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The Outlook for ERISA 'Stock-Drop' Litigation

Fiduciaries in class actions over employer plans stand to benefit from recent appellate guidance.

NEWSCOM

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FOLLOWING the implosions of Enron and WorldCom, ERISA "stock-drop" class actions surged, with dozens of cases being filed each year. Many district courts were reluctant to dismiss the actions at the pleadings stage, and many defendants ultimately were forced into sizeable settlements. With the current economic downturn, there has been a similar surge in filings of ERISA stock-drop class actions. These newly filed cases may follow a different path.

The federal appellate courts have provided district courts with more guidance on many issues involved in stock-drop cases, including when a presumption of prudence will apply to a fiduciary's decision to permit investment in company stock, the extent of plan fiduciaries' disclosure obligations, and on the balancing of fiduciary obligations under ERISA with the obligations that exist under federal securities law. That guidance may make it easier for fiduciaries to obtain early dismissals of stock-drop claims.

Because of the profound impact that the credit crisis has had on the financial sector, many of the defendants in this round of stock-drop litigation are financial institutions which are litigating these issues within the U.S. Court of Appeals for the Second Circuit. Dozens of corporate and individual defendants have been named to date.[1] Compared to its sister circuits, however, the Second Circuit's ERISA stock-drop case law is relatively undeveloped. Thus, litigants, and the district courts themselves, will likely look to precedent from other circuits to guide their decisions. The recent decision in *In re Bausch & Lomb Inc. ERISA Litig.*, No.

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06-6297, 2008 WL 5234281 (WDNY Dec. 12, 2008), is a useful example of how district courts in the Second Circuit are analyzing these claims. This article summarizes some of the key developments in Employee Retirement Income Security Act (ERISA) stock-drop litigation that will likely influence the decisions of those district courts.

What Is an ERISA Stock-Drop Case?

In an ERISA stock-drop case, a plan participant typically claims that the fiduciaries of the employer-sponsored defined contribution retirement plan breached their duties to plan participants by allowing participants to invest in company stock when the stock was allegedly too risky an investment option. The plaintiff usually also alleges that plan fiduciaries misrepresented or failed to disclose material information affecting the value of the company's stock.

ERISA stock-drop complaints are often, but not always, filed in tandem with securities litigation. The ERISA "tag-along" case typically involves the same underlying conduct and proceeds in parallel with a securities class action. But, unlike securities class actions, there is: (i) no automatic discovery stay; (ii) no heightened pleading standard for certain types of claims; and (iii) often no need for the defendant to prove scienter.

The Presumption of Prudence

ERISA fiduciaries are faced with a dilemma. Many company retirement plans are designed to provide employees an opportunity to invest in company stock. Indeed, plan fiduciaries who remove company stock as an investment option have been sued, when the employer stock later thrived, for preventing plan participants from investing in the company's stock. E.g., *Tatum v. R.J. Reynolds Tobacco Co.*, 392 F.3d 636 (4th Cir. 2004); *Bunch v. W.R. Grace & Co.*, 532 F.Supp.2d 283 (D. Mass. 2008). Yet, when the company stock price drops significantly, those same fiduciaries are often sued for allowing employees to invest in employer stock through the plan.

This dilemma arises from ERISA itself. ERISA fiduciaries must act prudently, diversify investments where appropriate, act with undivided loyalty to plan participants, and follow the plan documents. 29 USC §1104(a)(1). But in ERISA, Congress also promoted employee investment in company stock and expressly exempted company stock in Eligible Individual Account Plans (EIAPs) and Employee Stock Ownership Plans (ESOPs) from ERISA's prudence requirement insofar as it requires diversification. Id. §1104(a)(2). Accordingly, courts have developed a range of standards for assessing claims that ERISA fiduciaries acted imprudently by allowing investment in employer stock.

Usually courts have given the highest level of deference to fiduciaries of plans that, as a matter of plan design, *require* company stock be offered. E.g., *Wright v. Oregon Metallurgical Corp.*, 360 F.3d 1090, 1097-98 (9th Cir. 2004); *Urban v. Comcast Corp.*, No. 08-733, 2008 WL 4739519, at *12 (E.D. Pa. Oct. 28, 2008). Such fiduciaries have no discretion in offering company stock as an investment option. By analogy to the common law of trusts, if the sponsor requires the fiduciary to invest in a particular stock, then the fiduciary has no discretionary authority, and his action is arguably "immune from judicial inquiry." *Edgar v. Avaya*, 503 F.3d 340, 346 (3d Cir. 2007).[2]

> The federal appellate courts now generally agree on three key principles. First, the degree of deference granted to plan fiduciaries as to company stock is correlated to the discretion provided through plan design. Second, fluctuations in stock price, standing alone, are insufficient to rebut the presumption of prudence. Third, there is now substantial authority that the presumption of prudence applies at the pleading stage.

At the opposite end of the spectrum are plans that give the fiduciaries unfettered discretion over whether to include employer stock as an investment option. In those cases, some courts have suggested that "where the plan *merely permits* investment in a particular stock, the fiduciary's conduct is subject to de novo review." *Graden v. Conexant Sys. Inc.*, 574 F.Supp.2d 456, 462 (D.N.J. 2008) (emphasis in original). In between lies a third possibility, when a plan fiduciary is not required to offer the company stock as an investment option, but is "more than simply permitted" to do so. Id. at 463. A "presumption of prudence" attaches in such cases, entitling the fiduciary "to a presumption that it acted consistently with ERISA" by offering employer stock. *Moench v. Robertson*, 62 F.3d 553, 571 (3d Cir. 1995).

Most courts of appeals have adopted the *Moench* presumption and, increasingly through rulings on motions to dismiss, have required plaintiff to show more than a mere fluctuation in stock price to overcome the presumption of prudence. Nonetheless, the precise articulation of the standard varies. For example, in the U.S. Court of Appeals for the Third Circuit, the plaintiff must show that the fiduciary "could not have believed reasonably that continued adherence to the [plan's] direction was in keeping with the settlor's expectations of how a prudent trustee would operate." *Moench*, 62 F.3d at 571. The Third Circuit has explained that even a 20 percent drop in stock price in a single day was not the "type of dire situation" that defeated the presumption of prudence. *Edgar*, 503 F.3d at 348.

The U.S. Court of Appeals for the Fifth Circuit has held that the *Moench* presumption is not overcome unless the plaintiff establishes "persuasive and analytically rigorous facts demonstrating that reasonable fiduciaries would have considered themselves bound to divest." *Kirschbaum*, 526 F.3d at 256. A 40 percent drop in stock price coupled with allegations of "round-trip trading" fell short because the company at all times remained a viable going concern and its stock was never in danger of becoming worthless. Id. at 255-56. The Sixth and Seventh Circuits have adopted a similarly high bar for overcoming the presumption of prudence. See, e.g., *Kuper v. Iovenko*, 66 F.3d 1447, 1458-59 (6th Cir. 1995) (80 percent decline insufficient to establish imprudence); *Pugh v. Tribune Co.*, 521 F.3d 686, 702 (7th Cir. 2008); *Nelson v. IPALCO Enters. Inc.*, 480 F.Supp.2d 1061, 1097 (S.D. Ind. 2007) (90 percent decline insufficient), aff'd sub nom. *Nelson v. Hodowal*, 512 F.3d 347 (7th Cir. 2008). Cf. *Wright*, 360 F.3d at 1097-98 & n.3 (declining as a matter of law to adopt *Moench* rather than a rule of stronger immunity, but then concluding that if *Moench* applied, the "case [did] not present a situation where a company's financial situation [was] seriously deteriorating and there [was] a genuine risk of insider self-dealing").

Very recently the district court in *In re Bausch & Lomb* adopted the logic of the *Moench* presumption. Because the sponsor expressly designed the plan to "offer and maintain" the employer stock fund, the presumption of prudence applied. 2008 WL 5234281, at *5 & n.4. The court concluded that "[m]ere stock fluctuations" alleged were insufficient to overcome that presumption, since "the presumption of prudence is rebutted only when a company's overall viability appear[s] to be in jeopardy." Id. at *6 (quoting *Wright*, 516

F.3d at 1098). Because the company's financial condition was not in the "type of jeopardy" that would have required prudent fiduciaries to override the terms of the plan and stop participant investment in the company stock, the court dismissed the breach of prudence claim. Id.

The federal appellate courts now generally agree on three key principles. First, the degree of deference granted to plan fiduciaries as to company stock is correlated to the discretion provided through plan design. Second, fluctuations in stock price, standing alone, are insufficient to rebut the presumption of prudence. Instead, a plaintiff is required to show something in addition to stock fluctuations—"stock-drop plus"—to state a claim. Third, there is now substantial authority that the presumption of prudence applies at the pleading stage and that dismissal under Rule 12(b)(6) will be proper if the complaint fails to allege sufficient facts to overcome it. E.g., *Pugh*, 521 F.3d at 699; *Edgar*, 503 F.3d at 349 n.14; *Wright*, 360 F.3d at 1098. While the Second Circuit has not yet ruled on this issue directly, there is strong authority for the court to reach similar conclusions.

Misrepresentation Claims

The complaints in ERISA stock-drop cases often claim that defendants breached the fiduciary duty of loyalty to participants by misrepresenting or concealing material facts about the company. As with breach of the duty of prudence claims, the Second Circuit has not addressed these claims in depth.

A fiduciary violates ERISA if it affirmatively misrepresents benefit information to participants. *Varity Corp. v. Howe*, 516 U.S. 489 (1996). But still open is the question of whether a disclosure obligation beyond ERISA's specific statutory disclosure requirements (e.g., 29 USC §1024(b)(4)) can be inferred from ERISA's general fiduciary standards. The Second Circuit has declined to "infer an unlimited disclosure obligation on the basis of general provisions that say nothing about disclosure." *Board of Trustees v. Weinstein*, 107 F.3d 139, 146-47 (2d Cir. 1997). In a subsequent decision, the Second Circuit recognized a limited duty to provide information about plan benefits when the fiduciary knows that failure to do so might harm participants. *Devlin v. Empire Blue Cross & Blue Shield*, 274 F.3d 76, 88 (2d Cir. 2001).

There is a clear trend to reject claims of fiduciary liability based on alleged nondisclosures of non-public, adverse corporate information (as distinguished from information about the terms of the plan). The Third Circuit in *Edgar* held that fiduciaries did not breach their duty of loyalty by failing to "inform Plan participants about several adverse corporate developments prior to [the company's public] earnings announcement." 503 F.3d at 350. It was enough that fiduciaries provided accurate information about the risks associated with a non-diversified investment in company stock. Id. *In re Bausch & Lomb* endorsed *Edgar's* analysis and found that there was no fiduciary liability when the plan documents correctly described the risks of investing in the company stock fund and any advance disclosure of non-public corporate information to participants "would have been in violation of federal securities law that prohibit trading on nonpublic adverse information." 2008 WL 5234281, at *9.

Absent clear direction from the Second Circuit, there is every reason to expect that district courts in the New York area will continue to look to out-of-circuit precedent like *Edgar* for guidance limiting ERISA misrepresentation and nondisclosure claims.

Efficient Market Hypothesis

The Second Circuit may also embrace recent authority applying the "efficient market hypothesis" familiar from securities law, e.g., *In re Ames Dept. Stores Inc. Stock Litig.*, 991 F.2d 953, 967-68 (2d Cir. 1993), to conclude in the ERISA context that the plaintiff's theory of loss causation is not viable. The efficient market hypothesis suggests that because the market price of a stock incorporates all publicly available information about the company, plan fiduciaries are generally entitled to rely on that valuation and are not required to second-guess whether the market may be overvaluing the stock. See *Rogers v. Baxter Int'l Inc.*, 521 F.3d 702, 705 (7th Cir. 2008) ("[Plaintiff's theory] amounts to an assertion that pension fiduciaries have a duty to outsmart the stock market, a contention with little prospect of success.").

Plaintiff's rejoinder may be to allege that the stock was not efficiently priced because there was material adverse information about the company that was not public. But here, too, the efficient market hypothesis can counter the breach of prudence claim. First, the fiduciary might not have been able to divest the plan of company stock without causing the very price drop that the plaintiff claims should have been avoided. *Kirschbaum*, 526 F.3d at 256. Second, the market's actual reaction to the disclosure may demonstrate the flaw in plaintiff's claims: if the post-disclosure stock price demonstrates the continued viability of the company, then a fiduciary would have had no basis to remove company stock as an investment option against the expressed direction of the plan's sponsor.

Drawing on the reasoning in *Edgar* and *Pugh*, respectively, the district court in *In re Bausch & Lomb* observed that "the actual movement of B&L stock confirms that any alleged [corporate problems] did not draw into question the soundness of the stock as a long-term investment," and so held that the plaintiffs had failed to rebut the presumption of prudence. 2008 WL 5234281, at *6 n.5.

Similarly, claims of alleged nondisclosure may also be defeated by the efficient market hypothesis. As a threshold matter, ERISA fiduciaries have generally no duty to disclose non-material information to participants, *Adams v. Freedom Forge Corp.*, 204 F.3d 475, 492 (3d Cir. 2000), and "information that, when revealed, has no effect on a stock's price is not 'material,'" *Nelson*, 512 F.3d at 350. Further, even if fiduciaries concededly possessed material, non-public information, the efficient market hypothesis shows that the alleged losses could not have been avoided by disclosure. Fiduciaries could not disclose inside information only to participants without violating the securities laws, but if they publicly released it, then the market price would have immediately reflected the disclosure and the plan would have sustained the same losses anyway. *Edgar*, 503 F.3d at 350.

Conclusion

There is now substantial authority for increased scrutiny of the underlying logic of stock-drop claims, starting at the motion to dismiss stage. The earlier era of vague, fact-intensive reasonableness standards is likely coming to a close. In view of the large number of recently filed stock-drop cases, litigants should expect additional judicial guidance, and from the Second Circuit in particular, in this rapidly evolving area of the law.

1. E.g., Consolidation Order, *In re Lehman Brothers ERISA Litig.*, No. 08-cv-05598 (SDNY Sept. 4, 2008).

2. However, several courts have concluded that liability may attach for complying with plan provisions if the terms are inconsistent with ERISA's fiduciary requirements. E.g., *Agway Inc., Employees' 401(k) Thrift Investment Plan v. Magnuson*, No. 5:03-CV-1060, 2006 WL 2934391 (NDNY Oct. 12, 2006). Nonetheless, when a "plan utterly compel[s] investment in company stock…a plan participant would bear an even heavier burden of showing a fiduciary duty breach." *Kirschbaum v. Reliant Energy Inc.*, 526 F.3d 243, 255 (5th Cir. 2008).

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