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MAKING EMPLOYER STOCK SAFE FOR YOUR 401(K) PLAN: MANAGING THE RISK

As the saying goes, "Heads I win, tails you lose." Many Employee Retirement Income Security Act ("ERISA") plaintiffs' lawyers, no doubt, felt this way following the economic implosions of Enron, WorldCom, Dynegy, and others. 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. Where once the price of stock in a 401(k) plan falling to zero constituted the basis for a lawsuit, later claims asserted that temporary price fluctuations provided a sufficient factual basis for asserting a breach of fiduciary duty. More aggressive lawsuits spawned more aggressive defenses, both in litigation and in plan design. The pace of new lawsuits has slowed to some extent in recent months, probably because of a variety of practical and legal considerations—a rising stock market, some favorable developments in case law, better plan design, and better communication to participants. In combination, these factors have resulted in fewer "easy targets" for plaintiffs' lawyers. But the legal theories underlying the company stock cases have changed very little, and the risk for plan sponsors offering company stock investment options is still significant.

Just as disappointed public shareholders bring federal securities-fraud lawsuits when they suffer investment losses, ERISA plan participants litigate when they think plan fiduciaries have done bad things. Litigating cases involving a drop in the price of employer stock held by employee benefit plans is different from securities-fraud lawsuits. 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. ERISA stock-drop cases are often brought in tandem with lawsuits alleging securities-law violations. The ERISA stock-drop lawsuit has a certain sex appeal for plaintiffs' lawyers compared to class-action securities litigation. While the Private Securities Litigation Reform Act of 1995 ("PSLRA") requires plaintiffs to

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plead fraud with particularity, and while the PSLRA 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.

Stock-drop cases do follow a familiar pattern, however. The price of company stock (offered as an investment in the 401(k) plan) drops—sometimes precipitously, sometimes in a protracted decline. Retirement-plan participants then sue, alleging that the plan's fiduciaries knew or should have known that the employer stock was not a prudent investment option for the plan.

A COMPANY'S RISK PROFILE

It is very common for plan sponsors that offer company stock as an investment option to have a high-risk profile for company stock litigation. A sharp decline in stock price, a falling stock market, or a bad press release may be the only missing ingredient for a lawsuit. A high-risk profile usually involves some or all of the following:

- Inadequate plan documents—overlapping or ambiguous roles of directors, officers, and plan committees (multiplies the available defendants).
- A weak or nonexistent statement of the long-term nature of the company stock fund (the absence of a strong statement of the company's intent can impose higher duties on fiduciaries and increase monitoring duties).
- Inside fiduciary committees (increases the risk of duty-of-loyalty problems).
- Forced investment in company stock or restrictions on participant investment choice (greatly increases fiduciary exposure).

Very few companies are choosing to eliminate the company stock fund. The key is managing the risk.

TYPICAL CLAIMS

Four basic claims tend to populate most ERISA stock-drop complaints: (1) the "Why did you let me invest my money in your crummy stock?" imprudent-investment claim; (2) the "Why didn't you tell me the company stock was going to tank?" failure-to-disclose claim; (3) the "Why didn't you monitor the bozos running our plan?" duty-to-monitor claim; and (4) the "How can you look out for my interests when you're busy running the company and lining your own pockets?" duty-of-loyalty 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 knowledge of impending company collapse, knowledge of serious company mismanagement, and knowledge that the price of the stock is inflated due to fraudulent activities.

The failure-to-disclose claim is premised on the theory that plan fiduciaries made affirmative misrepresentations or did not disclose information that they knew would have a materially adverse effect on the price of the stock. Courts have split on whether the failure-to-disclose claim runs afoul of securities laws.

The duty-to-monitor claim emanates from the idea that those who appoint plan fiduciaries have an independent duty to monitor and prevent their appointees from breaching any fiduciary duties owed to plan participants.

Finally, the duty-of-loyalty claim derives from the fact that ERISA fiduciaries are obligated to act solely in the interest of plan participants and beneficiaries. When company officers and directors serve on the fiduciary committee with authority over company stock, their loyalty to participants may be more easily called into question (especially if committee members personally sold company stock while taking no action to sell the plan's stock).

THE USUAL SUSPECTS

The defendants in the typical company stock case consist of a broad combination of:

- The board of directors.
- The company sponsoring the plan.
- Corporate officers (usually including the CEO and CFO).
- Inside fiduciary committees, such as the plan investment committee and administrative committee.
- Any board committee with authority to appoint plan fiduciaries.

In the reported company stock cases, the federal district courts have focused on the question of who is an ERISA fiduciary and why corporate officials may (or may not) enjoy fiduciary status. Whether or not a person is a fiduciary is of critical importance. When economic disasters befall companies and retirement-plan accounts become worthless, ERISA fiduciaries can be held personally liable to make good retirement-plan losses resulting from their actions or from their inactions.

How does someone become a fiduciary to a retirement plan? Fiduciaries are, of course, people in a position of trust who represent the interests of retirement-plan participants. They are usually responsible for controlling or managing a retirement plan's assets or operations. Under ERISA, fiduciary status can be acquired in a number of ways. In most cases, a fiduciary is named in the plan documents (such as administrative or investment committees) or appointed through an express delegation of authority (such as the appointment of an investment manager or trustee). Even where there is no express appointment or delegation of fiduciary authority, however, a person may be a "functional" fiduciary. ERISA defines "fiduciary" not in terms of formal titles or designations, but in functional terms of control and authority over the plan. An ERISA "functional" fiduciary, according to the federal courts, includes anyone who exercises discretionary authority over the plan's management, anyone who exercises authority or control over the plan's assets, and anyone having discretionary authority or responsibility in the plan's administration.

What has become apparent from the litigation to date is that a court reviewing an employee benefit plan will carefully sift through the governing plan's language concerning the allocation and delegation of fiduciary responsibility to determine who is a plan fiduciary and who is potentially liable to make good the retirement plan's losses.

THE INSIDE-INFORMATION PROBLEM

ERISA law regarding disclosure obligations of fiduciaries who are employees of the plan sponsor is uncertain, and this uncertainty is a potent weapon in the hands of an organized plaintiffs' bar. Plaintiffs allege that inside fiduciaries have an ERISA obligation to disclose material nonpublic information to plan participants, notwithstanding compliance with federal securities laws. They also allege that information contained in SEC filings incorporated into plan communications (*e.g.*, summary plan descriptions) becomes a fiduciary disclosure subject to uncertain ERISA standards. Fiduciaries who are employees of the plan sponsor will always know more about the financial condition of the employer and will know it before most outsiders. The materiality of inside information will be judged (at least by plaintiffs' lawyers) with perfect hindsight. These allegations carry the implication of greater moral wrongdoing than mere failure to monitor the performance of an investment fund.

DUTY TO MONITOR

Under ERISA, the person who appoints a fiduciary generally has a duty to monitor the continuing competence of the appointed fiduciary in light of the terms of the plan. *See* Carey and Miller, "The Employer Stock Cases: Does an Appointing Fiduciary Have a Duty to Disclose?" 13 ERISA Lit. Rep. 16 (August/September 2005). The duty to monitor may include a duty to provide information to an appointed fiduciary if such information would be important to the performance of the fiduciary's obligations under the plan. The weaker the standard for maintaining a company stock fund, the stronger and more burdensome the company's duty to monitor may become; the weaker the standard for maintaining the employer stock fund and the weaker the resulting protection for an appointed fiduciary, the greater the company's exposure to indemnification obligations and claims based on the duty to monitor. If a prudence claim fails, however, any related duty-to-monitor claim should also fail.

MANAGING THE RISK

A company that offers a company stock investment in its 401(k) plan may consider a number of possible litigation-prevention measures, but some measures are more valuable than others. For example, some inside committees have responded to litigation concerns by implementing procedures to more closely monitor the performance of company stock. In our view, the value of increased diligence is illusory. The decision to offer a company fund is inherently a plan-sponsor decision, outside the usual analytical concept that fiduciaries apply to other investments. No investment fiduciary given complete discretion to design an investment

fund for a plan would choose an employer stock fund. The purpose of the company stock fund is to invest in the stock of the employer, which by definition is unique. The performance of company stock relative to peer companies or other benchmarks is not an appropriate standard for determining prudence under ERISA. Regardless of the applicable standard of prudence for company stock, however, inside fiduciaries will always be exposed to allegations of failure to act on material inside information or of retaining the company stock fund due to conflicts of interest or other improper motives.

It has also been common for companies to respond to the litigation risk by replacing senior executives on the 401(k) plan's investment committee with mid-level employees. In many cases, this will be a fool's errand because mid-level employees often have equivalent access to material nonpublic information. Mid-level employees are also susceptible to allegations that their decisions were influenced by senior executives. Thus, the senior executives will remain subject to allegations of de facto control of the 401(k) plan investment committee.

For many plan sponsors, the current plan design is likely inadequate. No industry or company is immune from scrutiny. Action is required. Managing the risk should involve all of the following elements: (1) Clearly define and limit fiduciary roles with respect to company stock (*e.g.*, remove the board from the process); (2) review the plan design—include a strong statement of company intent regarding company stock as a long-term option, availability of other investment options, and participant freedom to invest in any option; (3) reduce exposure to inside-information claims as much as possible—appointment of an independent fiduciary is the best method; and (4) communicate clearly to participants that company stock is a long-term option and will be maintained as long as the company is viable. Also, stress the value of diversification and that the decision to invest in company stock is the participant's choice to make.

Jones Day has designed the fiduciary strategy for some of the nation's largest companies (as either company counsel or counsel for the independent fiduciary). Our recommended strategy is based on the current case law and the structure of ERISA and is designed to minimize the risk of company stock by:

- Substantially reducing exposure to inside-information claims;
- Providing more than a presumption that holding company stock is prudent;
- Utilizing modern portfolio theory in plan design as another defense to prudence claims; and
- Limiting the duty to monitor to issues of competence, not to performance of company stock.

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