VOL. 27, NO. 3 AUTUMN 2014

BENEFITS LAW JOURNAL

Let Them In: An Appeal for the Inclusion of 401(k) Plan Participants in Securities Class Actions Brought against Their Employers

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This article examines whether 401(k) plan participants invested in employer stock should be included as class members in securities class actions (or subsequent settlements) brought against their employers. To date, the only court to *directly* address the issue has held that plan participants should be included as class members in such lawsuits and should not be limited to only seeking relief under the Employee Retirement Income Security Act of 1974 (ERISA). Because the issue is far from settled, however, this article discusses the considerations for and against the inclusion of plan participants as class members in securities class actions involving their employers, and concludes that the prudent course would be to include, not exclude, plan participants as class members in these types of lawsuits.

INTRODUCTION

In the typical securities class action lawsuit, a company, its officers, and directors are confronted with allegations of impropriety

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that plaintiffs claim caused the company's stock price to be artificially inflated or significantly drop. If successfully prosecuted, these lawsuits (or any resulting settlements) can lead to monetary relief, oftentimes significant, for the company's shareholders—for either having paid too much to purchase the artificially inflated stock or for the decrease in the stock price after the alleged impropriety was uncovered. Yet, one group of shareholders that has frequently been overlooked in such recoveries is company employees who invested in employer stock through the 401(k) plan sponsored by the company, the thinking being that, unlike other shareholders, plan participants generally do not purchase company stock on the open market and have the ability to seek redress under ERISA, not the federal securities laws. In *Kurzweil v. Philip Morris Cos., Inc.,* the US District Court for the Southern District of New York rejected this line of thinking, holding instead that because plan participants suffer the same injury as other company shareholders, they too should be included as members in the securities class.[1]

However, outside of *Kurzweil*, courts have provided little guidance with respect to the inclusion or exclusion of plan participants as class members in securities class actions against their employers. The current absence of controlling precedent in this area underscores the need for further judicial intervention. Given the undeveloped state of the law, this article seeks to: (1) summarize the limited case law on this topic; (2) examine the arguments that have previously been made for and against the inclusion of plan participants in securities class actions; and (3) propose that, following the same reasoning that allows other shareholders to recover for fraud on the market, plan participants should also be included as class members in these types of lawsuits.

DISTRICT COURT'S DECISION IN *KURZWEIL V. PHILIP MORRIS COS., INC.*

In *Kurzweil v. Philip Morris Cos., Inc.*, plaintiffs filed a class action on behalf of company shareholders alleging that the company violated federal securities laws by misrepresenting and concealing information about its products, which resulted in an artificially inflated stock price.[2] Although the case ultimately settled, a dispute arose after the settlement over whether employees who invested in company stock through the company's defined contribution funds (collectively, the Fund) could file claims with the settlement fund that had been approved by the district court.

The Fund had sought to file claims on behalf of plan participants who lost money during the class period. In rejecting both the Fund's and the plan participants' claims, the settlement fund administrators took a formalist interpretation of who should be deemed part of the plaintiff class. Plan participants, they noted, did not purchase or sell shares of company stock. Rather, they purchased and sold Fund units, which were valued at the price of a share of company stock at the close of business on the day the purchase or sale was executed. Further, unlike other shareholders, an order from a plan participant to buy or sell did not necessarily result in an open-market transaction; sometimes, the Fund simply reallocated company stock between plan participants.[3]

The Fund and certain plan participants appealed the administrators' denial of their claims to the district court. Relying on the US Supreme Court's decision in *Blue Chip Stamps v. Manor Drug Stores,*[4] which held that *only* a purchaser or seller of a security had standing to bring an action relating to that security, the administrators argued that the plan participants did not have standing to file a claim for settlement proceeds because they had purchased or sold Fund units, not company stock. Noting that the plaintiff class had sought relief under the Securities Exchange Act of 1934,[5] a remedial statute that should be construed flexibly, the district court rejected the administrators' argument, holding instead that the semantic distinction between "unit" and "stock" was unpersuasive in precluding recovery and sacrificed "substance to form." The district court chose to focus on the injury sustained by the plan participants, stating:

> [The] consequences [a]re identical for these would-be claimants [*i.e.,* the 401(k) plan participants] to the consequences suffered by open-market purchasers and sellers whose claims have been honored… If the would-be claimants suffered damage that is just as real and measureable, and arises from the same source, as the damage suffered by Class Members, they would seem to have every right to be included in that group…"[6]

Further, whereas the plaintiffs in *Blue Chip Stamps* posed the risk of vexatious litigation because they had not bought or sold any stock, but only *claimed* that they would have purchased or sold stock absent the company's fraudulent conduct, the district court observed that such "dangers [were] not present here" because the plan participants, like other class members, were able to identify particular transactions that entitled them to "precisely measureable" relief. Additionally, that every instruction to purchase or sell by a plan participant may not have resulted in an open market transaction was immaterial to the district court given that the "damage" suffered by plan participants was "identical" to other class members and from the "same source."[7] The district court consequently ruled that plan participants were allowed to file recoverable claims with the settlement fund.

OTHER CASES ADDRESSING PLAN PARTICIPANT INCLUSION IN SECURITIES CLASS ACTIONS

Although no other decision has so directly addressed whether plan participants should be included as class members in securities class actions, a handful of cases nevertheless provide valuable insight on the subject.

Great Neck Capital v. PricewaterhouseCoopers

In *Great Neck Capital v. PricewaterhouseCoopers*, a plan participant objected to a proposed class action securities settlement that risked releasing claims brought against the company in a separate ERISA class action lawsuit.[8] The district court noted that the participant's objection raised several legal issues, including (1) whether a settlement of a securities fraud class action that extinguished without compensation nonfrivolous ERISA claims asserted by company employees in a separate lawsuit could be approved as fair, adequate, and reasonable over the employees' objection; and (2) whether the plan participant employees were class members in the securities lawsuit, and if so, whether they should be required to opt out of the securities case in order to bring their ERISA claims.

The district court advised the parties that it was inclined to view the proposed settlement as unfair given that "its effect would be to extinguish the [p]lan participants' ERISA claims without compensation, and…[would] require [p]lan participants to give up their right to participate in the settlement as a condition of asserting ERISA claims."[9] The parties thereafter revised the settlement to exclude the ERISA claims from the release provision, and to notably allow for the filing of claims by plan participants with the securities settlement fund.

In approving the revised settlement, the district court in *Great Neck Capital* rejected arguments that plan participant inclusion in the settlement class would lead to a double recovery for those plan participants also involved in the separate ERISA lawsuit. Rather, the court concluded that because the two lawsuits involved different legal rights, claims, and damages, the plan participants should not have to choose between the two lawsuits to the exclusion of the other.[10] Further, the district court identified yet another reason that plan participants *should be included* in the settlement class in the securities lawsuit. The court observed that the interests of the plan fiduciaries in *Great Neck* were in direct conflict with those of the participants, as the participants had an interest in preserving their claims in the ERISA lawsuit while the plan fiduciaries, who were defendants in the ERISA lawsuit, had an interest in having those claims released in the securities class action settlement.[11] Inclusion of plan participants in the settlement class provided a safeguard against any conflict of interest between or among the parties.[12]

The Motorola *Cases*

The US Court of Appeals for the Seventh Circuit reached the opposite conclusion—albeit for different reasons—in companion securities and ERISA class actions which had alleged that Motorola, Inc., artificially inflated the prices of its securities, including Motorola common stock, by making materially false and misleading statements.[13] After concluding that participants in Motorola's 401(k) plan had no recourse under ERISA for the plan fiduciaries' decision to continue offering company stock as an investment option notwithstanding the materially false and misleading statements,[14] the Seventh Circuit addressed whether the plan could file a claim with the settlement fund in the securities lawsuit on behalf of those participants who invested in company stock during the class period.

The parties had defined the settlement class in the securities case as follows:

> [A]ll persons who purchased *publicly traded* Motorola, Inc. common stock or registered debt securities during the [class period]...and who allegedly were damaged thereby. Excluded from the Class are the Defendants herein, members of the Individual Defendants' immediate families, any subsidiary, *affiliate*, or control person of any such person or entity, the officers of Motorola and the legal representatives, heirs, successors or assigns of any such excluded party.[15]

The district court disallowed the plan's claim to share in the settlement for two reasons: (1) plan participants purchased units through the plan and not publicly traded stock on the open market; and (2) the plan constituted an *affiliate* of Motorola, which was expressly excluded from the class, and because participants purchased company stock through the plan, they could not be part of the class.[16]

On appeal, the Seventh Circuit disagreed with the district court's first rationale, holding that although plan participants may have purchased units rather than shares of company stock, the parties did not dispute that the plan—the entity that filed the claim with the settlement fund—regularly purchased publicly traded company stock to ensure that it held a sufficient quantity of company stock to account for the participants' unit transactions.[17] However, the Seventh Circuit nevertheless affirmed the ruling because the plan was indisputably an "affiliate" of Motorola, as defined in the settlement class, and thus was excluded by settlement terms from filing a claim to share in the settlement proceeds, even if that claim was on behalf of the participants.[18] The court's decision serves as yet another warning that parties and their counsel, as well as plan fiduciaries, should pay close attention to the class definitions adopted during the securities litigation and any later settlement.[19] Moreover, it bears mentioning that class counsel in securities litigation often overlook plan participants in forming the class, hence even more compelling for plan fiduciaries to be vigilant in assuring that the plan and its participants are protected.

PRUDENCE DICTATES PLAN PARTICIPANT INCLUSION IN SECURITIES CLASS ACTIONS BROUGHT AGAINST THEIR EMPLOYERS

The foregoing case law provides numerous reasons for the inclusion of plan participants in securities class actions or settlements. First, it is undeniable that plan participants suffer the same loss as other company shareholders who purchase or sell their shares on the open market. A 401(k) plan is a material part of an employee compensation package and provides employees with a valuable retirement investment vehicle. Generally, participants have a variety of investment options, one of which may be the choice to invest in a company stock fund that, other than a small amount of cash for liquidity, exclusively holds publicly traded shares in company stock. Thus, it follows that plan participants pay the same inflated price for their investment in the company stock (or alternatively, have the value of their shares decrease by the same amount after company impropriety is revealed to the general public), and therefore, suffer identical losses to any other class member.[20] Indeed, ERISA Section 3(18), 29 U.S.C. Section 1002(18), requires that company stock purchased by a plan participant be bought at the same market rate as that paid by other shareholders to avoid running afoul of ERISA's prohibited transaction rules.

Second, there is no material distinction between purchasing publicly traded shares of company stock and units of a company stock fund. Rather, for the ease of administration, recordkeeping, and exchanges into and out of a stock fund, participant investments are reported in units rather than shares of stock. Accordingly, the use of the term "unit" serves as no more than an accounting mechanism, as contrasted with mutual fund investors who buy shares of a registered investment company and have no rights with respect to the underlying investments in the mutual fund itself.[21] Further, although some have argued that, under the unitized measurement method, the plan maintains a small amount of cash and liquid investments which may have some effect on the value of the relevant company stock,[22] in fact the cash held in the fund does not change the fact that plan participants must purchase the shares held in their accounts, as explained previously, at market rate.

Opponents of plan participant inclusion in securities class actions also point out that intrafund transfers of units among participants often do not require the plan to purchase stock on the open market. However, whether plan participants purchase shares on the open market by acquiring them through trades on the stock exchange or receive their investment interests from a selling plan participant is immaterial. Regardless of the source of the share, in both cases, ownership transfers from a willing seller to a willing buyer at a price determined by actual trading on the stock exchange. Indeed, to make recovery dependent on a transaction on the stock exchange makes it such that whether a participant's purchase of shares becomes eligible to share in class recovery depends on the whim of other plan participants. On a day when no other participant chooses to sell stock, a participant's purchase comes from the stock exchange, and therefore would be eligible for recovery under class settlement allocations or a class victory in litigation. Conversely, if sellers outnumber buyers, none of the participants purchasing on that day would find themselves entitled to a recovery. The law should not determine recovery eligibility on happenstance, but rather rational economic consequence.

Moreover, efficiency favors including plan participants in securities class actions brought against their employers. All transactions by company stock funds *could* take place on the stock exchange. However, intrafund purchases and sales by plan participants allow the plan (and consequently, its participants) to avoid unnecessary and excessive brokerage fees. This allows plan participants to effect more efficient transactions, but does nothing to reduce the economic consequence suffered by a plan participant when his or her employer artificially inflates its stock price. The fact that a particular share of stock may have been acquired by one participant prior to the beginning of a given class period does not change that on a trading day during the class period, one participant sold his or her stock for that day's *market* price, and another participant purchased stock for that day's *market* price—the same as any other class member.[23]

Third, federal securities and tax laws treat plan participants' investment in company stock no differently than the shares owned by other class members. Publicly traded common stock, for purposes of the federal securities law (and ERISA), is stock that is registered under the Securities Exchange Act of 1934 for trading on an established securities market. The stock offered to plan participants through a company stock fund is similarly registered using SEC Form S-8.[24] Under either approach, the SEC views participants as buying stock.[25]

The Internal Revenue Service likewise recognizes participant investment in an employer stock fund as an actual investment in shares of stock.[26] The participant has a "basis" in the shares of stock that is determined by reference to the purchase price of the stock on the date the participant invests in the stock fund, or the date matching contribution shares are allocated to his or her account. When the participant ultimately sells the shares, the excess of the sale price over his or her basis is taxed as short-term or long-term capital gains depending upon how long he or she has held the stock, just like any other shareholder.[27]

Further, plan participants exhibit the same indicia of ownership as any other shareholder. They must receive prospectuses for the stock, and they have the same right to vote their stock as any other shareholder. When plan participants trigger retirement payments, they can choose to receive the shares they own or the cash equivalent.

CONCLUSION

Notwithstanding the scarcity of case law, the only equitable solution is for ERISA plan participants to be included as equal class members in securities class actions brought against their employers. Plan participants make investment decisions to purchase company stock based upon the same market information available to other shareholders, pay the same price per share (which reflects the same inflated rate), and therefore suffer the same financial harm. To demarcate between shareholders making direct open-market purchases and shareholders obtaining stock through ERISA 401(k) plans would create a distinction that serves no more than semantic formality. The federal securities and tax laws treat both stock owners in the same manner. Both kinds of transactions similarly need a willing buyer and seller, and actual trading on the stock exchange determines the pricing of the share transfer for both transactions.[28]

Plan participant inclusion in securities class actions does not risk double recovery. Although some (or all) plan participants may file an ERISA lawsuit when plan fiduciaries continue to offer employer stock after it has become an imprudent investment option, the ERISA lawsuit is rooted in a separate legal theory, is intended to remedy breaches of duty by plan fiduciaries in carrying out the obligations imposed on them by ERISA, oftentimes has a different time frame, and has different damages measurements. As a result, it has no bearing on any recovery entitlement for fraud on the market in a securities class action and any concern of double recovery can be addressed by appropriate offsets.

In the meantime, because the law remains unsettled, the following can be used as temporary measures to protect the interests of plan participants in securities class actions brought against their employers:

1. Structure 401(k) plans to exclusively use open-market trading, rather than intra-plan trading, in order to insulate plan participants from the exclusion arguments discussed previously;

2. Set forth clear language in the 401(k) plan document that participation in the company fund requires the participant to purchase company stock at the prevailing market rate at the time; and

3. Require notice to all plan fiduciaries and plan participants of the filing or settlement of a securities class action brought against their employer, so that fiduciaries and participants at least have the opportunity to notify the court of their interest in being included in the class (or settlement class).[29]

NOTES

1. *Kurzweil v. Philip Morris Cos., Inc.*, 2001 U.S. Dist. LEXIS 83 at *8-9 (S.D.N.Y. Jan. 10, 2001).

2. *Id* at *1–9.

3. Nonetheless, as long as a plan participant owned Fund units, the individual was allowed to vote the underlying shares of company stock. *Id.* at *1.

4. *Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723 (1975).

5. 15 U.S.C. § 78a *et seq.*

6. *Kurzweil*, *supra* n.1, 2001 U.S. Dist. LEXIS 83 at *8-*9.

7. According to the court, delineating between plan participants who bought and sold units from one another and those who bought and sold units that required an open-market transaction was a distinction without difference. *Id.*

8. *Great Neck Capital Appreciation Inv. P'ship, L.P. v. PricewaterhouseCoopers, L.L.P.*, 212 F.R.D. 400, 406 (E.D. Wis. 2002). The plan participant asserted that even though plaintiffs in the securities class action were not plan participants and had not asserted claims under ERISA, the language of the release in the proposed settlement was so broad that it would likely extinguish the claims that had been asserted in the ERISA lawsuit. *Id.*

9. *Id.* at 406–07.

10. *Id.* at 414. Indeed, there is significant precedent distinguishing the two types of lawsuits. *See, e.g., Uselton v. Commercial Lovelace Motor Freight, Inc.*, 940 F.2d 564, 583 (10th Cir. 1991) ("ERISA does not provide a remedy for the types of misconduct that is…prohibited by the Securities Acts."); *Great Neck Capital Appreciation Inv. P'ship*, 212 F.R.D. at 406 (noting that ERISA and securities cases deal with different theories of recovery, different time periods, and a different measure of damages); *Rankin v. Rots*, 278 F. Supp. 2d 853, 878 (E.D. Mich., 2003) (noting differences in ERISA and securities claims involving company stock); *In re Global Crossing Sec. & ERISA Litig.*, 225 F.R.D. 436, 451–452 (S.D.N.Y.) (approving settlement with separate classes for the ERISA and securities claims).

11. *Id.* The court also observed that the plan fiduciaries had failed to notify plan participants of the original proposed settlement in the securities class action that included the broad release provision. *Id.*

12. Similarly, including plan participants prevents any type of attorney collusion in these types of lawsuits, given that the attorneys may have an economic incentive to exclude the plan participants from the class in order to minimize the class size

and maximize recovery for other class members as well as attorney compensation. Likewise, plaintiffs' attorneys may have an incentive not to include plan participants or serve them with notice in order to mitigate the opportunity for plan participants to object and intervene.

13. *In re Motorola Securities Litigation*, 644 F.3d 511, 515–16 (7th Cir. 2011).

14. *See Howell v. Motorola, Inc.,* 633 F.3d 522 (7th Cir. 2011).

15. *In re Motorola Securities Litigation*, *supra* n.13, 644 F.3d at 515 (emphasis in original).

16. *Id.* at 513.

17. *Id.* at 516–17.

18. *Id.* at 518–20 (holding that the plan was an "affiliate" of Motorola because it was under the company's control). Notably, plan participation in the class settlement would not have violated the policy of affiliate exclusion. *See* 19 No. 3 *ERISA Litig. Rep.* (Newsl.) at 15. Rather, the settlement money would turn into plan assets and would go to the individual employee accounts. *Id.*

19. Indeed, but for the class definition excluding affiliates, the Seventh Circuit likely would have granted the plan's request of a share of the settlement proceeds to distribute among its participants.

20. This principle applies regardless of whether the employee obtains the company stock as a result of an affirmative purchase or through an employer match. No meaningful distinction exists between receiving one's compensation via company stock and using proceeds from a paycheck to purchase stock on the open market. Further, companies base their matching stock contributions directly on the price that the stock sells for on the market. Therefore, the shares obtained by a participant through a company match reflect the same inflated value as any other shares for which a securities fraud class member would recover.

21. Those analogizing company stock funds to mutual funds argue that, like mutual fund shares, units represent beneficial interests in a pool of securities and other investments rather than a direct ownership of the security. They also add that, like mutual fund shares, the net asset value of units is determined once per day rather than fluctuating within a single day as common stock does. However, under federal securities law, an employer stock fund using unit accounting differs from a mutual fund. Company stock funds often are not really "funds" at all. A mutual fund is a registered investment company governed by the Investment Company Act of 1940. A purchaser of mutual fund shares buys shares of the registered investment company. Conversely, company stock funds are pools of shares of common stock and some cash, with a direct line of ownership between the participant and those shares of stock. *See* Kurzweil, *supra* n.1, U.S. Dist. LEXIS 83 at *2 (noting that employer stock fund consists of company and a small percentage of cash to maintain liquidity purposes and related needs); *Great Neck Capital Investment Appreciation Inv. Partnership, L.P. v. PriceWaterhouseCoopers, LLP*, 212 F.R.D. 400, 414 (E.D. Wis. 2002) (plan participants investing in the company stock fund "are the beneficial owners of stock purchased by the Plan during the class period and thus may be entitled to proceeds from the settlement."). When a participant invests in a company stock fund, he or she buys shares of the company's common stock.

22. *See George v. Kraft Foods Global, Inc.*, 641 F.3d 786, 792 (7th Cir. 2011) ("The value of a [company stock fund] is determined by the value of the relevant company stock as well as the value of the fund's cash buffer.").

23. There are some ERISA plans that do not use intraplan trading to effect transactions; every plan participant stock transaction occurs on the open market. To allow only these types of plans to join in securities class recoveries, but not plans that use intraplan trading arbitrarily punishes plan participants based on the administrative decisions of their plan fiduciaries.

24. *See In re Reliant Energy ERISA Litig.*, 336 F. Supp. 2d 646, 660-61 and n.29-30 (S.D. Tex. 2004); *see also In re JDS Uniphase Corp. ERISA Litig.,* 2005 WL 1662131, at *12 (N.D. Cal. July 14, 2005) ("[T]he federal securities laws require corporations that sponsor a 401(k) plan offering an employer's securities to file a Form S-8 registration statement with the SEC, and Part I of the Form S-8 is the Section 10(a) prospectus that must be disseminated to employees under the Securities Act."); 17 C.F.R. § 230.428(b)(1)(i) (Form S-8 SEC rules).

25. For this reason, the Seventh Circuit has stated that in securities-fraud actions, "federal securities law [] inform the meaning" of what it is that plan participants acquired. *See In re Motorola Sec. Litig.*, 644 F. 3d at 513. Additionally, the registration requirements do not differ for plans whose stock fund uses unit accounting as contrasted with plans employing share accounting.

26. I.R.C. § 402(e)(4) and Treas. Reg. § 1.402(a)-1(b). The Code provisions for the treatment of net unrealized appreciation apply regardless of the accounting method used by the fund. Rev. Rul. 68-32, 1968-1 C.B. 171.

27. I.R.C. § 402(e)(4) and Treas. Reg. § 1.402(a)-1(b). Furthermore, participants in company plans receive the same prospectuses received by outside shareholders. *See* 29 C.F.R. § 2550.404(c)-1(b)(2)(B)(1)(viii). Under ERISA Section 404(c), 29 U.S.C. § 1104(c), the participant also has the right to vote the shares allocated to his or her account (and receive annual proxy material), and to tender or not tender those shares in the event of a tender offer. *See* 29 C.F.R. § 2550.404c-1.

28. That the ERISA plan actually holds the stock (rather than the employees themselves) similarly should not prevent participant class inclusion because the primary purpose that the plan holds the stock is to provide tax benefits to its participants.

29. Typically, notice will go only to the recordholder for the stock, which may well be a custodian. Plans should insist in service contracts that notice of securities lawsuits (or settlements) be served on plan fiduciaries within a reasonable time period.

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