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An Introduction to ERISA Lawsuits Over 401(k) Plan Company Stock Funds

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Directors of public companies and their advisers have long understood that the announcement of adverse corporate news, followed by a meaningful stock price decline, may trigger a federal shareholder class action alleging securities fraud. Increasingly, the securities fraud lawsuit has a companion – a purported class action on behalf of participants and beneficiaries in the company’s 401(k) plan, seeking recovery under the Employee Retirement Income Security Act of 1974 (“ERISA”) for decreases in the value of company stock purchased at open market prices through the plan. Since Enron and continuing through the subprime mortgage crisis, these ERISA stock-drop lawsuits have alleged that the same corporate misconduct that harmed shareholders also harmed employees who had invested in the company’s stock, principally through their 401(k) plans, but also through corporate employee stock ownership plans (ESOPs). More recently, however, ERISA stock-drop cases are being viewed as stand-alone cases for plaintiffs’ attorneys, due to their lower threshold for liability and the decreased competition for lead counsel status.

Through 2010, more than 200 ERISA stock-drop cases have been brought. Of those, almost half have been settled for an aggregate total of over \$2 billion. Strikingly, despite these settlement recoveries, the plaintiffs of stock-drop cases have yet to obtain a final litigated judgment in their favor. While ERISA stock-drop cases involve many of the same factual allegations as their companion securities fraud cases – that material misstatements or omissions made by the company or corporate insiders resulted in a loss to those invested in the corporation’s securities through the 401(k) plan or the ESOP – important differences exist between the two types of cases.

I. The Parties

The first major difference between the two types of cases is the parties involved in the lawsuit. In securities cases, the plaintiffs consist of shareholders of the company’s stock who purchased the stock during a certain period (“the class period”), while the defendants are generally the corporation, officers and directors, agents, brokers and banks. In contrast, a plaintiff in an ERISA stock-drop case must be either a participant or beneficiary of the company’s 401(k) plan or ESOP.

Determining the proper defendants in an ERISA stock-drop case, however, is a much more complicated issue. Generally, only persons or entities who are fiduciaries may be liable for the administration of a 401(k) plan under ERISA. A person or entity may become a fiduciary to a 401(k) plan or ESOP by express designation in plan documents or may be deemed to be a fiduciary by exercising fiduciary responsibility over the plan. The test for the latter is one of function. A person or entity may be deemed a fiduciary with respect to a 401(k) plan or ESOP to the extent he or she exercises any discretionary authority or control over the management or administration of the plan, the disposition of its assets, or the investment options it offers to plan participants and beneficiaries. Courts often note that a fiduciary’s duties are the highest known to law. Consequently, the most frequently named defendants in stock-drop cases are the plan sponsor (usually the company), the named fiduciary of the plan and the plan administrator (usually an Employee Benefits Plan Committee but sometimes the company), any plan investment management committee, and the Board of Directors or a subset, for example, the Compensation Committee of the Board. Less frequently, the trustee of the trust that held the assets of the plan is also named as a defendant.

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II. The Claims

Unlike the typical securities case that revolves solely around material misrepresentations or omissions that adversely affected the company's stock, an ERISA stock-drop lawsuit focuses on the acts or omissions of the plan fiduciaries in maintaining the company stock fund during difficult financial or business conditions. Plaintiffs will typically allege that plan fiduciaries violated up to four separate duties to plan participants and beneficiaries. First, plaintiffs may allege that defendants breached their duty of prudence by continuing to offer company stock as a plan investment option and by failing to take appropriate action when they knew or should have known of financial or business concerns that made the plan's investment in company stock imprudent. Second, they may allege that the defendants failed to provide plan participants and beneficiaries with complete and accurate information regarding the company's soundness and the prudence of investing retirement contributions in the stock, including ERISA-mandated SPDs (a misrepresentation-based claim similar to that asserted in a securities case). Third, plaintiffs may allege that certain fiduciaries violated their duty to monitor the performance of the fiduciaries to whom they delegated certain responsibilities. Fourth, plaintiffs may allege that defendants violated their duty of loyalty to discharge their duties under the plan solely in the participants' interest, generally by misrepresenting the company's financial condition or leading participants to believe investment in company stock was a sound decision.

Two of ERISA's enforcement provisions are particularly relevant to plaintiffs' efforts to assert any of these four breaches against defendants: Sections 502(a)(2) and 502(a)(3). Section 502(a)(2) authorizes plan participants, beneficiaries and fiduciaries to pursue relief under a cross-referenced provision, Section 409 – the basic remedy for breach of fiduciary duty, which permits courts to award monetary relief in the form of damages reflecting losses suffered by the plan, or disgorgement of profits as well as non-monetary relief, including the removal of a fiduciary. Until recently, when the United States Supreme Court changed the landscape of Section 502(a)(3) in *CIGNA vs. Amara* by blurring the remedies available under that section, plaintiffs traditionally could only seek non-monetary relief, such as an injunction, to address violations of ERISA or the terms of the plan under Section 502(a)(3). It remains to be seen how expansively the courts will interpret *CIGNA* in addressing monetary claims under Section 502(a)(3).

Whether plaintiffs can bring a suit under Section 502(a)(2) or Section 502(a)(3) depends on whether they are seeking relief on behalf of the plan or on behalf of themselves as individuals. If plaintiffs are seeking relief on behalf of the plan, they are allowed to sue defendants under either section 502(a)(2) or section 502(a)(3) and thus, may seek both monetary and non-monetary relief. In such a case, if plaintiffs are successful, any damages or proceeds recovered would be given back to the 401(k) plan or ESOP and prorated accordingly to each adversely affected participant's or beneficiary's account. If, however, plaintiffs sue on behalf of themselves as individuals, they are technically only entitled to the relief provided under Section 502(a)(3). What constitutes non-monetary relief under section 502(a)(3) is unfortunately, at present, the subject of considerable dispute.

III. The Defenses

Critical to defending against one or more of the possible breaches asserted by plaintiffs is to first enforce the rule that fiduciary status under ERISA is not an all-or-nothing proposition. Consistent with ERISA's to the extent requirement for fiduciary liability, ERISA recognizes that fiduciaries may wear "two hats:" one for the performance of fiduciary functions, and another for separate business decisions that do not constitute management or administration of the plan. The threshold question is, therefore, not whether a defendant's actions adversely affected a plan participant's interest, but whether that defendant was acting as a fiduciary when committing the alleged breach. Accordingly, directors and officers of a company will be fiduciaries only to the extent that they exercise discretionary authority over the management of the plan or the management or disposition of its assets.

Protection under the "two hats" doctrine is thus potentially broad as it may insulate a director, officer, and company from liability in the preparation or signing of an SEC filing or prospectus, even if these documents do contain a material misrepresentation, because these documents were prepared and disseminated to all investors (not just participants and beneficiaries) pursuant to duties arising under the securities laws, not ERISA. Similarly, a director or officer could not be held liable under ERISA for failing to routinely disclose to

participants and beneficiaries complete and accurate information regarding the company's soundness and the prudence of investing retirement contributions in the stock because the securities laws subject public companies to periodic disclosure requirements and liability for misrepresentations in defined circumstances, such as when a company sells stock or if disclosure is necessary to correct an earlier statement. The courts have made clear that ERISA cannot be used to improperly interfere with the comprehensive regulatory scheme established under the federal securities laws. As such, disclosure duties under ERISA extend only to information about the 401(k) plan or ESOP and not to any information in the possession of a defendant in his or her capacity as employer or executive. Lastly, the "two hats" doctrine may prevent defendants, who are oftentimes high-level executives, from being placed in the untenable position of having to choose between unacceptable (and in some cases illegal) courses of action such as obtaining inside information and then making stock purchases and retention decisions on behalf of the plan or ESOP based on this inside information.

In addition to the "two hats" defense, defendants can also overcome the claims in an ERISA stock-drop lawsuit if plaintiffs wait too long to bring the case. Under ERISA Section 413, a plaintiff claiming that a defendant breached his fiduciary duty must file suit three years after the earliest date on which the plaintiff had actual knowledge of the alleged breach or six years after the date of the last action which constituted a part of the alleged breach (if the plaintiff did not have any knowledge). Depending on which deadline applies, should plaintiffs wait too long to file their lawsuit against defendants, their claims would be barred.

ERISA Section 404(c) provides another avenue of defense by focusing on the self-selection aspect of a 401(k) plan. Most 401(k) plans provide for individual accounts and offer a range of investment alternatives, and permit a participant or beneficiary to exercise control over how their 401(k) retirement savings are invested. Moreover, most participant-directed plans afford participants the option to invest account plan assets in the employer's own publicly traded stock, through an investment fund consisting solely of company stock. When a 401(k) plan permits participants to exercise this type of control over the assets in their individual retirement account, Section 404(c) insulates defendants from liability for investment losses resulting from such participant's exercise of control. Under this approach, some courts have thus concluded that one allegedly riskier investment alternative, such as company stock in some circumstances, combined with a multitude of other investment options, does not impair the prudence of the range of options made available through the plan by defendants. Other courts have concluded that because the participant made the investment decision that caused the loss, the participant cannot satisfy the legal requirement that he or she show the fiduciary breach caused the harm suffered.

IV. Damages

Because an ERISA stock-drop case has never been fully litigated to judgment in favor of the plaintiff, courts have not had the opportunity to fully address the proper measure of damages in this type of case. Plaintiffs, nonetheless, often rely on the damages methodology applied by a U.S. Court of Appeals in a case involving misappropriation of funds of a defined benefit plan (i.e., a traditional pension plan providing a benefit typically based on salary and years of service). Based on this ruling, plaintiffs typically assert that they are due the difference between the value of the assets on account of the breach and the value that the assets would have been worth if they had been invested in the "best performing alternative" under the plan. Most courts, however, have refused to follow this methodology in subsequent ERISA fiduciary breach claims, except in cases of egregious self-dealing or fraud, because such an approach ends up creating a windfall for plaintiffs by giving them the benefit of hindsight. Some courts, consequently, have suggested in cases involving abuse of plan assets that damages should be calculated with reference to the participant's actual investment habits and not the best performing alternative. That has been the most accepted methodology in negotiated settlements of these stock-drop cases.

Moreover, while winning securities plaintiffs can only derive their attorneys' fees under a common fund theory – they may be awarded a share of any damages they obtained for plaintiffs through judgment or settlement – the prevailing plaintiffs in a stock-drop case have the ability under ERISA to seek attorneys' fees under the common fund theory or from the defendants themselves. Generally, however, the common approach has been for ERISA plaintiffs' attorneys to recoup a portion of the settlement for their fees and costs.

V. Conclusion

The struggling economy will likely continue the proliferation of ERISA stock-drop cases. As retirement plans underperform, plaintiffs' lawyers will point fingers at plan fiduciaries. More and more, but perhaps not frequently enough, companies are reevaluating who in management should be responsible for plan administration, in an effort to protect, at a minimum, the CEO and the Board from fiduciary claims stemming from a stock decline. With proper design, members of senior management who are most likely to have knowledge of the events causing a stock decline may be insulated from ERISA based claims, leading to early dismissal of any lawsuit filed against them and protection against protracted litigation and discovery which only creates fodder for plaintiffs' attorneys.

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