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Looming Potential Downgrade of U.S. Government Securities May Require Action By Employee Benefit Plan Fiduciaries

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As our Great Nation breathed what for most of us was a huge collective sigh of relief yesterday evening, President Obama and Congressional leaders finally announced a deal for emergency legislation to end the stalemate over the nation's "debt ceiling" crisis. The agreement generally calls for over $2.4 trillion in spending cuts over the next decade in consideration for extending the U.S. debt limit. However, with the "countdown" to August 2 only a few hours away, Congress still needs to vote on the proposed agreement before the deadline in order to avoid a debt default.

Of course, even (as now seems likely) a technical debt default is averted, it remains uncertain if the proposed budget reductions will prove to be sufficiently significant to avoid a threatened downgrade to the nation's historic "AAA" credit rating. The major rating agencies formally placed U.S. fixed income securities "on watch" last month, and announced then that there was a 50/50 chance of a ratings downgrade (notwithstanding Congressional action to extend the debt ceiling). A downgrade by even one notch – to AA by Standard & Poor's, or Aa1 by Moody's Investor Services – is expected to negatively impact the financial markets (perhaps dramatically) and, as a consequence, the value of investments held by employee benefit plans. At this juncture, the specific impact of a downgrade in the rating of government securities is somewhat difficult to prognosticate, although it is entirely possible to expect that a ratings downgrade could lead to further investment risk aversion and a near-term volatility. There may also be some selling of government securities by certain investors who may no longer be permitted (by their investment guidelines or law) to continue holding them.

Most employee benefit plans subject to the Employee Retirement Income Security Act of 1974 ("ERISA") maintain substantial asset allocations to either U.S. Treasury securities or other forms of debt issued by (or backed by the "full faith and credit" of) the United States government or its various agencies. In addition to possibly having a direct adverse impact on those debt instruments, a downgrade might even negatively affect other asset classes (with the exception, perhaps, of gold, platinum, silver and other precious metals).

With respect to plan investments, ERISA plan fiduciaries are required to (i) act in the best interest, and for the exclusive benefit, of plan participants (and their beneficiaries), (ii) effectuate prudent decisions with respect to plan investments, and (iii) diversify plan assets so as to minimize the risk of large losses, unless it is clearly prudent not to do so. Because the reaction of financial markets to these anticipated events is uncertain at best, plan fiduciaries must carefully evaluate the current circumstances in light of the funded status of the plans for which they have responsibility and take prudent measures to ensure that these fiduciary obligations are fulfilled. Such steps would include *at least* the following actions:

- Review Investment Policies and Guidelines. Review relevant benefit plan Investment Policy Statements, and any separate Investment Guidelines, to ascertain whether a downgrade in U.S. debt ratings will engender a technical or other violation of such documents. Among other things, these documents should be carefully reviewed, not simply to ensure that a downgrade will not trigger a technical violation (e.g., where these policies provide that all government securities must be rated "AAA"), but also to avoid an *indirect* violation. This could occur, for example, where the "average" quality grade on fixed income securities is established at a sufficiently high level (many ERISA plans have average fixed income security quality grades of "AA") and where (the downgraded) U.S. government securities represent a significantly large portion of a plan's allocation to fixed income securities that a downgrade of government securities would cause the entire portfolio to fall below "AA."
- Contact the Plan's Independent Investment Advisor or Other Consultant. Plan fiduciaries should consult with their respective plan's independent investment advisor to determine whether there is a risk of a potential violation of such policies and guidelines in the event of a downgrade. If that proves to be the case, various alternatives (such as eliminating an investment or amending the investment quality grade standards under the investment policies/guidelines to account for the

anticipated downgrade) should be carefully considered.

- Clarify Decision-Making Protocols for Plan Investments. Plan fiduciaries should consider (and, if necessary, appropriately modify) the decision-making protocols applicable to the benefit plans for which they are responsible, so that they will be fully prepared to address time-sensitive investment decisions in a prudent manner and, given the current volatility inherent in most securities markets, perhaps on short notice. For plans with multiple investment fiduciaries, investment committees or large boards of trustees, consider clarifying steps for convening meetings (in person, or by telephone or video conference) on short notice, as well as possibly delegating authority to a subcommittee to address these issues. (Several of our clients have established "crisis" subcommittees to deal with these events both nimbly and prudently.) Consideration should also be given to retaining an independent investment fiduciary to actually make the necessary investment decisions – particularly for plan fiduciaries who may not have sufficient investment expertise to do so under these circumstances.

- Potential Impact on Non-U.S. Government Debt. Plan fiduciaries should also consult with the plan's investment professionals to ensure that they are in the process of prudently evaluating the possibility of a U.S. debt ratings downgrade, the potential widespread implications on the broader markets, and the overall impact of each of these events (both individually and collectively) on the plan. This examination should not be limited solely to the market for U.S. Treasury and agency securities or even to fixed income securities generally, as the impact of this type of ratings downgrade could also affect adversely equity and other securities. Request specific advice and recommendations from these professionals on how to address these issues.

- Address the Plan’s Liquidity Needs. Consult with plan administrators, investment professionals and other relevant individuals and entities to anticipate and address the plan's liquidity needs with the understanding that financial markets (again, not merely the fixed-income markets) may be volatile over an extended period of time.

- Practice and Document Procedural Prudence. During last week alone, the current Congressional stand-off impacted the stock market, and the value of equity securities, in a highly negative fashion. Indeed, the Dow Jones Industrial Average alone lost more than 700 points (or 5.49%). During these volatile investment periods, plan fiduciaries should follow established policies and procedures to prudently evaluate their plan’s investment portfolios and then adequately document their decision-making process.

Under ERISA, prudent decision-making consists of both *substantive prudence* and

procedural prudence. The term *substantive prudence* relates to the merits of a fiduciary's decision (was the action or inaction "correct"). In contrast, *procedural prudence* relates to the process used by a fiduciary to reach the decision. Courts obviously carefully scrutinize each of these components. However, absent unusual circumstances, they typically will focus with greater particularity and rigor on the latter by carefully analyzing and evaluating the specific process and safeguards used by ERISA plan fiduciaries in arriving at, and effectuating, their decisions (especially decisions relating to the investment of ERISA plan assets).

Procedural prudence represents a key defense to future litigation regarding investment decisions made in connection with investment market dislocations. Often fiduciaries consider certain steps to take when confronting market losses, opt to stay the course, but fail to document their thought process. Documenting procedural prudence, even when fiduciaries (after due deliberation) decide to take no steps at all, is often a helpful antidote to future litigation exposure.

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Please contact your primary employee benefits attorney at Proskauer if you would like more detailed guidance on these subjects.

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