agency authorized to enforce ERISA fiduciary requirements.

[13] DOL Reg. 2550.404a-1.

ii.The liquidity and current rates of return of the portfolio relative to the anticipated cash flow requirements of the plan, and

iii.The projected return of the portfolio relative to the funding objectives of the plan.[14]

By directing an investment (or investment course of action) be "reasonably designed as part of the portfolio", this guidance has been viewed by courts as the adoption by the DOL of the Modern Portfolio Theory.[15] Accordingly, risk and return characteristics of investment choices are held to be properly considered in light of their operation *within the portfolio as a whole*, taking into account the additional appropriate factors (e.g., diversification, liquidity and current returns relative to anticipated cash flow requirements, and projected returns relative to plan funding objectives).[16]

These statutory and regulatory provisions form the basis for judicial review of plan investment decision-making. It is noteworthy that the regulatory "safe harbor" outlined above is based on an "appropriate consideration" of qualitative and quantitative factors deemed relevant and generally in accordance with Modern Portfolio Theory.[17] This emphasis on the investment *process* is also reflected in case law, which holds generally that review of an investment or course of action for prudence purposes is focused on the procedure employed, not on the outcome yielded.[18] Courts have stated the rule as follows:

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[14] DOL Reg. 2550.404a-1. The regulation's preamble indicates that this guidance is not intended to provide an exclusive manner of compliance with prudence requirements: "It should also be noted that the Department does not view compliance with the provisions of the regulation as necessarily constituting the exclusive method for satisfying the requirements of the "prudence" rule. Rather, the regulation is in the nature of a "safe harbor" provision; it is the opinion of the Department that fiduciaries who comply with the provisions of the regulation will have satisfied the requirements of the "prudence" rule, but no opinion is expressed in the regulation as to the status of activities undertaken or performed that do not so comply."

[15] DiFelice v. U.S. Airways, 497 F.3d 410, 423 (4th Cir. Va. 2007).

[16] DOL Reg. 2550.404a-1 Preamble (An investment "should not be deemed to be imprudent merely because the investment, standing alone, would have, for example, a relatively high degree of risk.) Courts have drawn a distinction between this review of an investment's risk, to be determined within the context of the whole portfolio, and the requirement that each and every investment or course of action be "prudent" on an individual basis. ("That is, a fiduciary must initially determine, and continue to monitor, the prudence of each investment option available to plan participants.") DiFelice v. U.S. Airways, 497 F.3d 410, 423.

[17] DOL Reg. 2550.404a-1.

[18] *See* Brock v. Robbins, 830 F.2d 640, 648 (7th Cir. 1987) (a failure to follow reasonable procedures is imprudent even if the fiduciaries reached a reasonable decision). *See also* Anderson v. Mortell, 722 F. Supp. 462, 470 (N.D. Ill. 1989) (the duty of fiduciary is to conduct a prudent, independent investigation, not to achieve "the highest possible price" in sale of a plan asset).

> When deciding whether a plan fiduciary has acted prudently, a "[c]ourt must inquire whether the individual trustees, at the time they engaged in the challenged transactions, employed the appropriate methods to investigate the merits of the investment and to structure the investment." (internal quotation marks omitted). In other words, a court must ask whether the fiduciary engaged in a reasoned decision-making process, consistent with that of a "prudent man acting in like capacity"[19]

Notwithstanding the stringent level of care and consideration dictated under the forgoing ERISA prudence requirements,[20] plan fiduciaries have been afforded a great deal of freedom under ERISA in their choices regarding plan investment technique and strategy. In the Preamble to the foregoing regulation, the DOL indicates an intent to avoid limitation of "the investments, classes of investment, or investment techniques that might be permissible under the 'prudence' rule. No such list could be complete; moreover, the Department does not intend to create or suggest a 'legal list' of investments for plan fiduciaries."[21]

Ironically, the clearest indication of regulatory intent on the freedom to choose strategy comes from a DOL Advisory Opinion regarding the permissibility of use of the "Liability Driven Investing" pension portfolio management strategy:

> Within the framework of ERISA's prudence, exclusive purpose and diversification requirements, the Department believes that plan fiduciaries have broad discretion in defining investment strategies appropriate to their plans. In this regard, the Department does not believe that there is anything in the statute or the regulations that would limit a plan fiduciary's ability to take into account the risks associated with benefit liabilities or how those risks relate to the

[19] ERISA § 404(a)(1)(B). DiFelice v. U.S. Airways, 497 F.3d at 421, citing Flanigan v. GE, 242 F.3d 78, 86 (2d Cir. 2001).

[20] *See* Donovan v. Bierwirth, 680 F.2d 263, 272 (2d Cir.), *cert. denied*, 459 U.S. 1069 (1982) (the court emphasizes the high degree of care required under ERISA's prudence standard, noting that ERISA fiduciary duties are "the highest known to the law"). *See also* Donovan v. Mazzola, 716 F.2d at 1231.

[21] DOL Reg. 2550.404a-1 Explanatory Preamble.

portfolio management in designing an investment strategy.[22]

There is, however, one noteworthy piece of DOL guidance weighing in on the use of a particular type of investment – a 1996 DOL Information Letter regarding the use of derivatives.[23] In the letter, guidance is provided with respect to additional factors which should be considered in a decision to use derivatives (or in implementing and/or maintaining a derivatives-based strategy). Among the factors to consider are "..sufficient information to allow an independent analysis of the credit risk and market risk being undertaken by the plan..", to be determined by an "appropriate methodology used to evaluate market risk." Toward this end, the letter notes that "stress simulations are particularly important because assumptions which may be valid for normal markets may not be valid in abnormal markets, resulting in significant losses." In addition, the letter instructs:

> As part of its evaluation of the investment, a fiduciary must analyze the operational risks being undertaken in making the investment. Among other things, the fiduciary should determine whether it possesses the requisite expertise, knowledge, and information to understand and analyze the nature of the risks and potential returns involved in a particular derivative investment. In particular, the fiduciary must determine whether the plan has adequate information and risk management systems in place given the nature, size and complexity of the plan's derivatives activity, and whether the plan fiduciary has personnel who are competent to manage these systems.[24]

While there is no indication in this guidance that derivatives are deemed more "risky" or inherently less prudent than other investment types,[25] it does suggest that derivatives usage would require a specific form of expertise that may not be present at all plans, and that a layer of due diligence would likely be required above and beyond that with respect to other investments.

Accordingly, without providing any significant guidance regarding the selection of portfolio investment strategies (other than with respect to the use of derivatives or the LDI portfolio approach), there is an inference from the

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[22] DOL Advisory Opinion 2006-08A.

[23] DOL Information Letter to Honorable Eugene A. Ludwig, dated March 21, 1996.

[24] *Id.*

[25] The letter states that "investments in derivatives are subject to the fiduciary responsibility rules in the same manner as are any other plan investments." *Id.*

foregoing regulatory guidance that the "tried and true" or traditional approaches to portfolio management may provide a "less burdensome" or "safer" means of satisfying ERISA prudence requirements.

B. ERISA Civil Enforcement of Fiduciary Breaches

ERISA Section 409 "Liability for breach of fiduciary duty" provides that, with respect to breaches of fiduciary duty, fiduciaries are personally liable "to make good to such plan any losses to the plan resulting from each such breach."[26] ERISA Section 502 "Civil enforcement" provides empowerment to bring civil actions to enforce rights under ERISA.[27] With respect to enforcement of liability for fiduciary breaches (under ERISA Section 409), actions may brought by "the Secretary, or by a participant, beneficiary or fiduciary. . .".[28]

Accordingly participants, in addition to the DOL, are among parties who may bring civil actions to enforce breaches of fiduciary duty and recoup losses to the plan.[29] In this manner, ERISA Section 502(a)(2) arguably enhances the enforcement power under ERISA by "deputizing" as enforcers of fiduciary liability the large constituency of U.S. plan participants. Historically, however, a significant limitation on such actions by participants, seeking to recover losses with respect to DB plans, has been found in "Article III Constitutional Standing". Under the doctrine of Article III Constitutional Standing, a plaintiff must have "suffered an injury in fact".[30] Such "injury" has been held by some courts as lacking where, notwithstanding the losses suffered to a DB plan, the plan remained adequately funded to pay "all accrued or accumulated benefits".[31]

In large part for these reasons, the responsibility for enforcing rights with respect to DB plan investment decision-making has been left largely to the DOL. However, as indicated above, the DOL has traditionally refrained from prohibiting (or requiring) specific types of investment strategy, and would

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[26] ERISA § 409.

[27] ERISA § 502.

[28] ERISA § 502(a)(2).

[29] *Id.*

[30] Harley v. Minnesota Mining and Manufacturing Co., 284 F.3d 901, 906.

[31] Harley v. Minnesota Mining and Manufacturing Co., 284 F.3d at 907. *See also* Hughes Aircraft v. Jacobson, 525 U.S. 432, 440 ("Given the employer's obligation to make up any shortfall, no plan member has a claim to any particular asset that composes a part of the plan's general asset pool"). However, the rule governing Constitutional Standing is far from settled, with inconsistent positions taken among different Circuits. *See* Amicus Brief of the Secretary of Labor, Harley v. Minnesota Mining and Manufacturing Co., 284 F.3d 901.

therefore not likely bring an action where the investment course of action arising in an alleged breach of duty was the adherence to a "tried and true" or traditional portfolio allocation approach (unless there was some other visible failure in the investment decision-making process). Accordingly, significant DB plan risk exposure (and consequential large losses) continues to remain permissible, and quite likely, under ERISA.

Recent events, however, may have altered the landscape of enforcement and litigation. As mentioned above, plan funding levels have deteriorated significantly over the past twelve to eighteen months.[32] Accordingly, there is likely to be a growing universe of DB plan participants for whom receipt of benefits is uncertain, and who would therefore satisfy any applicable review of Constitutional Standing.[33]

II. ARE THERE SAFEGUARDS WHICH COULD HAVE BEEN TAKEN?

The most significant form of risk that arises in connection with DB plan funding and investment is a function of the deviation or "mismatching" that can occur between plan assets and liabilities.[34] Traditional pension investment performance measurement (or "benchmark" development) has been primarily "asset based" (i.e., based on performance of comparable assets in the market, often represented by indices). However, due to market fluctuations, both plan assets and liabilities can experience significant volatility, and not necessarily in the same direction. This difference is often referred to as "tracking error to liabilities" or "surplus volatility".[35] This volatility is largely driven by changes in interest rates, which in turn cause changes in the present value of plan liabilities and asset values of plan-held fixed income investments (and often occur in connection with volatility in other asset types as well, such as equities).

Safeguards against this risk are available in the plan investment industry, in strategy primarily known as Liability Driven Investing ("LDI").[36] The LDI strategy has two essential components: i) build a benchmark based on timing and amount of plan liabilities, not on the targeted return of assets, and ii)

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[32] *See* Note 1.

[33] *See* Notes 30-31.

[34] *See* Rene Martel, FSA, CFA, "LDI: Not One Magic Bullet" (Viewpoints, PIMCO Oct. 2008).

[35] *Id.*

[36] *Id.* ("With better understanding and knowledge, there is now a broader recognition that LDI is not a product. Instead, more and more people accept LDI as a process or framework to assess the risk position of defined benefit plans relative to their liabilities in order to identify the investment strategy that is best suited to the sponsor's objectives.").

construct a fixed income portfolio designed to "track" the benchmark.[37] In order to obtain maximum risk reduction benefits, derivatives such as interest rate swaps may also be used (but are not necessary). Furthermore, in order to generate sufficiently high returns, a remaining portion of the portfolio would be allocated to riskier assets such as equities (but this portion is much smaller than the traditional allocation).

Adoption of such a strategy can result in significant reduction in risk associated with a DB plan's funded status.[38] This is largely due to the fact that investments are structured to provide returns and income that match the timing and amounts of the plan's liabilities, so that the plan is essentially "hedged".[39]

For those plans considering the use of interest rate derivatives in connection with such a strategy, there are likely to be additional considerations (some of which are outlined in the DOL Information Letter regarding the use of derivatives, discussed above).[40] For instance, derivative positions can result in interim cash flow requirements to the portfolio, which fluctuate in accordance with interest rate changes. Such impacts could (and should) be modeled under different interest rate scenarios.[41] In addition, plan fiduciaries may not possess the expertise with which to understand how these investments operate and would impact the plan, and therefore may require outside advice.[42]

Accordingly, safeguards to DB plan underfunding do exist in the form of hedging-based strategies such as LDI. Although the strategy can be implemented through the use of derivatives, such usage is not required and may be limited in accordance with the needs, expertise and risk tolerances of the plan.

The following hypothetical should provide a better understanding as to

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[37] *See* "Liability-Driven Investing: PIMCO's Innovative Approach to Custom Solutions", PIMCO Product Focus, May 2007.

[38] Funded status represents the economic position of the pension plan: fair value of the assets – present value of the anticipated pension obligations (using several managerial and actuarial assumptions).

[39] One can think of a plan's liabilities as similar to bond investment but in reverse: various payment requirements are expected into the future at different times. Accordingly, LDI develops fixed income investment solutions which provide income to match these expected liabilities.

[40] DOL Information Letter to Honorable Eugene A. Ludwig, dated March 21, 1996.

[41] As discussed in the Letter, such modeling, or "stress testing", would likely be considered a necessary part of a prudent investment process. *Id.*

[42] *See* Susan Mangiero, Ph.d, AIFA, AVA, CFA, FRM, and Society of Actuaries Joint Pension Risk Research Project, "Pension Risk Management: Derivatives, Fiduciary Duty and Process" (October 2008) (In response to the question "What reasons account for your decision not to use derivative instruments to manage the risk of your defined benefit plan(s)?", "Lack of Fiduciary Understanding", "Perception of Excess Risk" and "[DB] Plan Risk Not Considered Significant" were the most frequent responses.).

how a plan might be faced with the type of investment decision-making described in this article. It also may serve to highlight several of the issues raised under ERISA, which will be explored further below.

Part I. The Proposal

You sit on the investment committee for your company's multi-billion dollar defined benefit pension plan. It is Spring 2007 and the plan is "fully funded" (pursuant to ERISA funding requirements) and in excellent financial health. With a portfolio allocation of 65% equities, the plan's strong investment performance can be attributed in large part to that of the S&P 500, which has earned double-digit annualized returns for the previous five years. Notwithstanding the success of your current portfolio performance, the committee is being presented with a portfolio allocation strategy called "Liability Driven Investing" which would represent a radical change.

In a presentation to the committee, the new investment advisor candidates argue that the plan funding level is exposed to a series of substantial risks. First, the plan is exposed to significant asset-based volatility associated with the plan's equities and other "risky" assets. Another primary risk arises from the volatility in interest rates, which causes the present value of the plans liabilities to fluctuate. It is explained that these could be greatly reduced, if not largely eliminated, through the use of a "hedging" strategy:

-First, a new performance benchmark for the plan would be created, based not on investment indices (such as the S&P 500 or the Lehman Aggregate Bond indices) but on the plan's liabilities. This would be accomplished by constructing a model of the timing and amount of the plan's forecasted future benefit payments.

-The investment advisor would create a portfolio of fixed income investments, with incoming interest and cash flows designed to "match" the (anticipated) outgoing benefit payments of the plan. Portfolio performance would be measured against the new liability-based benchmark.

-A portion of the plan assets would remain in equities and other asset classes intended to yield higher/excess returns, but this percentage would be far less than the plan's traditional allocation. The end result would be a portfolio with overall lower returns than the current plan, although likely exhibiting less volatility as measured against the plan's liabilities.

Part II. The Decision

After reviewing the proposal, there were aspects that appealed to you and the committee, but it was ultimately rejected (at least for the time being). One of the primary concerns raised was that the strategy seemed too "complex", and the committee was uncertain that they possessed the expertise necessary to approve, and then adequately monitor, the strategy implementation. There was also discussion of the potential use of "interest rate swaps" in the fixed income portion of the portfolio. Although it was advised that derivative usage would not be necessary in order to implement the strategy, it was ultimately recommended; and there were a number of the committee members who were uncomfortable with derivatives generally (again, largely due to a lack of committee expertise and understanding of the risks involved).

There was one other concern that weighed on you. In order to implement this strategy, you would be required, pursuant to financial accounting standards, to make a significant downward adjustment to your expected return assumption for the plan's investments. (The lower expected return would result from shifting asset allocation away from the historically higher performing equities asset class toward fixed income). This would have an immediate negative impact on company reported earnings, an outcome with which you were certain would please no one in upper management.

Spring, 2009

It is two years later, Spring 2009 and, after an unexpected credit crunch and subsequent market downturn, your company's defined benefit plan is now seriously underfunded. Not only has your plan portfolio lost in excess of 50% of its value from two years ago, but plan liabilities, calculated on a present value basis, have actually risen (in part due to current interest rates being at historically low levels). There is now significant uncertainty that the plan (or the company) has the ability to pay promised pension benefits when due (and there is informal discussion about termination of the plan). You are asking yourself now whether the committee was too hasty when it rejected the "Liability Driven Investing" approach two years ago. Of course, hindsight is always 20/20 and your plan has fared no worse than a large number of other U.S pension plans. Notwithstanding, you call your attorney and ask: as pension plan "fiduciaries" under ERISA, could the investment committee members be liable for failing to adequately consider a hedging strategy before rejecting it?

III. IF SO, IS SOMEONE RESPONSIBLE FOR FAILING TO TAKE THEM?

As discussed above, fiduciary duties with respect to plan investments are grounded in a prudent investment *process*,[43] with an emphasis placed on an "appropriate consideration"[44] and a "reasoned decision-making process"[45] given to investments and investment courses of action involved.[46] The question presented by this article is whether fiduciary liability could arise in connection with a failure to provide such adequate process *in considering*: i) existing pension portfolio-related risk exposure and/or ii) employing a strategy to reduce such risks (i.e., through a portfolio management strategy such as LDI). Such a

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[43] *See* Notes 17-19.

[44] Reg. 2550.404a-1.

[45] DiFelice v. U.S. Airways, 497 F.3d at 421.

[46] It should be noted that although Reg. 2550.404a-1 is provided as a "safe harbor" or non-exclusive means of satisfying prudence requirements, courts have looked to its provisions for guidance in determining whether investment actions were "prudent". *See* California Ironworkers v. Loomis Sayles & Co., 259 F.3d at1044.

failure could arguably arise in one of two decision-making contexts. First, as described in the hypothetical above, it could be alleged that plan fiduciaries rejected without an adequate process the proposal of such a strategy that was presented for consideration. Second, a claim could arise that fiduciaries failed to "appropriately consider" significant risk exposure in their existing traditional portfolio, and subsequently failed to pursue, or look into, LDI strategy solutions as a means of reducing that risk. In order to review the validity of potential claims, there are several issues to consider

Typically, investment-related breaches are found to arise in connection with the entering into, or adoption of, discrete investments or investment courses of action.[47] However, the question presented here is more likely to arise from some degree of *failure to act* (i.e., by *failing* to change existing portfolio allocations and/or *failing* to engage in a hedging strategy). Accordingly, in review of such claim, a court may look for authority supporting liability for what may be argued is a failure to act.[48]

In addition, as discussed above, ERISA neither restricts nor obligates fiduciaries in the types of investments or strategies which they may adopt.[49] A breach is not likely to arise from the failure to act itself (e.g., the *choice* not to adopt a hedging strategy). Instead, liability would likely be limited to instances where such investment inaction was found to be the result of a failure in the consideration and decision-making process (e.g., with respect to portfolio risk and available hedging strategies).[50] Applicable law indicates several principals which are likely to bear upon such a review.

First, ERISA prudence requirements broadly cover all aspects of the plan investment process, extending far beyond initial decisions to enter into investments. Under the "prudence rule" DOL Reg. 2550.404a-1 (discussed

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[47] See, for instance, Donovan v. Mazzola, 716 F.2d at 1232 (The issue before the court was "whether the individual trustees, at the time they engaged in the challenged transactions, employed the appropriate methods to investigate the merits of the investment and to structure the investment.").

[48] It is also possible for a claim to be made that the earlier-constructed traditional portfolio allocation is itself the investment course of action with respect to which a failure to give appropriate consideration. This is unlikely to succeed, however, as courts would review the decision-making in light of the information available at the time of the investment, when the availability of LDI and other hedging strategies was likely much less prevalent in the industry. *See* Note 19 above. *See also* Roth v. Sawyer-Cleator Lumber Co., 16 F.3d 915, 917-18 (8th Cir. 1994) ("[T]he prudent person standard is not concerned with results; rather it is a test of how the fiduciary acted viewed from the perspective of the time of the challenged decision rather than from the vantage point of hindsight." (internal quotation marks omitted)).

[49] *See* Notes 22-24 above.

[50] *E.g.*, by giving "appropriate consideration" to the applicable investment or investment course of action and available information, pursuant to Reg. 2550.404a-1.

above), the "appropriate consideration" requirement applies to both "investment[s]" and "investment course[s] of action"; and an "investment course of action" is defined as "any series or program of investments or actions related to a fiduciary's performance of his investment duties".[51] Although the scope of this definition has not been reviewed by courts, it is reasonable to expect that the term "investment course of action" could be held to include a portfolio management strategy, including the manner of benchmarking overall plan investment performance.[52] Furthermore, courts have recognized an ongoing "duty to monitor" investments, notwithstanding delegation of management authority to third parties.[53]

Second, applicable law generally holds that prudent investment process is reviewed from the standpoint of experts and in light of available industry standards. Courts hold that the ERISA prudent person standard is applied from the perspective of "a prudent fiduciary with experience dealing with a similar enterprise".[54] Where fiduciaries lack expertise in a specific area being considered, they have been held to have an affirmative duty to seek out such expertise.[55] In addition, in review of whether a fiduciary's methods employed and information reviewed satisfy ERISA prudence requirements, courts have looked at prevailing industry methods and standards.[56] This essentially means that although standards for ERISA prudence requirements may be reviewed by

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[51] Reg. 2550.404a-1(c)(2).

[52] Support for such interpretation may be found in the regulation itself, requiring for consideration, "i. The composition of the portfolio with regard to diversification, ii. The liquidity and current rates of return of the portfolio relative to the anticipated cash flow requirements of the plan, and iii. The projected return of the portfolio relative to the funding objectives of the plan", which are generally critical components in the development of a portfolio strategy and in LDI strategies in particular. *See* Notes 34-38.

[53] Liss v. Smith, 991 F. Supp. 278 (Defendants failed to monitor the fund's solvency and adjust levels. Defendants failed to utilize due care in selecting and monitoring the fund's service providers and in reviewing the performance of trustees.). *See also* Harley v. Minnesota Mining & Manufacturing Company, 42 F. Supp. 2d 898 (D. Minn. 1999) (The court held that the trustees' delegation of responsibility to an investment advisor did not relieve the trustees of their fiduciary obligation to monitor investments.).

[54] U.S. v. Mason Tenders District Council of Greater New York, 909 F. Supp. 882, 886, citing Marshall v. Snyder, 1 Empl. Ben. Cases (BNA) 1878, 1886 (E.D.N.Y. 1979).

[55] Katsaros v. Cody, 568 F. Supp. 360, 367 (E.D.N.Y. 1983), affirmed in relevant part, 744 F.2d 270, citing Donovan v. Bierwirth, 680 F.2d 263, 272-73).

[56] Analyzing "appropriate consideration" under DOL Reg. 2550.404a-1, Ironworkers v. Loomis Sayles & Co., 259 F.3d at 1044 ("..the district court found more persuasive Loomis' evidence that the Bloomberg system was the tool prevalently used in the industry and that only a few portfolio managers were using OAS analysis, and it made factual findings to that effect."). *See also* DiFelice v. U.S. Airways, 436 F. Supp. 2d (E.D.V.A., 2006) ("In the present context, this means that U.S. Airways was required to act pursuant to the standards of the investment industry . . .").

attorneys and in the courtroom, they are ultimately determined by the investment industry and its experts.

Furthermore, the common law of trusts provides some precedent for fiduciary liability in connection with a failure to adopt hedging strategies.[57] It is not uncommon in analysis of ERISA claims, for courts to look to trust law for guidance (to the extent not inconsistent with ERISA).[58]

Based upon the foregoing, to the extent that a court found that prevailing industry standards included knowledge of pension portfolio-related risks, such as interest rate risk or portfolio tracking error, and risk-hedging solutions such as LDI, it is plausible that a court could find that any wholesale rejection of these concepts could constitute an imprudent investment decision (i.e., via a failure to give "appropriate consideration"). Furthermore, as indicated above, it is unlikely that a lack of expertise would provide defense against such a claim.

Finally, it is worth mentioning that, in addition to the prudence requirements discussed above, the ERISA investment decision-making processes is also subject to the ERISA "Exclusive Benefit" rule. Stated above, ERISA requires that a fiduciary "discharge his duties with respect to a plan solely in the interest" of the plan participants, for the "exclusive purpose" of providing benefits and "defraying reasonable expenses" of plan administration.[59] Accordingly, in their consideration of DB investment strategies, fiduciaries are not permitted to take into account factors other than those involved in provision of benefits under the plan. Such impermissible factors might include the impact of certain investment strategies on the financial statement reporting of the plan sponsor. An example of this concern was described in the previous Hypothetical, where a reduction in the plan's allocation to equities would result in lower reported earnings (due to changes in plan asset expected return assumptions).[60] To the extent such influences were

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[57] *See* Randall H. Borkus, A TRUST FIDUCIARY'S DUTY TO IMPLEMENT CAPITAL PRESERVATION STRATEGIES USING FINANCIAL DERIVATIVE TECHNIQUES, 36 Real Prop. Prob. & Tr. J. 127, Spring, 2001, analyzing Brane v. Roth, 590 N.E.2d 587 (Ind. Ct. App. 1992) ("The court entered specific findings and conclusions determining that the directors breached their duties by retaining a manager inexperienced in hedging; failing to maintain reasonable supervision over him; and failing to attain knowledge of the basic fundamentals of hedging to be able to direct the hedging activities and supervise the manager properly.").

[58] *See* California Ironworkers v. Loomis Sayles & Co., 259 F.3d at1047, citing Harris Trust and Savings Bank v. Salomon Smith Barney Inc., 530 U.S. 238, 250 (2000) ("The common law of trusts is incorporated into analysis of ERISA claims unless inconsistent with the statute's language, structure or purpose.").

[59] ERISA §404(a)(1)(A).

[60] This factor could in certain instances bear significant weight, as reported earnings may be impacted significantly from changes in the expected return assumptions regarding plan investments.

found present in an investment decision-making process, fiduciary liability may be more likely to arise.

CONCLUSION

DB plans serve the important function of enabling employers to assume risk in connection with employee retirement income. This past year has demonstrated that, notwithstanding this "assumption of risk", there is still enormous risk exposure present within our defined benefit pension plan system, and the resulting volatility will most certainly impact retiree benefits. An underlying question presented in this article is whether this exposure is necessary.

To the extent that viable solutions in the reduction of DB plan risk exist and are readily available within the investment industry, plan fiduciaries may wish to consider them carefully and thoroughly. As to whether and in what contexts fiduciaries could be held liable for failing to do so, this issue remains uncertain. However, as discussed above, "consideration" lies at the heart of prudence under ERISA. Applicable case law makes clear that such process must be informed by relevant expertise and knowledge of industry practices (and not be influenced by factors other than those involved in the provision of plan benefits). As the risks inherent in DB plan funding continue to be realized, and as the pension investment industry continues to develop the solutions to those risks, it is not unreasonable to expect that their appropriate consideration will become viewed as required components of the prudent investment process.

See generally FAS 158. *See also* David Zion, CFA, CPA, The Magic of Pension Accounting, Part III. See also Susan Mangiero, Ph.d, AIFA, AVA, CFA, FRM, and Society of Actuaries Joint Pension Risk Research Project, "Pension Risk Management: Derivatives, Fiduciary Duty and Process" (In response to the question "What defined benefit plan risk areas concern you?", "Accounting Impact" was the number one risk concern among DB plan sponsors.).