ERISA Stock Drop Litigation Against Financial Institutions

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Nearly Two Dozen Sub-Prime Stock-Drop Cases Filed Over Past Year

Defendants Include:

- AIG
- Beezer Homes
- Bear Stearns
- Citibank
- Countrywide
- Fifth Third
- Freemont General
- Hartford
- Huntington BancShares
- IndyMac
- Lehman Brothers
- Lincoln National
- MBIA
- Merrill Lynch
- Morgan Stanley
- Regions Financial Corp.
- UBS
- Washington Mutual
- Wachovia
- Wells Fargo

- Many actions related to companies caught in sub-prime market correction
- Targets are companies with substantial stock-drops/bankruptcies
- ERISA cases represent perceived benefits to Plaintiff counsel (including lower pleading threshold, access to discovery, second bite at apple)

ERISA Stock Drop Cases: What they Are

What They Are

- Action on behalf of defined contribution plans (e.g., 401(k), ESOP)
- Based on loss to plan as a result of plan investment in company stock

Typical Allegations

- Breach of fiduciary duty of prudence for offering employer stock as plan option
- Breach of fiduciary duty by misleading participants into investing in company stock (Enron)
- Breach of fiduciary duty for failing to inform participants of material information related to company
- Other Alleged Breaches: Monitoring, Loyalty

Example Allegations in Subprime Stock-Drop Cases

Citigroup

- Plan's Investment in Citigroup was imprudent due to mismanagement and poor business practices, including:
  - Failing to disclose liabilities from off-balance sheet SIVs
  - Causing SIVs to issue debt based on misleading statements
  - Extending "low documentation" loans without considering risk
  - Failing to adequately disclose Citigroup's subprime exposure
  - Understating loan loss reserves

Bear Stearns

- Plan's Investment in Bear Stearns was imprudent because:
  - Bear spent billions buying subprime loans despite increasing delinquency rates
  - Bear failed to adequately disclose subprime loan loss exposure
  - Bear understated its loan loss reserves
  - Bear operated without requisite internal controls

Typical Merits Defenses Raised In Stock-Drop Cases

Prudence Claims

- Presumption of Prudence based on 404(a)(2)
- Procedural Prudence
- Substantive Prudence

Disclosure Claims

- No Disclosure Obligation
- No Loss Caused by Alleged Disclosure violation
- Misstatements not Made in Fiduciary Capacity

Class Certification

- Individualized Issues Raised by 404(c)
- Individualized Issues Raised by Disclosure Claims

Use of Presumption of Prudence Depends on Three Key Issues

1. Does Plan Support Presumption

- Presumption based on ERISA 404(a)(2), and principal that administrators are expected to follow terms of Plan
- Is the Plan an ESOP or EIAP
- Do the Plan provisions related to the company stock use mandatory, suggestive or permissive language

2. Do Facts of case rebut Presumption

- Whether continued adherence to Plan's terms was in keeping with Settlor's expectations
- Mere stock fluctuations typically not sufficient.
- Rebutting presumption often requires a precipitous stock decline and knowledge of impending collapse of company

3. Application of Presumption at Motion to Dismiss

- *Twombly v. Bell Atlantic*
- *Edgar v. Avaya*

Defending Merits of Prudence Claims

Factors

Procedural Prudence

- Due diligence with respect to corporate transactions
- Regular consideration of whether to offer company stock
- Seeking outside legal opinions
- Appointing independent fiduciary

Substantive Prudence

- Fiduciary need not predict future of company's stock price
- Analyst recommendations
- Bond ratings
- Investments in company stock by institutional investors
- Relative stock-price performance compared to market or peers over class period

Cases

- *Nelson v. IPALCO*, 480 F. Supp. 2d 1061 (After trial court found no imprudence even though stock declined 90%)
- *DeFelice v. US Airways, 497 F.3d 410* (After trial, court found no imprudence even though company filed bankruptcy)
- *Shirk v. Fifth Third Bancorp* (SJ finding presumption of prudence not overcome)

Theories for Defending Disclosure Claims

Disclosure Obligation Limited

- **IPALCO** (7th Cir): Plaintiffs allege that fiduciaries should have disclosed own sales of stock.
  - Court finds no duty to disclose non-material information; Inside sales were disclosed and did not move market, therefore immaterial

Statement not made in Fiduciary Capacity

- **Reliant Energy** (5th Cir): Securities filings were required to be made in corporate capacity; They were not fiduciary statements even though incorporated in S-8 and 10a Prospectus

No Harm From Lack of Disclosure

- **Avaya** (3rd Cir): Plaintiff argues that adverse information should have been disclosed earlier
  - Court finds that under efficient market hypothesis, market would have adjusted to disclosure of adverse information before Plan or participants could have sold shares

Potential Damages Difficult to Predict

Risk of Liability Improving

- No court has yet found liability after a trial
- Presumption of prudence is increasingly being applied
- Likely that more cases will go to trial

Size of Liability Difficult to Predict

- Plaintiffs claim loss should be measured by "best alternative investment." (*But see Leister v. Dovetail* (7th Cir. Posner) (rejecting that measure of damage))
- Potential recovery by "holders" may depend on liability theory

Settlements can be Expensive

- *In re Delphi Corp. ERISA litigation* ($47 million settlement)
- *In re General Motors ERISA litigation* ($37.5 million settlement)
- *Lively v. Dynegy* ($17.9 million settlement)

Resolution of Subprime-driven ERISA Stock-Drop Cases Will Vary by Facts of Case and Court

Huntington Bancshares

S.D. Ohio, 2:08-cv-0165 (Feb. 9, 2009)

- Plaintiff alleged that investment in Huntington Bancshares became imprudent when company merged with Sky Financial Group, which had a $1.5 billion subprime exposure.
- Court dismissed complaint, in part because:
  - public pension plans continued to invest in Company stock.
  - Hungtington's stock price moved in tandem with its peers.
  - No "red flags" that Defendants failed to see.
  - Court noted unprecedented, ongoing credit crisis.
  - Court noted that the courts "are currently experiencing a significant rise in 'stock drop cases' due to the current status of the Stock Market and the economic climate in general."

NovaStar Financial

W.D. Mo., 08-cv-00490 (Feb. 11, 2009)

- Plaintiff alleged that investment in company stock were imprudent because the company business relied on subprime mortgages for revenues, and because of improper conduct in originating those loans.
- Court denied the motion to dismiss, finding the complaint adequate where it alleged that there was a precipitous decline in company stock price and that Defendants knew or should have known of the impending collapse of the company.

Strategies to Minimize Risk and Expense

Limit Executive Liability

- Clearly demarcate responsibilities in Plan documents, including appointment and oversight
- Remove senior executives and board members from committees with administrative responsibilities
- Consider using independent fiduciary

Revise Plan

- Revise plan to hard-wire company stock as option within plan; or
- Remove company stock from plan options

Procedural Steps

- Review investment options on regular basis
- Implement regular monitoring process over investments