



When a company's stock price falls, two shoes drop: the securities class action and the ERISA class action

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Sudden drops in stock prices often trigger lawsuits by shareholders under the Securities Exchange Act of 1934. If a company offers its employees company stock through a retirement (401(k)) plan, the company may face a second round of lawsuits. Its employees who are also shareholders through that plan have a second remedy in addition to those provided by the securities laws: section 502(a) of the Employee Retirement Income Security Act (ERISA), which authorizes participants to obtain relief from plan fiduciaries for breaches of fiduciary duty. Plan fiduciaries are those who have "any discretionary authority or discretionary control" over the plan or any authority or control over the administration or assets of the plan. Fiduciaries include investment advisers, company officers, human resources executives, or other plan administrators.

These ERISA "stock-drop" lawsuits typically rely on the same facts as the parallel securities lawsuits. ERISA plaintiffs, however, have a number of advantages over securities plaintiffs. Among other things, ERISA plaintiffs do not need to prove intentional wrongdoing, and they do not need to plead the facts of their case with as much detail as securities plaintiffs. With about \$10trn in retirement plan assets and an economic downturn that has caused the value of many employer securities held in these plans to drop, ERISA stock-drop litigation has increased in recent years.

The most common types of ERISA stock-drop claims are: (1) breach of fiduciary duty of prudence for failure to monitor the employer stock and sell it when retaining it became too risky, or imprudently offering the employer stock as an investment option, and (2) breach of fiduciary duty of loyalty for failure to disclose information relating to the value of the stock. Plan fiduciaries are personally liable for losses resulting from breaches of their fiduciary duties (although many companies have insurance for such claims). The plan participants can recover the difference in the value of the stock before and after the drop, which be a substantial amount of money if a large portion of the participants' assets were held in the company stock. In the past, plan participants could only sue on behalf of the plan, such that the monetary recovery was returned to the plan, but since the Supreme Court's 2008 decision in *LaRue v. DeWolff, Boberg & Assoc.* (552 US 248), individual participants have been able to bring suit for losses to individual 401(k) accounts and directly receive any money recovered in the lawsuit.

Claims that the fiduciary retained employer stock imprudently

ERISA plan fiduciaries must discharge their duties "with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." In stock-drop cases, the plaintiffs typically allege

that the plan fiduciaries breached this duty by failing to sell the employer stock prior to the price drop despite knowing that continued investment in the company was imprudent.

"Hardwired" plans require investment in or offering of employer stock

Many plans require that the administrator invest in employer stock or offer employer stock as an investment option -- they "hardwire" the stock into the plan. In certain individual account plans (i.e., ESOPs), this is a legal requirement. In other individual account plans (i.e., 401(k) plans), the plan sponsor chooses to require investment in the employer stock. Although it might appear that a plan administrator should not be held liable for retaining the stock when it is "hardwired" in the plan because the administrator has no discretion to decide whether to invest in, or offer as an option, the employer stock, many courts have nonetheless held that the plan administrator can be liable for violating the duty of prudence. These courts have reasoned that the administrator still retains the discretion to remove employer stock as an investment or option if doing so would violate the administrator's fiduciary duties.

Most courts grant fiduciaries a presumption of prudence for hardwired plans

Most courts (with the notable exception of the First Circuit) have adopted what is called the "*Moench* presumption" (after a leading Third Circuit case, *Moench v. Robertson*, 62 F.3d 553 (3d Cir. 1995)), which grants the plan fiduciary a presumption of prudence in retaining employer stock unless the "investments no longer serve the purpose of the trust," when the plan requires investment in or offering of the employer securities. To rebut the presumption of prudence, the "plaintiff must show that the ERISA 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." For example, if a company is in a truly dire financial situation, the fiduciary may be required to divest the plan of the employer stock. The plaintiff must rely on publicly-available information to meet this standard; it cannot succeed by alleging that the plan fiduciaries should have divested the plan of the employer stock based on inside information.

Some courts, such as the Fifth Circuit, have adopted the *Moench* reasoning but have made clear that the strength of the presumption varies with the fiduciary's discretion; when a plan mandates inclusion of employer stock as an investment option, it is more difficult for a plaintiff to rebut the presumption. However, because of ERISA's requirement that every asset in an ERISA plan be under the discretion of a fiduciary, when the issue is fully fleshed out by the courts, "hardwiring" may not prove to be a completely successful defense and may, in fact, inadvertently bestow unwanted fiduciary status on the board of directors or the company.

Most courts have held that the *Moench* presumption applies at the motion to dismiss stage, forcing the plaintiff to plead facts sufficient to show that, given the standard set out in the presumption, a breach of duty is still plausible. The 2007 *Bell Atlantic Corp. v. Twombly* decision, (550 U.S. 544) makes the *Moench* presumption all the more valuable for defendants. Pleadings in ERISA stock-drop cases have often consisted of conclusory statements and recitations of the elements of the claims, without any real factual allegations. Post-*Twombly*, the plaintiffs will have to

allege specific facts sufficient to make their claims plausible, even in those courts that do not apply the *Moench* presumption of prudence. For example, a Massachusetts federal court recently rejected the plaintiff's prudence claims because the plaintiff only made "conclusory allegations of riskiness" of continuing to invest in the employer's securities, even though the plaintiff had specified the employer assets he believed were problematic. Since *Twombly*, courts frequently dismiss prudence claims on the pleadings.

Claims that the fiduciary failed to disclose or misrepresented information about the company

Because plan fiduciaries are often company officers or employees, they frequently have extensive knowledge of the company's financial condition, including knowledge of non-public information. As a result, plaintiffs in ERISA stock-drop cases often allege that the plan fiduciaries failed to disclose material information to plan participants that would have allowed them to decide to divest themselves of company stock before a price drop. ERISA does not explicitly require fiduciaries to disclose this type of information. So, courts have fashioned a fiduciary duty not to make a misrepresentation (either by act or omission) out of ERISA's fiduciary duty of loyalty. These allegations of misrepresentations or failures to disclose information often track those made in parallel securities litigation and usually focus on public disclosures, such as SEC filings. As in securities litigation, the plaintiffs must also show that the misrepresentations or failures to disclose information actually caused the losses to their retirement plan accounts. A majority of courts have construed this to require the plaintiffs to prove that they relied on the alleged misrepresentation or omission in retaining the employer stock.

The plan fiduciary's affirmative duties of disclosure are limited

An ERISA fiduciary's duty of disclosure is generally limited to a duty not to mislead, which encompasses a duty to speak truthfully and a duty to disclose information where failure to do so might be harmful. While the fiduciary must make general warnings about the risks of investment in employer stock so that the plan participants are aware of the dangers of making such an undiversified investment, a fiduciary is not required to advise participants on the specific risks of, or opine on the wisdom of, investing in the employer securities at a particular time. Plan fiduciaries do not have a general duty to disclose information about the employer's financial condition. Moreover, plan fiduciaries may not trade on inside (non-public) information, so a failure to disclose or trade on inside information cannot constitute a breach of fiduciary duty. While plan fiduciaries may have an obligation to respond truthfully to questions from participants about terms of the plan, it is not clear whether a court would extend this principle to questions about the financial state of an employer.

Fiduciaries may be liable for public statements about the company

When plan fiduciaries do speak about the employer's financial condition, they are only liable to ERISA plan participants for misleading statements if they make the statements in connection with fiduciary conduct, as opposed to "settlor" or "corporate" conduct. For example, if they disclose misleading information about the company in their

role as company officers, that does not subject them to ERISA fiduciary liability, even if they are liable under the securities laws for that same conduct. Courts are split, though, on whether plan fiduciaries are liable for the contents of company information, such as SEC filings, when that information is incorporated by reference into plan materials. This can happen, for example, when a company uses its prospectus as the ERISA summary plan description provided to plan participants. Some courts have held that, because the securities laws require companies to provide their SEC filings to plan participants, plan fiduciaries are acting in their corporate capacity -- fulfilling their corporate duties under the securities laws -- when the SEC filings are incorporated into plan documents. They are not, therefore, acting as plan fiduciaries and are not liable under ERISA.

To the extent that a court considers the plan fiduciaries to be acting as plan fiduciaries, though, they will be held liable for misstatements in SEC filings incorporated into plan documents. Because disclosure claims frequently center on allegedly misleading statements in the SEC filings incorporated into plan documents, the ability of the defendant to exit the litigation early will often depend on the court's approach to incorporation of these filings into plan documents.

Key differences between ERISA and securities litigation

In addition to the different standards of liability, ERISA stock-drop litigation is different in other ways from securities litigation, even though the ERISA stock-drop cases are typically based on the same facts.

Securities litigation defendants have certain advantages over ERISA defendants

Certain factors make it easier for plaintiffs to survive a motion to dismiss in an ERISA stock-drop case than in a securities class action case. For example, defendants in ERISA stock-drop cases do not have the benefit of the heightened pleading standard required by the Private Securities Litigation Reform Act (PSLRA). Securities fraud plaintiffs must, in their initial complaints, "specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed" and must also plead similar facts supporting any fraud claims.

If the plaintiffs fail to meet this standard, the court is likely to dismiss their claims on the pleadings, ending the case very early. ERISA plaintiffs, on the other hand, only have to meet the general notice pleading standard, although Twombly with its stricter pleading requirements has reduced this pleading disparity somewhat. Some courts have imposed stricter pleading requirements on plaintiffs bringing disclosure/misrepresentation claims in stock-drop cases when those claims involve an element of fraud. PSLRA plaintiffs must also allege facts to support a "strong inference" of the defendant's intention to mislead, while ERISA plaintiffs are not required to plead a state of mind at all.

ERISA stock-drop class action law is unsettled

Also, courts have not yet reached a consensus on whether ERISA stock-drop cases are appropriate for class-action

status, a factor that can dramatically change the progress and risks of litigation. Some courts have denied class certification in ERISA stock-drop cases because the putative class members' claims were not sufficiently similar; other appellate courts have reversed trial court class-certification decisions and instructed the trial courts to reconsider the similarity of the claims and the manageability of the class action. In other cases, classes have been certified. The standard for proving causation in ERISA stock-drop class actions is also unsettled. ERISA plaintiffs must show that their losses were caused by the breaches of fiduciary duty, but it is not clear whether the "fraud-on-the-market" theory, which allows some securities class-action plaintiffs to prove causation on a class-wide (rather than individual) basis, is available to ERISA plaintiffs. If plaintiffs are prevented from using a fraud-on-the-market theory, they must prove that each individual plaintiff relied on the alleged misrepresentations or omissions about the employer stock, thus making class certification inappropriate.

Conclusion

While ERISA stock-drop cases are often filed along with securities lawsuits based on the same facts, the progress of the litigation may be very different. The prudence claim in a stock-drop case may be dismissed earlier than in the securities lawsuit if the court embraces the *Moench* presumption. Early dismissal of disclosure claims often depends on whether the court believes that incorporation of SEC filings into plan documents or some other act of the fiduciary with a dual corporate role is a fiduciary act or a purely corporate act. Although these stock-drop cases are common, plan fiduciaries have strong legal defenses.

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