



# The Enron Litigation: Lots of Noise, Only a Little Substance . . . So Far

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*As practitioners, we must spend more time advising our corporate clients of the duties that the board of directors, the administrative committees, and the trustees assume when they sign on the dotted line, so that they approach their jobs with more solemnity than they may have in the past. It is incumbent upon those hearing this advice to listen and to act on it.*

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Those of us who have been preaching the need for prudent and knowledgeable action by fiduciaries for many years felt a little like overprotective mothers calling out the warnings of generations: “Button your sweater, you want to catch pneumonia?” “Careful, you’ll poke someone’s eye out!” After all, no one really dies of pneumonia from playing in the snow, do they, and how many kids did you know growing up that lost an eye by running with scissors? In the same manner, our clients listened to us with that cynical demeanor, knowing that there was no way the bubble was going to burst on their plans (particularly in this great market!) and that there was no way they would be called to task before the Department of Labor (DOL) or the courts. Come on! How many ERISA lawsuits have you ever seen???

And then came Enron. As horrified as we all were at the events that unfolded in the Enron matter, some of us felt just a little vindicated. (“See, didn’t I tell you to listen to me??”) Suddenly, everyone’s worst nightmare was happening—thank goodness, to someone else. And we could all watch and see what happens. Earlier this fall, on September 30, 2003, a federal district court judge issued the first opinion related to the collapse of Enron’s stock price and its effect on the retirement plans, in *Tittle v. Enron Corp.* [2003 WL 22245394 (S.D. Tex., 2003)]. This decision set the stage for what will happen next, as we get to the real trial.

This article discusses some of the aspects of the *Tittle* decision, focusing on the ERISA-related lessons that plan fiduciaries and service providers can and should learn from this preliminary stage of litigation. Many of these lessons can also be learned (or at least be reinforced) by carefully reviewing the *amicus* brief filed by the DOL in the *Tittle* matter, and the complaint filed by the DOL in its own litigation against Enron and the fiduciaries of Enron’s retirement plans. The DOL brief can be accessed at <http://www.edol.gov/soll/images/EnronBrief1.fnl.PDF>, and the DOL’s complaint in its lawsuit against the fiduciaries can be accessed at: <http://www.eric.org/forms/uploadFiles/2C4C0000001.filename.lawsuit.pdf>.

This article concentrates on the impact of this decision on ERISA operational issues. As such, it does not discuss the securities law, racketeering law, or civil procedure pleadings aspects of the case.

## Nine Important Lessons

We have to admit that there is a certain amount of entertainment value to reading the Enron-related litigation and watching what can happen when many of the basic tenets of benefits laws allegedly are broken

all at once by a variety of different actors—the company officials, the lawyers, the auditors. But, besides the drama, there are nine important lessons that fiduciaries should learn or have reinforced by the *Tittle* decision:

1. Know if you are a named fiduciary.
2. Understand that your actions can make you a functional fiduciary.
3. The power to appoint and remove other fiduciaries makes you a fiduciary, even if you are “just an outside director.”
4. Non-fiduciary service providers can have liability, too.
5. Directed trustees can have liability, too.
6. Insider fiduciaries should be careful with respect to decisions involving company stock.
7. Respond truthfully to all questions and if additional information would be material, do more than just respond with the truth.
8. If you give participants the right to direct their investments, make sure you comply with ERISA Section 404(c). The burden of proof is on you.
9. Section 404(c) does not help if investment alternatives are not prudent.

### Background and Procedure

The most important thing to keep in mind when reading the *Tittle* decision is the litigation procedure underlying the decision. In April 2002, participants in Enron’s retirement plan filed a lawsuit against Enron and numerous other parties who were either fiduciaries of Enron’s retirement plans or provided service to Enron’s retirement plans. In 2002, many of the defendants filed motions to dismiss all or portions of the action against them. When a court rules on a motion to dismiss, it examines whether the plaintiffs will have a case if all the facts they allege are true. Furthermore, this decision is made based “on the pleadings”—that is, on written filings, such as the complaint and response, that have been filed with the court. At this point in the litigation, the parties to the lawsuit have not presented court testimony or examined witnesses, and the court making the decision is not reaching any conclusions of fact. By filing motions to dismiss, the defendants are essentially telling the court: even if everything they say is true, we have not done anything for which we have liability. (It is the litigation equivalent of the kid in the schoolyard accused of wrongdoing yelling, “Oh, yeah? So what if I did!?”) The court then determines if it agrees with the defendants. If so, the case is dismissed. If not, the case goes on to trial (and the decision on the motion to dismiss will serve

as a type of roadmap for the trial).

It is also important to keep in mind that the court reviewing these issues is a district court—that is, the lowest court of our federal judicial system. Decisions made by a district court have no required precedential value to any other lawsuit. Nonetheless, they are helpful in determining how a trial judge might look at the facts and the law and come up with a decision. Further, they may be “persuasive precedent” in another trial—that is, one judge may look at what the earlier judge decided and go along. Last, the decision by the district court will frame the questions that arise on appeal, which will be heard by a federal circuit court of appeals. A decision of an appellate court is binding in that circuit. Supreme Court decisions, which arise from appeals from circuit courts, are binding throughout the country.

- *Lesson 1*— Know if you are a named fiduciary.
- *Lesson 2*—Understand that your actions can make you a functional fiduciary.
- *Lesson 3*—The power to appoint and remove other fiduciaries makes you a fiduciary, even if you are “just an outside director.”

A lot of discussion in the *Tittle* decision focuses on the responsibilities of the various Enron plan fiduciaries. But, before addressing the substantive responsibilities of the fiduciaries, the court made sure to differentiate which of the defendants were fiduciaries and therefore charged with the substantive fiduciary responsibilities under ERISA.

First, the *Tittle* court quickly concluded that, as a matter of law, all members of the 401(k) Plan Administrative Committee were fiduciaries, because the Administrative Committee was named as a fiduciary in the plan document. “Named fiduciaries” are always ERISA fiduciaries.

Second, certain defendants (such as the Plan Administrative Committee and the directed trustee) argued, based on a 3<sup>rd</sup> Circuit case [*Confer v. Custom Engineering Co.*, 952 F.2d 34 (3<sup>rd</sup> Cir. 1991)], that they could not be considered fiduciaries because they were acting on behalf of the Plan Sponsor (*i.e.*, Enron), and had no actual discretion in regard to the Plan. The DOL disagreed with this contention in its *amicus* brief, stating that the clear language of ERISA Section 3(21) defines fiduciaries based on function rather than title. The *Tittle* court agreed that the

determination of whether an individual is a fiduciary is a very fact-specific inquiry. As a result, it is very hard for a court to decide on a motion to dismiss—when few facts are fleshed out—whether an individual is a fiduciary. Nonetheless, the *Tittle* court was able to confirm that, based on the facts alleged by the plaintiffs (and subject to disproof at trial), the corporate officers were fiduciaries because they had discretionary authority over plan management or plan assets. Furthermore, the court noted that these corporate officers have two sets of fiduciary obligations: to the corporation as officers and to plan participants as a plan fiduciary. These obligations could conflict, putting the individual between a rock and a hard place.

Third, the *Tittle* court (in agreement with the DOL's *amicus* brief) held that the members of the Compensation Committee of Enron's board of directors were fiduciaries as a matter of law. This determination was based on the settled law that a person with power to appoint and remove plan fiduciaries is herself a fiduciary. Furthermore, the appointing party has a fiduciary duty to monitor the performance of those she appoints.

#### **What Are the Lessons to Be Learned From This?**

- If the plan says you are a fiduciary, you are a fiduciary.
- If you act like a fiduciary, you are a fiduciary.
- If you have the power to appoint other fiduciaries, you are a fiduciary, and you have a duty to monitor.
- If you have dual fiduciary roles, you need to resolve any conflicts.

The third lesson is particularly important for boards of directors. If the plan provides that the sponsoring company is the Plan Administrator (which will always be a fiduciary), then the board members (who comprise the governing body of a corporation) will become fiduciaries by virtue of their ability and often obligation to appoint or hire others to do the work. In today's post-Sarbanes-Oxley environment, it is increasingly important for the board to know its responsibilities.

Because the definition of "fiduciary" is functional in nature, an employer may not realize exactly which of its employees are fiduciaries of the plan. However, the employer should take action to identify the plan's fiduciaries, to ensure that they are properly educated on their responsibilities and the procedures that they should be following. In addition, if the employer carries fiduciary liability insurance, it is important that the proper individuals are covered.

- *Lesson 4*—Nonfiduciary service providers may have liability, too.
- *Lesson 5*—Directed trustees may have liability, too.

Because of Enron's relatively weak financial condition and the limits on Enron's fiduciary liability insurance policies, the plaintiffs in the lawsuit appear to have named as defendants every organization that ever provided services to an Enron retirement plan. Fortunately, the *Tittle* court was quick to note in its decision that these service providers were not fiduciaries unless their actions went beyond the scope of their normal professional services.

Nonfiduciary service providers cannot be liable for legal damages (*e.g.*, money damages) for knowingly participating in a fiduciary breach. They may be liable, however, for equitable relief (injunctions and restitution) under ERISA Section 502(a)(3) if they knowingly participate in a fiduciary breach. An earlier decision, *Harris Trust and Saving Bank v. Salomon Smith Barney, Inc.* [520 US 238 (2000)], dealt with the responsibilities and liabilities of a nonfiduciary who was involved in a prohibited transaction. Broad language in the *Harris Trust* decision indicated that ERISA Section 502(a)(3)—which authorizes a private cause of action for "appropriate equitable relief" to redress violations of ERISA Title I (including a breach of fiduciary duties)—"admits of no limit on the universe of possible defendants." Practitioners eyed that language with concern, believing it to be the possible linchpin of new ERISA lawsuits against service providers. The *Tittle* court did not disappoint. *Tittle* confirms that, in the opinion of this court, equitable remedies are available against nonfiduciary parties-in-interest who knowingly participate in any fiduciary breach. The court did not dismiss the causes of actions against the Enron service providers for equitable relief. Equitable relief includes such court actions as granting injunctions, requiring restitution, or the creation of "constructive trusts" over property acquired with ill-gotten gains. Equitable relief does not include monetary damages.

A significant portion of the *Tittle* decision addresses the obligations of directed trustees. Northern Trust, the trustee at the time that the Enron blackout period began, averred that it was a directed trustee, required to follow directions from another responsible fiduciary. As a result, it argued that its obligations extended only to making sure that the direction from the responsible fiduciary was properly made and then executing the direction. Northern Trust argued that, as a directed trustee, it had no obligation to independently assess the merit of the direction.

The *Tittle* court closely examined other cases that analyzed this question, as well as the statutory language of ERISA. First, it pointed to ERISA Section 403(a)(1), which indicates that the directed trustee will be subject to directions by the responsible fiduciary that are proper and in accordance with ERISA and the plan. Furthermore, ERISA Section 405(b)(3)(B), which deals with co-fiduciary liability, specifically states that, “No trustee shall be liable under this subsection for following instructions referred to in section 403(a)(1).” This would support Northern Trust’s contention that it cannot be liable for following the directing fiduciaries’ instructions.

Nonetheless, the *Tittle* court pointed out that Section 405(b) begins with the prefacing phrase, “Except as otherwise provided in . . . section 403(a)(1) and (2) . . .” The court acknowledged that this circular reference back to Section 403(a)(1) is confusing. But the court further noted that when Congress had intended to completely relieve an otherwise responsible fiduciary of its potential liability, it did so explicitly—as when it provided for the delegation of responsibility to investment managers [ERISA Section 405] and when it limited fiduciary liability when participants direct their own investments. [ERISA Section 404(c)] Therefore, the court questioned whether this same type of relief was appropriate for directed trustees who simply follow instructions, when ERISA does not offer that same level of explicit, protective language.

In the end, the *Tittle* court found that ERISA’s broad definition of who is a fiduciary and its protective purpose mandated a finding that a directed trustee has a greater duty than just making sure that a direction from the responsible fiduciary is proper. It said that “§ 403(a) should be read to maintain some, rather than virtually eliminate, fiduciary obligations of a directed trustee to question and investigate where he has some reason to know the directions he has been given may conflict with the plan and/or the statute.” In particular, the *Tittle* court found that if Northern Trust knew or should have known of the Enron financial problems, and yet complied with the directions to continue purchasing the company stock, the trial court could find that there was a breach of fiduciary duty. The cause of action against Northern Trust proceeds to trial.

#### **What Are the Lessons to Be Learned from This?**

Under ERISA, a party-in-interest includes anyone who provides services to the Plan. Therefore, the *Tittle* court’s interpretation of ERISA, if adopted by higher

courts, opens up the potential for additional types of lawsuits against service providers. Because of this possible liability, it is important for service providers to carefully review their activities to make sure that they are not participating or assisting in a fiduciary breach. Further, it is important to ensure that services agreements clearly provide for appropriate indemnification by the service provider’s client if a claim is brought against the service provider on these grounds.

The bigger lesson may apply to those financial institutions that believe that they are protected from liability as directed trustees simply by relying on the directions from the responsible fiduciaries as long as those directions appear on their face to be valid. The American Bankers Association filed an *amicus* brief with the *Tittle* court noting that, since ERISA was enacted, its membership has relied on the “facial compliance” standard. The court dismissed this historic approach, saying “[T]his court is not persuaded by the Association’s argument for a minimum standard that would shield its members from liability.” This type of finding could significantly alter the way that financial institutions do business with retirement plans. More to the point, financial institutions may determine that reduced fee structures based on limited liability are no longer appropriate, resulting in an increase in administrative expenses for plans.

- *Lesson 6*—Insider fiduciaries should be careful with respect to decisions involving company stock.

Some insider fiduciaries of public company retirement plans that hold company stock have argued that they could not disclose corporate problems to the participants. Such disclosure, the argument goes, would subject the fiduciaries to prosecution under Securities Rule 10b-5. [17 C.F.R. § 240.10b-5.] Among other things, this rule prohibits company officials from disclosing nonpublic information only to selected investors.

On its face, this argument appears compelling. The *Tittle* court, however, didn’t buy it. The court specifically stated that the potential liability under Securities Rule 10b-5 was not a valid reason for failing to disclose material information to plan participants. The court agreed with the position of the DOL in its *amicus* brief that there is no inherent conflict between insider fiduciaries’ ERISA obligations and those imposed by the securities laws. After all, both the court and the DOL noted that nothing stopped the insider fiduciaries from making the material informa-

tion public to *all* investors and shareholders, which is permissible under Rule 10b-5.

#### **What Is the Lesson to Be Learned from This?**

The important lesson to be learned is that the insider trading laws will not protect insider fiduciaries from fiduciary breach claims based on failure to disclose material information to plan participants. If you are a fiduciary of a plan that holds publicly traded company stock and you are an insider of that company, it may be advisable to retain an independent fiduciary to make all decisions regarding the company stock. If you do not do this for *all* decisions regarding company stock, it may be advisable to hire an independent fiduciary if the stock price begins to decrease.

- *Lesson 7*—Respond truthfully to all questions and if additional information would be material, do more than just respond with the truth.

The *Tittle* court's discussion of the fiduciary's duty to disclose Enron's financial condition is the area in which the court comes the closest to making new law. The plaintiffs alleged that Enron and the retirement plan fiduciaries not only failed to comply with their fiduciary duty to affirmatively disclose Enron's financial condition, but actually misled the plan participants about its condition.

The US Supreme Court, in *Varity v. Howe* [516 US 489, 19 EBC 2761 (1996)], ruled that a fiduciary who is asked a specific question by a participant about benefits must fully and accurately disclose information material to that question. However, the Supreme Court in *Varity* specifically declined to address whether fiduciaries have any obligation to disclose information without being asked. Therefore, this question has been bandied about in various circuit courts, with inconsistent rulings from court to court. In some circuits, courts have held that fiduciaries must respond with all information important to a participant's situation, even if the response goes beyond the specific question asked. Some courts have held that fiduciaries have a duty to respond truthfully, but do not have to volunteer relevant information.

The *Tittle* court held that the plaintiffs properly alleged that the fiduciaries failed to disclose material information about Enron's financial condition. The decision stated that fiduciaries must affirmatively disclose the material information if remaining silent would mislead plan participants.

#### **What Is the Lesson to Be Learned from This?**

Fiduciaries are best protected from liability when they actually recognize their obligations to represent participants' best interests. If fiduciaries know something that would impact participants' decisions to invest under the plan, they should share that information with those who are making the investment decisions, particularly when it is the participants. Generally, with each new piece of information that the fiduciary discovers, it must ask itself the question of whether it has a duty to disclose this information to the participants—that is, is it material, would it help participants make prudent plan decisions, and would withholding the information be tantamount to misleading the participants.

- *Lesson 8*—If you give participants the right to direct their investments, make sure you comply with ERISA Section 404(c). The burden of proof is on you.

The *Tittle* court examined the applicability of ERISA Section 404(c) to the claims of the plaintiffs and the defense of those being sued. Under this section, a fiduciary may allow participants to direct their own investments and, if proper procedures are followed and required information is provided, fiduciaries will not be responsible for any losses occasioned by those investment decisions. The court confirmed that Section 404(c) of ERISA is an affirmative defense for a fiduciary charged with a breach of fiduciary duty. This means that the fiduciary claiming the defense has the burden of proving that it complied with the Section 404(c) procedural and information requirements. Without clear records of this compliance, it is very hard to meet this burden of proof, and there will be no Section 404(c) defense to a fiduciary breach.

#### **What Is the Lesson to Be Learned Here?**

When we counsel clients regarding fiduciary matters, there are two things that we emphasize. The first is that a fiduciary's actions must be prudent and in compliance with the standards set forth under ERISA. As important as this substantive prudence is, it is even more important that the fiduciaries be procedurally prudent as well. Procedural prudence requires that fiduciaries keep accurate and complete records so that they are able to demonstrate that they complied with ERISA in making their decisions.

It is particularly important that the threshold disclosure rule be followed, or else the Section 404(c)

defense is stillborn. Under DOL Regulation Section 2550.404c-1(b)(2)(i)(B)(1)(i), any plan that claims to be an ERISA Section 404(c) plan must provide a participant with “an explanation that the plan is intended to constitute a plan described in section 404(c) of the Employee Retirement Income Security Act, and Title 29 of the Code of Federal Regulations Section 2550.404c-1, and that the fiduciaries of the plan may be relieved of liability for any losses which are the direct and necessary result of investment instructions given by such participant or beneficiary.” If a fiduciary wants to advocate that it is 404(c) compliant, it must be sure that this statement (or something quite similar) is in the SPD and/or the investment disclosure material given to all participants.

- *Lesson 9*—ERISA Section 404(c) does not help if investment alternatives are not prudent.

Although this is second nature to experienced benefits professionals, it is important that clients know that Section 404(c) will not be a defense if some or all of the investment alternatives are not prudent. The *Tittle* plaintiffs alleged that it was inappropriate to offer Enron stock as an investment alternative under the 401(k) plan. The court held that if the plaintiffs could prove that this was so, the fiduciaries could not protect themselves with Section 404(c) as a defense. In particular, in order for Section 404(c) to shift the responsibility for investments to the employees, any losses must be the result of the participants’ exercise of control over their accounts’ investments. If the investment alternatives are poorly chosen or maintained, then the losses may be independent of the participants’ exercise of control and within the realm of the retained liabilities of the plan fiduciaries.

The *Tittle* court found that there were sufficient allegations of a failure by the Enron fiduciaries to prudently select and monitor the investment choices.

Therefore, the claims of fiduciary breach remain part of the lawsuit, notwithstanding the possibility that Section 404(c) applies.

### **What Is the Lesson to Be Learned Here?**

Plan fiduciaries must be vigilant in examining the investment options made available to 401(k) plan participants, and in replacing those that are no longer prudent. If the selection of funds is not acceptable, then the fact that the participants have had the ability to choose among them is little protection from fiduciary responsibility.

### **Conclusion**

As noted above, this stage of the Enron litigation is a long way away from the point at which the plaintiffs are awarded damages or the defendants go home exonerated (or some combination of both). However, there are still many lessons to glean from the manner in which the court looked at the complex maze of ERISA, securities, and racketeering law. Some of these lessons have been touted by speakers at podiums around the country for the past several years. In those situations, the Enron litigation gives these warnings some flesh and blood, making them more profound. Perhaps, however, the biggest lesson to be learned by some from this litigation is the fact that it exists—that is, participants will not stand idly by and watch their retirement savings turn to dust without attempting to hold someone accountable. Therefore, plan fiduciaries must perform their duties in a manner that encourages the best outcome, while protecting themselves from undue liability.

As practitioners, we must spend more time advising our corporate clients of the duties that the board of directors, the administrative committees, and the trustees assume when they sign on the dotted line, so that they approach their jobs with more solemnity than they may have in the past. It is incumbent upon those hearing this advice to listen and to act on it.