HEED THE PLAN OR FACE YOUR PERIL: FAILING TO FOLLOW PLAN PROCEDURES PRODUCES NIGHTMARES

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To Our Clients and Friends:

Process matters. A recent case, *Stanford v. Foamex L.P. et al.*, serves as a haunting reminder that you ignore process at your own peril. As Foamex fell into bankruptcy and its stock price plummeted, the company's executive officers made what appeared to be the right decision to shut down the Foamex Stock Fund in their 401(k) plan. But they failed to follow the plan procedures for doing so and, as a result, found themselves on the losing side of a lawsuit.

FOAMEX'S FRIGHTENING TALE

The Foamex 401(k) Plan. Foamex, a manufacturer of polyurethane and polymer foam products, was the sponsor of a typical 401(k) plan under which employees made elective deferrals and the company made matching contributions. The employees directed how their plan interests were to be invested among various investment options. One of those options, the Foamex Stock Fund, consisted primarily of Foamex's publicly traded stock with a cash component designed "to satisfy daily participant exchange or withdrawal requests."

The plan document gave the company's Benefits Committee the "complete authority to control and manage the operation and administration of the Plan," including the exclusive authority to determine the investment options to be offered under the plan and the exclusive authority to set the cash percentage to be held in the Foamex Stock Fund. The members of the Benefits Committee were four senior executives of Foamex, including Gregory Christian, the company's general counsel who served as the committee chairman.

Fidelity Management Trust Co. was the "directed trustee" of the plan. Pursuant to the trust agreement, the Benefits Committee was to instruct Fidelity as to which investment options were to be made available to plan participants. The trust agreement absolved Fidelity of liability for following such directions if they were in writing and signed by an authorized signatory, unless it was clear that such directions were prohibited by the Employee Retirement Income Security Act of 1974 (ERISA) or contrary to the terms of the trust agreement. Foamex's director of compensation and benefits, Thomas McGinley, was not a member of the Benefits Committee, but he served as the committee's secretary and he was authorized to sign on behalf of the committee.

As the plan sponsor, Foamex reserved the ability to amend the plan at any time.

"Good" Business Decisions. On July 13, 2005, as Foamex was experiencing severe financial difficulties and the price of Foamex stock fell to $1.00 per share, the Benefits Committee determined that the Foamex Stock Fund was no longer a prudent investment option. The committee decided to prohibit new investments into the fund, but allowed participants to keep their current Foamex Stock Fund investments if they so chose. The plan documents were properly amended to reflect the committee's determination. So far, so good.

But then things turned ghastly. In September 2005, as Foamex's fiscal woes became dire and its stock slipped to $0.05 per share, Mr. Christian – acting on behalf of Foamex but not the Benefits Committee – directed Fidelity (through letters signed by Mr. McGinley) to increase the cash percentage in the Foamex Stock Fund from 5% to 20%. In early January 2006, after the company filed for bankruptcy protection and declared that the Foamex stock would be rendered worthless, Mr. Christian – again acting on behalf of Foamex but not the Benefits Committee – directed Fidelity (again through letters signed by Mr. McGinley) to increase the cash percentage in the fund to 50%, as an interim step toward closing the fund, and then to sell all of the Foamex stock in the fund. Fidelity followed each one of these directions, selling all of the stock in the fund by January 30, 2006.

Then came the eye of the storm. Foamex experienced a brief financial revival as a result of increased demand for its products caused by hurricanes in the Gulf of Mexico during August and September of 2005. In February 2006, when it appeared that the stock price would rise, Mr. Christian decided to reverse the liquidation of the Foamex Stock Fund, and directed Fidelity to buy back Foamex stock but maintain a 50% cash percentage. From February 2006 until December 2006 (when the Foamex Stock Fund was ultimately liquidated), the stock price rose from $0.02 to $4.15, but because the fund was not fully invested in the stock, the net asset value of the fund over this period rose from $0.01 to only $0.15 per unit.

William Stanford, a participant whose plan interests were invested in the Foamex Stock Fund, sued (on behalf of all plan participants) Foamex, Mr. Christian, the other members of the Benefits Committee and Fidelity for breaches of their fiduciary duties under ERISA.

Failure to Follow Plan Documents. It is hard to argue that the decisions made by Mr. Christian to increase the cash percentage and liquidate the stock fund as the stock became worthless were not prudent decisions. Similarly, it is difficult to challenge the prudence of reversing the liquidation when the stock started to rebound (although one might have decreased the cash percentage from 50% at that point). It is reasonable to assume that the Benefits Committee would have done the same, had it made the decisions. But all of the

parties in the case agreed that the committee was not involved in these decisions. Everyone agreed that Mr. Christian made the decisions on behalf of Foamex, and that the plan did not authorize Mr. Christian to act unilaterally without the formal approval of a majority of the committee members.

Under ERISA, a plan fiduciary (including someone who exercises "any authority or control respecting the management or disposition of [a plan's] assets") is obligated to "discharge his duties with respect to a plan . . . in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with" ERISA. The judge concluded that Mr. Christian, on behalf of Foamex, was performing a fiduciary function by directing Fidelity regarding the management of the Foamex Stock Fund. The judge also concluded that Fidelity and Mr. Christian were not acting "in accordance with the documents and instruments governing the plan" when they followed Mr. Christian's directions, because the plan clearly authorized only the Benefits Committee to take these actions, and not Foamex or Mr. Christian.

The Invisible Plan Amendment? Under ERISA, a company may take actions as a "plan sponsor" (such as establishing a plan or amending the terms of a plan) without being held to ERISA's fiduciary standards. Foamex and Mr. Christian argued that they, in effect, amended the plan when they increased the cash percentage and liquidated the stock fund, and were thus acting in a "plan sponsor" capacity. The judge observed that, while the company could have amended the plan, *the company had not in fact taken any action to amend the plan*. There being no actual amendment to speak of, the judge found it unnecessary to address Foamex's and Christian's argument,[1] serving as yet another reminder that plan procedures are not to be trifled with.[2]

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[1] *However, the judge nonetheless (surprisingly) proceeded to say in dicta that a plan amendment did not always fall into the category of "plan sponsor" conduct. The judge agreed that amending a plan "to prohibit participants from directing new investments or transferring existing investments into the Foamex Stock Fund might arguably be a settler function . . . . But to the extent that the Foamex defendants decided to liquidate existing investments in the Foamex Stock Fund, the Foamex defendants were acting as fiduciaries."*

[2] *Another recent case decided this past June, Richard Tatum v. R.J. Reynolds Tobacco Company, provides similar reproach. Reynolds also liquidated its stock fund when the stock plummeted, and was then sued when the stock recovered. Unlike Foamex, however, Reynolds did try to amend the plan. The problem was that, while the plan authorized the Employee Benefits Committee (EBC) to amend the plan "by vote of a majority of the members of the Committee," the amendment was signed only by the secretary of the EBC; no formal EBC action had been taken to eliminate the stock fund. Of course, the judge annulled the amendment.*

Co-Fiduciary Liability. The three other members of the Benefits Committee faired better than Mr. Christian: the judge dismissed the claim that they breached their fiduciary duty to follow the plan documents, reasoning that they took none of the complained of actions. But like any good scary movie, danger lurked around the corner despite their hope that the horror had ended. As plan participants, the members of the Benefits Committee received written notification of the increases to the cash percentage in the Foamex Stock Fund as well as written notification of the liquidation, and subsequent re-installment, of the fund. The judge concluded that there was a question as to whether the members knew about, and therefore had an obligation to "fix," Mr. Christian's fiduciary breach under ERISA's co-fiduciary liability rules, and allowed a claim for co-fiduciary liability to proceed.

Directed Trustee Liability. The claims against Fidelity (for failure to follow the trust agreement and for co-fiduciary liability) were also allowed to proceed. Fidelity argued that it could not be held liable for following Mr. McGinley's written directions because he was authorized to sign on behalf of the Benefits Committee. The judge agreed that if the directions in fact came from the Benefits Committee, such directions would not be prohibited by ERISA or be contrary to the terms of the trust agreement, thereby exonerating Fidelity from liability. The problem for Fidelity was that the direction letters were carelessly written, including ambiguous statements such as "[the directions] shall apply until such time as *Foamex International Inc.* directs [Fidelity] in writing of any deviation to this letter" and "a decision has been made by *Foamex L.P.* to eliminate the Foamex Stock Fund as an investment option in the Plan" (*emphasis added*). The judge opined that these ambiguous statements raised factual questions as to whether Fidelity knew or should have known that the directions were not emanating from the Benefits Committee and were therefore contrary to the trust agreement.

CHASING AWAY THE DEMONS

It is unfortunate how easily this lawsuit could have been avoided. All Foamex and the members of the Benefits Committee had to do was read the plan document and follow the simple procedure of having the Benefits Committee approve Mr. Christian's recommendations. All Fidelity had to do was take a little more care to be certain that the direction letters were coming from the Benefits Committee. The lesson of Foamex is that process matters a great deal. Don't ignore it – and, at the very least, take the following simple, but prudent, steps:

- review your plan document and make sure that it clearly establishes who are the plan fiduciaries and how they have to act;

- ensure that any future actions taken on behalf of your plans are taken in accordance with the procedures laid out in the plan document;
- review past actions that have been taken on behalf of the plan, (going back at least three years, the normal statute of limitations under ERISA) and if those actions were not taken in accordance with correct plan procedure, consider remedial actions;
- keep a careful and complete record (such as committee and board minutes) of all decisions and actions that are taken on behalf of the plan; and
- take care to draft clear communications that cannot be misconstrued to have unintended or ambiguous meanings.

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Please feel free to contact us with any questions.

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