

## Finally Good News: Court Rejects Lawsuit Over Temp Drop in Employer Stock

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As the saying goes, "heads I win, tails you lose." Many Employee Retirement Income Security Act of 1974 (ERISA) plaintiffs' lawyers, no doubt, felt this way following the economic implosions of Enron, WorldCom, and Dynegy. The bad facts giving rise to the collapse of the 401(k) plan's company stock holdings in Enron resulted in an avalanche of civil lawsuits and an adverse district court decision. Aberrant behavior by a few executives at Enron mushroomed into a new ERISA litigation industry. Variations on the Enron theme soon emerged. Instead of the price of stock in a 401(k) plan going to zero as the basis for a lawsuit, later claims asserted temporary price fluctuations provided a sufficient factual basis for asserting a breach of fiduciary duty. More aggressive lawsuits spawned more aggressive defenses. As a result of these new cases with more aggressive claims, the pendulum in the case law appears to be swinging back to the center.

What happened at Enron? When Enron stock plunged from \$30 to a few pennies per share during 2001, a lot more than money was lost. Along with nearly all of the equity invested in one of America's most heavily capitalized corporation went people's confidence in the integrity of ERISA-regulated retirement plans. All told, 11,000 Enron employees lost close to \$1 billion in 401(k) plan savings.

Just as disappointed public shareholders bring federal securities fraud lawsuits when they suffer investment losses, so do the ERISA plan participants when they think the plan fiduciaries have acted unfavorably toward the plan. Following Enron, similar "stock drop" ERISA cases allege that the plan fiduciaries, like the Enron 401(k) plan fiduciaries, knew or should have known that the company stock was not a prudent retirement plan investment, yet they allowed the participants to accumulate it anyway.

Litigating cases involving a drop in the price of the employer stock held by the employee benefit plans is different from securities fraud lawsuits. In the words of the Supreme Court, "ERISA is a comprehensive and

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reticulated statute."<sup>1</sup> There are different types of stock plans, different legal standards, different procedural considerations, and different types of discovery. As a result, the case law has developed in fits and starts.

Stock drop cases do, however, follow a familiar pattern. Company stock is offered as an investment vehicle in the company's retirement plan. The company stock price precipitously declines and the retirement plan participants sue, alleging the plan's fiduciaries knew or should have known that the employer stock was not a prudent investment option for the plan.<sup>2</sup>

ERISA stock drop cases are often brought in tandem with lawsuits alleging securities law violations. The ERISA stock drop lawsuit has a certain seductive appeal for the plaintiffs' lawyers compared to class action securities litigation. While the Private Securities Litigation Reform Act of 1995 (PSLRA) requires the plaintiffs to plead fraud with particularity, and while the PLSRA stays all discovery pending resolution of the adequacy of the pleadings, ERISA does not. Most courts do not require ERISA plaintiffs to "plead fraud with particularity" when alleging a fiduciary breach under ERISA.<sup>3</sup>

Three basic claims tend to populate most ERISA stock drop complaints: (1) the "why did you let me invest my money in your crummy stock?" or the imprudent investment claim; (2) the "why didn't you tell me the company stock was going to tank?" or the failure to disclose claim; and (3) the "why didn't you monitor the bozos running our plan?" or the duty to monitor claim. The imprudent investment claim challenges the act of offering company stock as a plan investment when it was not prudent to do so. Theories of why it was imprudent to offer company stock include: (1) knowledge of impending company collapse, (2) knowledge of serious company mismanagement, and (3) knowledge that the price of the stock is inflated due to fraudulent activities. The failure to disclose claim is premised on the theory that the plan fiduciaries made affirmative misrepresentations or did not disclose information that they knew would have a materially adverse effect on the price of stock. Courts have split on whether the failure to disclose claim runs afoul of securities laws.<sup>4</sup> Finally, the duty to monitor claim emanates from the idea that those who appoint the plan fiduciaries have an independent duty to monitor and prevent their appointees from breaching any fiduciary duties owed to the plan participants. A recent case involving the merits of the plaintiffs' three fiduciary duty breach theories casts significant doubt on their viability as to temporary stock drop claims.

### ***Temporary Drop in Retirement Plan's Company Stock Is Not Fiduciary Breach***<sup>5</sup>

In June of 2002, Cardinal Health (Cardinal) acquired Syncor International Corp. (Syncor) in a stock-for-stock merger. In conduct-

ing its due diligence investigation in preparation for the merger, Cardinal uncovered potential illegal payments made by a subsidiary of Syncor in Taiwan and China. Allegations were made that Syncor's subsidiary was bribing foreign doctors to use its services in order to increase its sales figures. Immediately following disclosure of the alleged bribery scheme, the price of Syncor stock dropped. As a result, the price of Syncor stock tumbled and the merger partners agreed that Syncor shareholders would receive .47 shares of Cardinal stock for each share of Syncor stock in the merger, rather than .52 shares as originally planned.

A number of the participants in Syncor's ERISA plan (Syncor plan) then sued. They stated that their 401(k) plan accounts had been adversely affected by the resulting dip in the price of Syncor shares. Three standard-issue fiduciary breach claims were asserted: (1) the bribery scheme was implemented by the highest levels of the Syncor management; therefore, the defendants knew or should have known that Syncor stock was not a prudent plan investment; (2) the defendants failed to adequately disclose what they knew to the committee members; and (3) the defendants failed to properly monitor the committee members.<sup>6</sup> After examining the witnesses in depositions and reviewing the relevant documents, the defendants filed a motion asking the court to throw the plaintiffs' lawsuit out, as the facts did not support the plaintiffs' legal theories. The district court ultimately agreed.

The court concluded the defendants had not been imprudent and had not violated their fiduciary duties by failing to diversify Syncor stock in the plan because the plan mandated that employer-matching contributions be made in Syncor stock.

The court next considered the question of whether the plan's retention of Syncor stock was imprudent. The general rule with regard to employee stock ownership plans is that the decision to retain employer stock in a 401(k) plan is presumed to be legally correct.<sup>7</sup> A plaintiff can overcome this presumption by showing the fiduciary acted unreasonably under the circumstances.<sup>8</sup> The court concluded that, to state this type of claim:

[a] plaintiff must demonstrate that the fiduciaries knew that the "company's financial condition is seriously deteriorating and that there is a genuine risk of insider self-dealing."<sup>9</sup>

The Syncor plaintiffs "failed to produce evidence that Syncor's financial condition, despite the international bribery scheme, deteriorated in any way."<sup>10</sup> The court was not convinced by the plaintiffs' argument that the drop in Syncor's stock price after public disclosure of the bribery scheme was sufficient to overcome the presumption requiring the court to assume the plan's fiduciaries' decision to retain company stock was reasonable.

Mere stock fluctuations, even those that trend downward significantly, are insufficient to establish the requisite imprudence to rebut the *Moench* presumption.<sup>11</sup>

While the plaintiffs pointed to the alleged bribery scheme and the dip in Syncor's stock price as evidence of a financial impact, it was not enough. The defendants produced evidence showing the plaintiffs' theory was refutable. Syncor demonstrated its international operations generated only about 6 percent of its overall revenues. Because the bribery scheme was limited to Syncor's international operations, it had almost no effect on Syncor's financial condition. Syncor stock outperformed both the NASDAQ index and the S&P 500 index during the class period. Numerous reports written by investment advisors concerning the disclosure of the bribery scheme continued to recommend retaining Syncor stock.

The plaintiffs' claims that the board (1) breached its fiduciary duty by failing to monitor the committee members or (2) failed to provide them with accurate information regarding the true value of Syncor stock suffered a similar fate. The court explained that the plaintiffs' "duty to monitor" and "duty to inform" claims were derivative of their general "prudence" claim. Since the committee members committed no breach of fiduciary duty of prudence by retaining Syncor stock as a 401(k) plan investment, the board committed no breach of fiduciary duty by (1) failing to monitor the committee members or (2) failing to provide them with accurate information.

Thus, while falling company stock prices are rarely pleasant experiences, the developing case law shows that a temporary drop in the price of employer stock held by a qualified retirement plan may not be reason enough to file a class action lawsuit.

### Notes

1. *Nachman Corp. v. Pension Benefit Guar. Corp.*, 446 U.S. 359, 361 (1980).
2. See e.g., *In re WorldCom, Inc.*, 263 F. Supp. 2d 745 (S.D.N.Y. 2003); *Rankin v. Rots* (Kmart); 278 F. Supp. 2d 853, 875-877 (E.D. Mich. 2003); *In re Dymegy Inc.*, ERISA Litigation, 309 F. Supp. 2d 861 (S.D. Tex. 2004); *In re Enron Corp.*, Securities, Derivative, and ERISA Litigation, 284 F. Supp. 2d 511, 601 (S.D. Tex. 2003).
3. See, e.g., *Pietrangelo v. NUI Corp.*, 2005 WL 1703200 at \*9 (D.N.J. Jul. 20, 2005) (declining to apply heightened pleading standard unless the fraudulent act itself is the alleged fiduciary breach); *In re Elect. Data Sys. Corp.*, ERISA Litigation, 305 F. Supp. 2d 658, 672 (E.D. Tex. 2004) (the heightened pleading standard does not apply unless the plaintiffs plead breach of duty is part of a scheme to defraud).
4. Compare *In Re McKesson HBOC Inc.*, ERISA Litigation, 391 F. Supp. 2d 812 (N.D. Cal. 2005), with *In re Enron Corp.*, Securities, Derivative, and ERISA Litig., 284 F. Supp. 2d 511, 601 (S.D. Tex. 2003).

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5. *In re Syncor*, ERISA Litigation, 410 F. Supp. 2d 904 (C.D. Cal. 2006).

6. *Id.*, at 908.

7. *Moench v. Robertson*, 62 F.3d 553 (3d Cir. 1995).

8. *Id.*

9. 410 F. Supp. 2d at 910.

10. *Id.*, at 911.

11. *Id.*