
**ERISA FIDUCIARY DUTIES REGARDING 401(k) & ESOP
INVESTMENTS IN EMPLOYER STOCK¹**

BY

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OVERVIEW

Substantial ERISA fiduciary litigation has arisen challenging eligible individual account plan investments in employer stock. One strand, which has continued apace, is litigation challenging fiduciary duties related to employee stock ownership plans (ESOPs) of closely held companies. This litigation has been around since ESOPs were first formed in the late 1970's. This traditional ESOP claim arises in the context of a closely held company typically wholly or majority-owned by the ESOP. The participants in these ESOPs generally do *not* have the ability to direct their investments; rather, they acquire ownership in the company through the tax-advantaged ESOP as part of their compensation package. Claims unique to these cases are discussed in Part V and include valuation issues, i.e., did the ESOP pay no more than "adequate consideration" for the stock. These cases also often explore the extent of the ESOP's control of the company and the often less-than-clear line between where the ESOP and fiduciary duties end and the management of the company begins.

A newer strand of litigation challenges 401(k) or like plan investments in a public company's stock. The 2000-2002 stock market downturn led to numerous cases claiming that ERISA fiduciaries breached their fiduciary duties related to an eligible individual account plan's (typically a 401(k) plan) investments in employer stock;³ this litigation shows no signs of abating, as each new story of business setbacks in the *Wall Street Journal* or *The New York Times* leads to a flurry of ERISA class action lawsuits.⁴ In these 401(k) plans, the employer stock fund is one of several investment options offered to participants, and the participant is allowed typically to direct his own contributions among these funds. The 401(k) plan often offers an employer match and, prior to the 2006 Pension Protection Act, the plan often required this match to be invested in the employer stock fund. Because of tax changes effective for 2002,⁵ many of these 401(k) plans also have designated this employer stock fund as an ESOP.⁶

³ See, e.g., Leigh Jones, *A "Perfect Storm" for pension suits?*, Nat. L. J. (Dec. 13, 2004) (discussing uncertainty in law and continued rise in class action lawsuits challenging 401(k) investments in employer stock); Brett Nelson, *Open Season on 401(k)s; Lawyers Line Up to Sue Employers with Thrift Plans*, FORBES, Nov. 25, 2002 at 60 ("Lawyers have filed 115 suits against 35 companies claiming employees' 401(k) plans got shafted.").

⁴ The 2008 flurry of post-subprime crisis stock drop suits filed against financial companies is the most recent example of this dynamic. The website maintained by the lead plaintiffs firm in this area, Keller Rorhback, also aptly illustrates this. It lists seventeen companies it currently has litigation against. See www.erisafraud.com (last visited September 17, 2010).

⁵ See *Economic Growth & Tax Relief Reconciliation Act of 2001* (EGTRRA), Pub. L. No. 107-16, § 662(a), amending I.R.C. § 404(k)(2)(a) (for tax years beginning after December 31, 2001, allowing employers to deduct dividends paid on ESOP shares when

Investment in employer stock, whether through ESOPs or through other eligible individual account plans such as 401(k) plans, puts into play the fundamental tension between Congress' strong encouragement of employee ownership through the Internal Revenue Code and ERISA, and the fact that Congress placed these tax-favored investments in ERISA plans. These plans subject fiduciaries to the "highest duties known to law"⁷ and, when an employer goes under or suffers serious setbacks, the employee/participant often loses not only his job, but also a substantial part of his retirement savings. Such losses lead to lawsuits. A review of the cases in the epilogue would suggest that the claims are limited only by a plaintiff's imagination. Nonetheless, when these claims are analyzed, they generally⁸ distill down to the following two types of claims regarding investments in publicly-traded stock:

those dividends are, at election of participants, paid to ESOP and then reinvested in employer stock).

⁶ The Department of Labor ("DOL") and Internal Revenue Service ("IRS") regulations specifically permit this: "An ESOP may form a portion of a plan the balance of which includes a qualified pension, profit-sharing, or stock bonus plan which is not an ESOP. A reference to an ESOP includes an ESOP that forms a portion of another plan." 29 C.F.R. § 2550.407d-6(a)(4); Treas. Reg. § 54.4975-11(a)(5). See also *In re Duke Energy ERISA Litig.*, 281 F. Supp. 2d 786, 794 (W.D.N.C. 2003) (rejecting argument ESOP stock fund in a 401(k) plan is not entitled to the ESOP presumption); *Edgar v. Avaya, Inc.*, 503 F.3d 340, 345 (3d Cir. 2007) (same).

⁷ E.g., *Donovan v. Bierwirth*, 754 F.2d 1049 (2d Cir. 1985).

⁸ Plaintiffs also sometimes allege a free-floating "duty of loyalty" claim. Instead of tying an alleged breach of loyalty to particular conduct, the plaintiffs allege a separate claim that a breach of the duty of loyalty exists because plan fiduciaries allegedly had interests (e.g., incentive compensation schemes or insider sales of stock) adverse to the plan. Because ERISA specifically allows plan fiduciaries to have interests adverse to the plan, e.g., ERISA § 408(c)(3), 29 U.S.C. § 1008(c)(3), *Pegram v. Herdrich*, 530 U.S. 211, 225-26 (2000), some courts have dismissed this claim on the pleadings. See *Edgar v. Avaya, Inc.*, 2006 WL 1084087, at *10-11 (D.N.J. April 25, 2006) (merely alleging dual loyalties for directors who act as fiduciaries is insufficient), *aff'd*, 503 F.3d 340 (3d Cir. 2007); *In re Bank of America Securities, Derivative & ERISA Litig.*, 2010 WL 3448197, at *21-2 (S.D.N.Y. Aug. 27, 2010) (same); *In re Lehman Brothers Securities and ERISA Litig.*, 683 F. Supp. 2d 294, 303 (S.D.N.Y. 2010) (same); *Crocker v. KV Pharmaceutical Co.*, -- F. Supp. 2d --, 2010 WL 1257671, at *25 (E.D.Mo. Mar. 24, 2010) (same); *Herrera v. Wyeth*, 2010 WL 1028163, at *7 (S.D.N.Y. Mar. 17, 2010) (allegations of directors selling their stock insufficient to survive motion to dismiss); *Harris v. Amgen, Inc.*, 2010 WL 744123, at *8 (C.D.Cal. Mar. 2, 2010) (merely alleging directors' compensation tied to stock performance is insufficient); *Johnson v. Radian*, 2010 WL 2136562, at *14 (E.D.Pa. May 26, 2010) (same); *In re Constellation Energy Group, Inc.*, 2010 WL 3221821, at *8 (D.Md. Aug. 13, 2010); *In re Citigroup ERISA Litig.*, 2009 WL 2762708, at *26-*27 (S.D.N.Y. Aug. 31, 2009); *Benitez v. Humana, Inc.*, 2009 WL 3166651, at *11-*12 (W.D.Ky. Sept. 30, 2009); *Johnson v. Radian Group, Inc.*, 2009

1. *The prudent investment claim*: The fiduciaries knew or should have known that the employer stock was not a prudent investment option for the plan.
2. *The disclosure/Varsity claim*: The fiduciaries made misrepresentations on or failed to disclose material adverse information affecting the value of the employer stock.⁹

For ESOP investments in closely-held companies, the valuation of the employer's stock may also be at issue,¹⁰ and plaintiffs also may allege that

WL 2137241, at * 21-*22 (E.D. Pa. July 16, 2009); *Morrison v. MoneyGram International, Inc.*, 607 F. Supp. 2d 1003, 1058 (D. Minn. 2009); *In re Avon Products, Inc. ERISA Litigation*, 2009 WL 884687, at* 17 (S.D.N.Y. Mar. 30, 2009) (adopting Report and Recommendations of Mag. Judge Dolinger); 2009 WL 848083, at *17 (S.D.N.Y. Mar. 3, 2009) (Report and Recommendations of Mag. Judge Dolinger); *In re Harley Davidson, Inc., Sec. Litig.*, 660 F. Supp. 2d 953, 968-69 (E.D. Wis. 2009); *Halaris v. Viacom, Inc.*, 2008 WL 3855044 (N.D. Tex. Aug. 19, 2008); *In re AOL Time Warner, Inc. Securities and ERISA Litig.*, 2005 WL 563166, at *8 (S.D.N.Y. Mar. 10, 2005) (claim insiders sold shares fails to state a claim because sales are not made in a fiduciary capacity); *In re WorldCom Inc. ERISA Litig.*, 263 F. Supp. 2d 745, 768 (S.D.N.Y. 2003) (same); *In re Dynegy Inc. ERISA Litig.*, 309 F. Supp. 2d 861, 896-97 (S.D. Tex. 2004) (same). *See also, e.g.*, *Martin v. Feilen*, 965 F.2d 660, 670 (8th Cir. 1992) (“the ESOP fiduciary is not prohibited from being on both sides of a transaction involving the ESOP’s assets, but he must serve both masters (or at least the ESOP) with the utmost care and fairness.”). Other courts have allowed this claim to go forward at the pleading stage. *See, e.g.*, *Dann v. Lincoln National Corp.*, -- F. Supp. 2d --, 2010 WL 1644276, at *9 (E.D. Pa. Apr. 20, 2010); *Patten v. Northern Trust Co.*, 703 F. Supp. 2d 799, 814-15 (N.D. Ill. 2010); *Banks v. Healthways, Inc.*, 2009 WL 211137, at *4-*5 (M.D. Tenn. Jan. 28, 2009); *Urban v. Comcast Corp.*, 2008 WL 4739519, at *15 (E.D. Pa. Oct. 28, 2008); *In re Guidant Corp. ERISA Litig.*, 2008 WL 2498127, at *6 (S.D. Ind. June 19, 2008); *In re Diebold ERISA Litig.*, 2008 WL 2225712, at *11 (N.D. Ohio May 28, 2008). *In re Electronic Data Sys. Corp. “ERISA” Litig.*, 305 F. Supp. 2d 658, 672-74 (E.D. Tex. 2004); *Hill v. Bellsouth Corp.*, 313 F. Supp. 2d 1361, 1369-70 (N.D. Ga. 2004) (included allegations of insider sales by fiduciaries).

⁹ For a discussion of claims related to ERISA fiduciary disclosure duties, *see* Rachal, Shapiro & Lincoln, *The Duty to Disclose and Fiduciary Breaches: Claims and Issues in ERISA Litigation*, a version of which is the basis for Chapter 25 in *ERISA LITIGATION* (BNA 3rd ed 2008 & 2010 Supplement).

¹⁰ Some plaintiffs have also pursued such claims for publicly traded stock, i.e., that because the employer stock was allegedly inflated through fraud, the plan paid more than “adequate consideration” for that stock. For publicly traded stock, such a claim contravenes the plain language of ERISA § 3(18), 29 U.S.C. § 1002(18), (defining “adequate consideration” as “the price of the security prevailing on a national securities exchange”), and has been rejected by the courts. *See In re CMS Energy ERISA Litig.*,

corporate mismanagement and corporate transactions implicate various fiduciary duties under ERISA. Plaintiffs also often allege co-fiduciary breaches under ERISA § 405(a), 29 U.S.C. § 1105(a),¹¹ and a derivative¹² duty to monitor claim:

312 F. Supp. 2d 898, 917 (E.D.Mich. 2004); *Pietrangelo v. NUI Corp.*, 2005 WL 1703200, at *13 (D.N.J. July 20, 2005).

¹¹ Under ERISA §§ 405(a)(1) & (a)(3), the plaintiffs must prove that the fiduciary had actual knowledge of the breach and either knowingly (1) participated in, (2) undertook to conceal, or (3) failed to take reasonable efforts to remedy the breach. Under § 405(a)(2) plaintiffs must show that the fiduciary's own breach enabled another to commit a breach. *See, e.g., In re Sprint Corp. ERISA Litig.*, 33 EB Cas. 2196, 2004 WL 2182186, at * 4 to *6 (D.Kan. Sept. 24, 2004); *cf. In re Syncor ERISA Litig.*, 351 F. Supp. 2d 970, 988 (C.D.Cal. 2004) (dismissing co-fiduciary claims absent allegations of actual knowledge); *In re AOL Time Warner, Inc.*, 2005 WL 563166, at *6 (S.D.N.Y. Mar. 10, 2005) (same).

¹² Plaintiffs also may attempt to bring derivative-type claims against *non*-fiduciaries for "knowing participation" in a fiduciary's breach. Although such a claim is limited to "appropriate equitable relief" under § 502(a)(3) and requires proof of the primary violation, plaintiffs plead this type of claim to attempt to gain access to additional defendants and thus to potential additional sources of funds for any settlement or judgment. After *Harris Trust*, it is clear a "knowing participation" claim can be based on knowing participation in a prohibited transaction, a § 406 violation. *Harris Trust v. Salomon Smith Barney, Inc.*, 530 U.S. 238 (2000). The courts are split as to whether a non-fiduciary can be liable for knowing participation in a fiduciary breach under ERISA § 404. *See Mertens v. Hewitt Assoc.*, 508 U.S. 248, 253-54 (1993) (strongly suggesting no such claim); *Reich v. Stangl*, 73 F.3d 1027, 1031-32 (10th Cir. 1996) (distinguishing between allowing knowing participation claims based on ERISA § 406 and prohibiting those based on ERISA § 404); *Reich v. Rowe*, 20 F.3d 25, 31 at n.7 (1st Cir. 1994) (same); *In re Wachovia Corp. ERISA Litig.*, 2010 WL 3081359, at *17 (W.D.N.C. Aug. 6, 2010) (dismissing claim at pleading stage as alleged against employer); *In re Constellation Energy Group, Inc.*, 2010 WL 3221821, at *8 (D.Md. Aug. 13, 2010) (same); *In re Pfizer, Inc. ERISA Litig.*, 2009 WL 749545, at *15-*16 (S.D.N.Y. Mar. 20, 2009) (dismissing claim at pleading stage because the relief sought from an alleged nonfiduciary was not permissible under ERISA § 502(a)(3)); *In re Bausch & Lomb, Inc. ERISA Litig.*, 2008 WL 5234281, at *12 (W.D.N.Y. Dec. 12, 2008) (dismissing claim in an employer stock drop case against the employer/plan sponsor); *Pennsylvania Fed. v. Norfolk So. Corp.*, 2004 WL 228685, at *8 (E.D.Pa. Feb. 4, 2004) (same in rejecting claim for knowing participation in a fiduciary breach in an employer stock case), § 1292(b) *appeal granted*, (3d Cir. Case No. 05-1787); *Agway, Inc. Employees' 401(k) Thrift Investment Plan v. Nels G. Magnuson*, 2006 WL 2934391, at *25 (N.D.N.Y. Oct. 12, 2006) (employer stock case dismissing claim against third party/auditor to plan and holding that liability under ERISA § 502(a)(3) depends upon "a showing of actual participation in the prohibited transaction at issue"); *compare In re Enron Corp. Securities, Derivative & ERISA Litig.* (*Tittle v. Enron Corp.*), 284 F. Supp. 2d 511, 571-72 (S.D. Tex. 2003) (suggesting can bring knowing participation claims based on a fiduciary breach in an employer stock case); *L.I. Head Start Child Dev. Servs. v. Frank*, 165 F. Supp. 2d 367 (E.D.N.Y. 2001) (*following* *Diduck v. Kaszycki & Sons Contractors, Inc.*, 974 F.2d 270, 279-81 (2d Cir. 1992), and finding that attorneys alleged to have knowingly participated in a breach of duty could be liable to return legal fees received in

that the ones who appointed the fiduciaries (often a company's directors or senior officers) had a duty to monitor and prevent the appointees' alleged breach of duty regarding plan investments or disclosures.

I. PROCEDURAL AND REMEDY ISSUES

The litigation on 401(k) investments in publicly traded employer stock has raised a host of procedural issues. At the initial pleading stage, the U.S. Supreme Court's decisions in *Bell Atlantic Corp. v. Twombly*,¹³ and *Ashcroft v. Iqbal*,¹⁴ now require plaintiffs to plead a "plausible" claim to survive a motion to dismiss.

Additional procedural hurdles can encumber plaintiff in bringing a stock drop suit. For example, in *Hastings v. Wilson*,¹⁵ plaintiffs brought a putative class action arising out of the loss in value of stock in Northwest Airline precipitated by the airline's voluntary filing for Chapter 11 in September 2005. Defendants argued that since the scope of any fiduciary duties depended on construction of contractual terms bargained under and subject to the Railway Labor Act, the ERISA fiduciary claims were precluded because they were subject to the exclusive, mandatory jurisdiction of labor arbitrators under the Railway Labor Act. The Eighth Circuit agreed, and also held that plaintiffs lacked standing against certain fiduciaries because the named plaintiffs were not participants in the plan involving those fiduciaries.¹⁶

The majority of the procedural issues can be distilled down to two issues. One set involves how the ERISA case interrelates with any parallel securities fraud lawsuit. Because many of these cases arise out of a common nucleus of operative facts involving alleged securities fraud, another issue is whether Rule 9(b) of the Federal Rules of Civil Procedure and its plead-fraud-with-particularity standards apply to the claims of fiduciary breach under ERISA. Finally, because the remedies available for claims for individual relief under ERISA § 502(a)(3), 29 U.S.C. § 1132(a)(3), are limited to traditional forms of equitable relief (which

that improper transaction); *Rudowski v. Sheet Metal Workers Local 24*, 113 F. Supp. 2d 1176, 1180-81 (S.D. Ohio 2000) (denying defendants' motion for summary judgment where plaintiffs sought to enjoin a nonfiduciary union from coercing the trustees of a multiemployer welfare fund in the exercise of their fiduciary duties); *Noa v. Keyser*, 519 F. Supp. 2d 481 (D.N.J. 2007) (recognizing knowing participation in breach of fiduciary duty claim under ERISA § 404, but dismissing claim because there was no fiduciary breach).

¹³ 550 U.S. 544 (2007).

¹⁴ 129 S. Ct. 1937 (2009).

¹⁵ 619 F. Supp. 2d 646 (D. Minn. 2009), *aff'd*, 516 F.3d 1055 (8th Cir. 2008).

¹⁶ 516 F.3d at 1059-1060.

has not been construed to include investment losses),¹⁷ plaintiffs inevitably frame their cases as being brought derivatively as class actions on behalf of the plan under ERISA § 502(a)(2), 29 U.S.C. § 1132(a)(2). Because the ultimate relief sought is payment to the individual's account, and because these claims typically involve participant-directed plans in which the participant – not the plan or the fiduciary – decides where to invest the funds at issue, whether these cases and the claims therein can proceed as derivative class actions may be contested issues.

A. Relationship Between the ERISA Case and the Securities Fraud Case

The initial issues that arise relate to consolidation of the cases and coordination of discovery. The securities and ERISA cases (and any federally filed derivative cases) are typically combined and brought before one judge for coordinated or consolidated proceedings (referred to as being “MDL-ed”) because they arise out of a common nucleus of operative facts.¹⁸ The MDL panel also typically provides that the transferee judge maintains discretion to establish separate tracks for the ERISA cases.¹⁹ The Private Securities Litigation Reform Act (PSLRA) provides, however, that there “shall be” a stay of discovery in the securities case pending ruling on a motion to dismiss.²⁰ The transferee judge thus typically grants “ERISA-unique” discovery, while staying the rest of discovery pending resolution of the securities motion to dismiss.²¹ Depending on the

¹⁷ Although ERISA § 502(a)(3) is a “catch all” provision that allows for claims for individual relief for fiduciary breaches, *Varity Corp. v. Howe*, 516 U.S. 489, 507-15 (1996), § 502(a)(3) provides for only narrowly circumscribed equitable relief. *E.g.*, *Mertens v. Hewitt Assocs.*, 508 U.S. 248, 255-62 (1993); *Great-West Life & Annuity Ins. Co. v. Knudson*, 534 U.S. 204, 210-15 (2002). Because of this limitation, ERISA § 502(a)(3) has not been construed to provide a remedy for claimed investment losses. *E.g.*, *Coan v. Kaufman*, 457 F.3d 250, 263-64 (2d Cir. 2006) (claim invested 401(k) funds in funds that earned less than benchmark funds); *Rego v. Westvaco Corp.*, 319 F.3d 140, 144-45 (4th Cir. 2003); *Helfrich v. PNC Bank, Kentucky, Inc.*, 267 F.3d 477, 482-83 (6th Cir. 2001); *Kerr v. Charles F. Vatterott & Co.*, 184 F.3d 938, 945 (8th Cir. 1999).

¹⁸ *E.g.*, *In re WorldCom, Inc. Secs. & “ERISA” Litig.*, 226 F. Supp. 2d 1352, 1353-55 (J.P.M.L. Oct. 8, 2002); *see also Federal Ins. Co. v. Raytheon Co.*, 426 F.3d 491 (1st Cir. 2005) (applying a “substantial overlap” test to conclude an ERISA lawsuit fell within an ERISA fiduciary policy’s “prior and pending” litigation exclusion from the earlier securities litigation).

¹⁹ *E.g.*, *id.* at 1354-55.

²⁰ 15 U.S.C. § 78u-4(b)(3)(B).

²¹ *See, e.g., In re AOL Time Warner Inc. Secs. & “ERISA” Litig.*, 2003 WL 22227945 (S.D.N.Y. Sept. 26, 2003) (staying all non-ERISA-specific discovery so as to protect the PSLRA stay).

particular facts of the case, the court may lift the PSLRA stay as to documents produced to government agencies.²²

The consensus on how these coordinated cases shall be managed and tried is that the numerous distinctions between the securities fraud and ERISA cases (e.g., bench versus jury trial; fiduciary duties versus scienter issues) typically leads to separate but coordinated case tracks. The rulings to date include the following situations:

- Many plans use unitized employer stock funds,²³ in which, because of netting and aggregating, the participants' orders to buy or sell do not necessarily result in open market trades by the plan. Two courts have held or suggested that the individual participants were nonetheless "purchasers" under the securities laws and, therefore, entitled to share in the settlement proceeds based on those individual purchases.²⁴
- One court held that a final, court-approved securities settlement barred ERISA plaintiffs "from seeking additional damages related to the value of the stock for the time period covered by [the securities] lawsuit,"²⁵ whereas another has held that a securities settlement of claims based on "open market" purchases does not bar claims based on the employer match.²⁶
- A court approved an objector's modification to exclude ERISA claims from a proposed securities settlement, noting that plan fiduciaries may have breached fiduciary duties by not protecting the participants' interests in the securities settlement in the

²² See, e.g., *In re WorldCom Secs. Litig.*, 234 F. Supp. 2d 301, 304-06 (S.D.N.Y. 2002) (ordered discovery of documents produced to government agencies and creditors' committee and also noting documents would likely soon be in hands of ERISA plaintiffs). Cf. *In re AOL Time Warner Secs & "ERISA" Litig.*, 2003 WL 21729842, at *1 (S.D.N.Y. July 25, 2003) (rejecting same; no prejudice from stay where company is not in bankruptcy).

²³ Because unitization lowers transaction costs and allows participants to invest their money on the day of the fund exchange, most employer stock funds for publicly traded companies (some surveys suggest around 90%) are unitized.

²⁴ *Kurzweil v. Philip Morris Cos.*, 2001 WL 25700, at *3-4 (S.D.N.Y. Jan. 10, 2001); *Great Neck Capital Appreciation Investment P'ship v. Pricewaterhouse Coopers (In re Harnischfeger Indus., Inc. Secs. Litig.)*, 212 F.R.D. 400, 414 (E.D.Wis. 2002).

²⁵ *In re Waste Mgmt. Inc. Secs. Litig.*, 2003 WL 1463585, at *2 (N.D.Ill. Mar. 19, 2003).

²⁶ *Koch v. Dwyer*, 1999 WL 528181, at *12 (S.D.N.Y. July 22, 1999).

following ways: (i) the plan fiduciaries would have benefitted from the broadly worded securities release; (ii) the plan participants had nonfrivolous claims; and (iii) the plan fiduciaries failed to provide notice to the participants of the proposed securities settlement.²⁷

The Department of Labor (“DOL”) has also issued guidance in this area through its promulgation of a prohibited transaction class exemption (“PTCE”) for the release of claims related to litigation.²⁸ Although the DOL admits that it is unclear whether the settlement of claims in the ERISA or securities litigation would constitute a prohibited transaction, as commentators have noted, most defendants will comply with this exemption’s requirements because the point of settling claims is to end litigation, not to create new and novel issues to litigate.²⁹ The primary requirement imposed is that the plan must retain an independent fiduciary to review and approve the settlement of an ERISA case or a securities case if that settlement releases “parties in interest,” which include the company as employer and its directors and officers.³⁰

B. Fed. R. Civ. P. 9(b’s) “Plead Fraud With Particularity” Requirements For ERISA Fiduciary Claims

Employer stock cases are often predicated on alleged underlying securities fraud. On the *Fed. R. Civ. P. 9(b)* issue, the threshold issue is whether these are “disclosure” claims or whether they are “prudent investment” claims. If the claim arises out of fiduciary duties related to prudent investments, the courts often hold that only the “notice pleading” standard of *Fed. R. Civ. P. 8(a)* applies.³¹ Depending on the facts and theories alleged, the courts may hold that the

²⁷ *Great Neck P’ship*, 212 F.R.D. at 414.

²⁸ See 68 Fed. Reg. 75,632 (Dec. 31, 2003) (PTCE 2003-39).

²⁹ See Mark Machiz, Nell Hennessy, & Christopher Capuano, *Understanding the DOL’s New Class Exemption for the Release of Claims in Connection With Litigation*, 31 Pens. & Ben. Rep. (BNA) 2 (Jan. 13, 2004). What creates the potential prohibited transaction is the release of a claim by the plan against a party in interest, e.g., the company and its directors and officers. For the securities claim, the issue is whether the plan or the participants (as beneficial owners of the stock) are the ones with the securities claim; if it is only the participants who have a valid claim, there would be no prohibited transaction involved in settling with just them. *Id.* For the ERISA claim, the issue is whether the plan is actually releasing any claim, since the plan is not an enumerated party with standing to bring suits for fiduciary breaches. *Id.*

³⁰ 68 Fed. Reg. at 75,634-35; see also 72 Fed. Reg..

³¹ *E.g.*, *In re Beazer Homes USA, Inc.*, 2010 WL 1416150, at *3 (N.D.Ga. Apr. 2, 2010); *Stein v. Smith*, 270 F. Supp. 2d 157, 166-167 (D. Mass. 2003); *Vivien v. WorldCom, Inc.*, 2002 WL 31640557, at *5 (N.D.Cal. July 22, 2002).

disclosure claims sound in fraud and thus must meet *Fed. R. Civ. P.* 9(b)'s "plead fraud with particularity" requirement:

- *Examples of courts concluding Fed. R. Civ. P. 9(b) applies:* Crocker v. KV Pharmaceutical Co., -- F. Supp. 2d --, 2010 WL 1257671, at *23, 26 (E.D.Mo. Mar. 24, 2010) (holding that although word "fraud" was not pled, claims were still averments sounding in fraud and 9(b) applied); Harris v. Koenig, -- F. Supp. 2d --, 2010 WL 2560038 (D.D.C. June 10, 2010) (allegations sound in fraud and concealment where plaintiffs argue same in support of application of six year statute of limitations); *In re IKON Office Solutions Securities Litig.*, 86 F. Supp. 2d 481, 488-89 (E.D. Pa. 2000) (claim alleging "misled" participants or that "knowingly" participated in or undertook to conceal fiduciary breaches); Koch v. Dwyer, 1999 WL 528181, at *6 (S.D.N.Y. July 22, 1999) (claim alleging acted to conceal fiduciary breaches and that used fraudulently inflated numbers to value the stock sound in fraud); Cokenour v. Household Int'l, Inc., 32 EB Cas. 1783, 2004 WL 725973, at *8 (N.D.Ill. March 31, 2004) (claim alleging intentional misrepresentations); *In re General Motors ERISA Litig.*, 2006 WL 897444, at *13-16 (E.D.Mich. April 6, 2006) (apply Rule 9(b) to disclosure and misrepresentation claims); Rogers v. Baxter International, Inc., 417 F. Supp. 2d 974, 984-985 (N.D. Ill. 2006) (claims alleging breach of duty of loyalty); *In re Calpine Corp. ERISA Litig.*, 2005 WL 3288469 (N.D.Cal. Dec. 5, 2005); *In re Syncor ERISA Litig.*, 351 F. Supp. 2d 970, 977-978 (C.D. Cal. 2004) (applying FRCP 9(b) to claim fiduciaries were engaged in fraudulent conduct, but concluding allegations met this standard); *In re Westar Energy ERISA Litig.*, 2005 WL 2403832, at *26 to *28 (D.Kan. Sept. 29, 2005) (claims alleging misrepresentations and material omissions).
- *Examples of courts concluding Fed. R. Civ. P. 9(b) does not apply:* Howell v. Motorola, 337 F. Supp. 2d 1079, 1089 (N.D. Ill. 2004) (claim alleging negligent misrepresentation and failure to disclose); *In re Electronic Data Sys. Corp. "ERISA" Litig.*, 305 F. Supp. 2d 658, 672 (E.D. Tex. 2004) (FRCP 9(b) did not apply to claims of a breach of a duty to inform unless plaintiffs also plead it is part of a scheme to defraud); *In re Xcel Energy, Inc., Secs., Derivative & "ERISA" Litig.*, 312 F. Supp. 2d 1165, 1179 (D. Minn. 2004) (did not apply because the defendants' duty to act arose out of the adverse conditions that were concealed by the company's fraudulent conduct, not the alleged fraud); Smith v. Aon Corp., 2006 WL 1006052, at *6 (N.D.Ill. April 12, 2006) (Rule 9(b) not applicable to ERISA fiduciary claims); *In re Cardinal Health, Inc. ERISA Litig.*, 424 F. Supp. 2d 1002, 1015-1016 (S.D. Ohio 2006) (same); *In re Marsh ERISA Litig.*, 2006

WL 3706169, at *2 (S.D.N.Y. Dec. 14, 2006) (same); *Pietrangelo v. NUI Corp.*, 2005 WL 1703200, at *9 (D.N.J. July 20, 2005) (declining to apply Rule 9(b) unless breach is the fraudulent act itself); *In re Polaroid ERISA Litig.*, 362 F.Supp.2d 461, 469-470 (S.D. N.Y. 2005) (concluding that despite allegations of fraud, claim was for fiduciary breach).

Although the rulings are somewhat disparate, the distinction suggested in *In re Electronic Data Systems Corp. "ERISA" Litig.*³² and *In re Xcel Energy, Inc., Securities, Derivative & "ERISA" Litigation*³³ between alleging that the fiduciary breached a duty to disclose versus alleging that the fiduciary was himself engaged in fraudulent conduct when acting as a fiduciary (such as through *intentional* misrepresentations) may develop into a principled method for determining whether and when ERISA fiduciary claims are subject to *Fed. R. Civ. P.* 9(b).

C. Class Actions on Behalf of the Plan Under ERISA § 502(a)(2)

To open the remedies door to the “make whole” relief of Section 409 of ERISA, 29 U.S.C. § 1109, plaintiffs frame their 401(k) cases as class actions not brought on behalf of themselves, but rather derivatively on behalf of the plan under Section 502(a)(2) of ERISA, 29 U.S.C. § 1132(a)(2). However, the ultimate relief sought is an allocation to the participants’ individual accounts. Moreover, these claims typically involve participant-directed plans in which the participant – not the plan or the fiduciary – decides where to invest the money. Thus, the class members as the purported derivative plaintiffs for the plan are often engaging in the same conduct they are challenging, i.e., they are continuing to invest in the very stock they claim is allegedly imprudent and harmful to the plan.³⁴ In addition, ERISA § 404(c), 29 U.S.C. § 1104 (c), can provide a statutory safe harbor defense based on the individual participant’s direction of his investments,³⁵ while failure to meet this safe harbor does not mean a fiduciary is

³² 305 F. Supp. 2d 658, 672 (E.D.Tex. 2004).

³³ 312 F. Supp. 2d 1165, 1179 (D.Minn. 2004).

³⁴ In derivative suits, “[a] shareholder ordinarily will be estopped from suing derivatively if he has participated in the wrong complained of, ratified it, or acquiesced in it.” 7 C Wright, Miller & Kane, FEDERAL PRACTICE AND PROCEDURE, § 1834 p. 143 (2d Ed. 1986).

³⁵ *Cf. Wiseman v. First Citizens Bank & Trust Co.*, 212 F.R.D. 482, 487-88 and 215 F.R.D. 507, 510-11 (W.D.N.C. 2003) (class commonality and typicality requirements not met for participant-directed investments in 401(k) plan); *Thomas v. Aris Corp.*, 219 F.R.D. 338, 340-43 (M.D.Pa. 2003) (same; detrimental reliance not presumed on ERISA disclosure claims and possibility of § 404(c) defense renders each potential class member’s claims significantly different from and atypical of each other).

necessarily liable for a participant's investment choices.³⁶ ERISA itself has not been construed to have a fraud-on-the-market theory to provide presumed reliance for disclosure claims.³⁷ Thus, disclosure claims often raise a host of individualized issues regarding materiality and reliance; in addition, the disclosure claim is typically to the effect that the participants (not the plan) were misled regarding their investment decisions.³⁸ Not surprisingly, whether and how these cases and claims can proceed as derivative class actions can become hotly contested. Most courts concluded that releases may bar claims,³⁹ and courts have denied class certification because the class representative was inadequate,⁴⁰ e.g., in some cases the courts have concluded the plaintiff did not have standing because he/she sold his/her stock during the very period in which it is alleged the stock was artificially inflated, and thus suffered no requisite "injury-in-fact" from

³⁶ *Jenkins v. Yaeger*, 444 F.3d 916, 923-24 (7th Cir. 2006) (noting the ERISA § 404(c) regulation states it is simply a safe harbor, and concluding there is an implied exception that permits participants to be responsible for their own investment choices even if ERISA § 404(c) does not apply).

³⁷ Among other things, plaintiffs would have to prove that the SEC filings and other statements made to the market that caused the claimed fraudulent inflation were made in an ERISA fiduciary capacity. *E.g.*, *Pegram v. Herdrich*, 530 U.S. 211, 226 (2000) (threshold question in any claim of fiduciary breach is whether person was acting in a fiduciary capacity). Since these are invariably corporate communications, the causal tie between the claimed ERISA fiduciary breach and the alleged market inflation is missing.

³⁸ *E.g.*, *Lively v. Dynegy, Inc.*, 2007 WL 685861 (S.D.Ill. Mar. 2, 2007) (detrimental reliance not presumed on ERISA disclosure claims); *In re Electronic Data Systems Corp. "ERISA" Litig.*, 224 F.R.D. 613, 630 (E.D.Tex. 2004) (individualized nature of reliance inquiry precludes class disclosure claim), *rev'd other grounds*, *Langbecker v. Electronic Data Systems Corp.*, 476 F.3d 299 (5th Cir. 2007).

³⁹ *See, e.g.*, *Howell v. Motorola Inc.*, 2005 WL 2420410 (N.D.Ill. Sept. 30, 2005) (dismissing 401(k) case when named plaintiff signed release releasing ERISA claims); *Langbecker v. Electronic Data Systems Corp.*, 476 F.3d 299, 313 (5th Cir. 2007) (concluding releases can exclude participants from any recovery); *Ogden v. Americredit Corp.*, 225 F.R.D. 529, 537 at fn. 9 (N.D.Tex. 2005) (noting issue); *cf. Moore v. Comcast Corp.*, -- F.R.D. --, 2010 WL 1375462, at *4-5 (E.D.Pa. Apr. 6, 2010) (release did not preclude class certification and did not preclude named plaintiff from serving as class representative); *In re Williams Cos. ERISA Litig.*, 231 F.R.D. 416 (N.D.Okl. 2005) (allowing plaintiffs to cure by adding a named plaintiff who had signed a release); *Nelson v. IPALCO Enterprises, Inc.*, 2005 WL 1924332, at *4-*7 (S.D.Ind. Aug. 11, 2005) (concluding that release excluding benefits due under thrift plan did not release fiduciary breach claim for investments in employer stock).

⁴⁰ *See, e.g.*, *Ogden v. Americredit Corp.*, 225 F.R.D. 529 (N.D.Tex. 2005) (finding that class representative in employer stock was inadequate because of lack of knowledge and basic understanding of lawsuit).

the claimed fiduciary breach.⁴¹ In two circuit court opinions, the Second Circuit in *Coan v. Kaufman*⁴² and the Fifth Circuit in *Langbecker v. Electronic Data Systems Corp.*,⁴³ have suggested that the due process concerns embodied in the *Federal Rules of Civil Procedure* impose limits on a plaintiff's ability to pursue claims "on behalf of the plan" absent protection of the interests of the absent plan participants.

Finally, on the issue whether claims affecting a subset of participants may be brought on behalf of the plan, the Supreme Court answered yes in *LaRue v. DeWolff, Boberg & Associates, Inc.*⁴⁴ In *LaRue*, the Court unanimously held that ERISA § 502(a)(2) does permit a plaintiff to bring a suit to recover for breaches of fiduciary duty that impair the value of plan assets allocated to a participant's individual account. The plaintiff was a participant in his employer's 401(k) plan, which permitted him to direct his investment among a menu of investment options. The plaintiff alleged that the plan fiduciaries breached their duties by failing to carry out his investment instructions, resulting in a loss of \$150,000 to his individual account.⁴⁵ In concluding that this stated a claim under ERISA § 502(a)(2), the Court distinguished between claims brought by participants in defined benefit plans as opposed to those brought by participants in defined contribution plans.⁴⁶ In the defined contribution plan context, the Court reasoned that fiduciary errors affecting plan assets do not need to threaten the entire plan's solvency to cause a participant to lose benefits, and thus an ERISA § 502(a)(2) claim may be proper.⁴⁷ The Court made clear, however, that its ruling did not

⁴¹ Taylor v. KeyCorp., 2010 WL 3702423, at *3-5 (N.D. Ohio Aug. 12, 2010); Brown v. Medtronic, 619 F. Supp. 2d 646, 650-651 (D. Minn. 2009); *In re Boston Scientific Corp. ERISA Litig.*, 254 F.R.D. 24, 30 (D. Mass. 2008). *But see* Moore v. Comcast Corp., -- F.R.D. --, 2010 WL 1375462, at *3-4 (E.D. Pa. Apr. 6, 2010) (named plaintiff still could have suffered injury in fact despite sale of stock options during alleged period of artificial inflation); Patten v. Northern Trust Co., 703 F. Supp. 2d 799, 806-8 (N.D. Ill. 2010) (same).

⁴² 457 F.3d 250 (2d Cir. 2006).

⁴³ 476 F.3d 299 (5th Cir. 2007).

⁴⁴ 128 S.Ct. 1020 (Feb. 20, 2008). The Seventh Circuit applied *LaRue* in the employer stock drop context in *Rogers v. Baxter Inter'l., Inc.*, 521 F.3d 702, 705 (7th Cir. 2008), to hold that participants who suffered an alleged loss with respect to their individual account holdings of employer stock may bring suit under ERISA § 502(a)(2) even though not all accounts in the plan suffered a loss as a result of the alleged breach of fiduciary duty.

⁴⁵ *Id.* at 1022-23.

⁴⁶ *Id.* at 1025-26.

⁴⁷ *Id.* See also *Rogers v. Baxter Int'l., Inc.*, 521 F.3d 702 (7th Cir. 2008).

determine whether defenses such as exhaustion may apply to this claim,⁴⁸ while the concurrence stated it is an open issue whether claims based on rights arising under the plan terms (the right to direct plan assets came from the plan) may be required to be brought as a claim for benefits under ERISA § 502(a)(1)(B).⁴⁹

II. SUBSTANTIVE ISSUES COMMON TO DISCLOSURE/VARIETY AND THE PRUDENT INVESTMENT CLAIMS

A. Damages and Duties in Light of the Securities Laws “Disclose or Abstain” Rules

Plaintiffs often predicate their ERISA cases on underlying allegations of securities fraud, including claiming that employer stock was an imprudent plan investment because it was allegedly inflated through fraud. Although these allegations often lend emotional appeal to the ERISA case, they create a thorny thicket of damage and duty issues that are still only beginning to be played out. On their own terms, these “inflated through fraud” claims run up against the fact that *no one* – the courts, the DOL, or the Securities Exchange Commission (“SEC”)⁵⁰ – would allow fiduciaries or participants to trade while in the possession of material, nonpublic information.⁵¹ This is known as the securities

⁴⁸ 128 S.Ct. at 1024 n. 3.

⁴⁹ *Id.* at 1027-28 (C.J. Roberts, concurrence).

⁵⁰ The DOL notes this in its preamble to its § 404(c) regulation. 57 F.R. 46906, 46923 (October 13, 1992). The courts are in accord. *E.g.*, *In re McKesson HBOC Inc. ERISA Litig.*, 2002 WL 31431588, at *6 (N.D.Cal. Sept. 30, 2002) (plan fiduciaries cannot trade on material, adverse, nonpublic information), 391 F. Supp. 2d 812, 837-38 (N.D. Cal. 2005) (same); *Hull v. Policy Management Systems Corp.*, 2001 WL 1836286, at *9 (D.S.C. Feb. 9, 2001) (same). The SEC has long held fiduciaries cannot use their fiduciary duties to justify trading on inside information. *In re Cady, Roberts & Co.*, 40 SEC 907, 1961 WL 59902, at *6 (Nov. 8, 1961).

⁵¹ The courts have also generally rejected the notion plan participants or fiduciaries are entitled to have access to inside information. *See Edgar v. Avaya, Inc.*, 503 F.3d 340, 349-351 (3d Cir. 2007) (no fiduciary duty to provide participants with inside corporate developments in advance of public earnings announcements and securities filings); *Rogers v. Baxter Int’l, Inc.*, 521 F.3d 702, 706 (7th Cir. 2008) (suggesting same); *Nelson v. Hodowal*, 512 F.3d 347 (7th Cir. 2008) (holding no affirmative duty to provide participants with inside information as to executives’ company stock sales); *Fisher v. JP Morgan Chase & Co.*, 703 F. Supp. 2d 374, 386-87 (S.D.N.Y. 2010) (no affirmative duty to disclose nonpublic information); *In re Bank of America Securities, Derivative & ERISA Litig.*, 2010 WL 3448197, at *23 (S.D.N.Y. Aug. 27, 2010) (same); *Gearren v. McGraw-Hill Cos., Inc.*, 690 F. Supp. 2d 254, 271-72 (S.D.N.Y. 2010) (no affirmative duty to disclose financial information); *In re Wachovia Corp. ERISA Litig.*, 2010 WL 3081359, at *16 (W.D.N.C. Aug. 6, 2010) (same); *Fisher v. JP Morgan Chase & Co.*, 703 F. Supp. 2d 374, 386-87 (S.D.N.Y. 2010) (same); *Harris v. Amgen, Inc.*, 2010 WL 744123, at *13 (C.D.Cal. Mar. 2, 2010) (same); *Herrera v. Wyeth*, 2010 WL 1028163, at

laws' "disclose or abstain" rule, which prohibits a fiduciary or participant from trading prior to disclosure of this information to the market. Thus, absent disclosure, the fiduciaries and participants are prohibited from trading, but once the disclosure is made, they suffer the same loss as the stock falls to its "true price" on the disclosure of the alleged fraud.⁵² Inflated-through-fraud claims also raise issues as to the proper method for measuring damages,⁵³ and whether "loss causation" requirements may apply to such claims.⁵⁴

*7 (S.D.N.Y. Mar. 17, 2010) (same); *Patten v. Northern Trust Co.*, 703 F. Supp. 2d 799, 813-14 (N.D.Ill. 2010) (same); *In re Bausch & Lomb, Inc. ERISA Litig.*, 2008 WL 5234281, at *8-*9 (W.D.N.Y. Dec. 12, 2008) (no affirmative duty under ERISA to disclose non-public information with participants); *Banks v. Healthways, Inc.*, 2009 WL 211137, at *3-4 (M.D. Tenn. Jan. 28, 2009) (dismissing claim for nondisclosure of company stock information to the extent it was based on information that was non-public or not required to be disclosed under ERISA); *Sims v. First Horizon Nat'l Corp.*, 2009 WL 3241689, at *25-28 (W.D. Tenn. Sept. 30, 2009) (same); *In re Citigroup ERISA Litig.*, 2009 WL 2762708, at *20-25, *26 (S.D.N.Y. Aug. 31, 2009) (same); *Shirk v. Fifth Third Bancorp.*, 2009 WL 692124, at *16-19 (S.D. Ohio Jan. 29, 2009) (same). *See also* SEC Release Nos. 33-7881 & 34-43154 at Part III (A)(2) (Final Rule Selective Disclosure and Insider Trading), 2000 WL 1201556, at *24 (Oct. 23, 2000) (cannot influence the buying or selling of shares by a plan while in the possession of material, non-public information). *But see* *Brieger v. Tellabs*, 629 F. Supp. 2d 848, 865-866, 46 EB (BNA) Cases (BNA) 2569 (N.D. Ill. June 1, 2009) (although the court dismissed plaintiff's disclosure and misrepresentation claims after trial, the court rejected defendants' argument that the investment committee was unable to disclose certain information out of fear of violating securities laws, because allowing it would have permitted violation of ERISA under guise of complying with another statute when other option might exist).

⁵² *See* *Edgar v. Avaya, Inc.*, 503 F.3d 340, 349-351 (3d Cir. 2007); *McKesson HBOC*, 2002 WL 31431588, at *6; *Cokenour v. Household Int'l, Inc.*, 2004 WL 725973, at *5 (N.D.Ill. Mar. 31, 2004) (denying motion to dismiss but noting problems with such claims); *cf., e.g., In re Enron Corp. Securities, Derivative & ERISA Litig.* (Tittle v. Enron Corp.), 284 F. Supp. 2d 511, 565-67 (S.D.Tex. 2003) (participants have no right to profit from inside information, but fiduciaries' public disclosures of fraud may have prevented further harm); *Pietrangelo v. NUI Corp.*, 2005 WL 173200, at *4 (D.N.J. July 20, 2005) (concluding this raises fact issues regarding damages and causation inappropriate to resolve in a motion to dismiss); *In re Honeywell Int'l ERISA Litig.*, 2004 WL 3245931 at *12 (D.N.J. June 14, 2004) (same; plan may have been able to avoid loss by stopping future purchases); *Gee v. UnumProvident Corp.*, 2005 WL 534873, at *14-15 (E.D.Tenn. Jan. 13, 2005) (same); *In re JDS Uniphase Corp. ERISA Litig.*, 2005 WL 1662131, at *9 (N.D.Cal. July 14, 2005) (same; distinguishing between a divesture claim and one based on continued investment).

⁵³ *Cf.* RESTATEMENT (SECOND) TRUSTS, § 205, comment (e) (when claim fiduciary breached duties by paying too much for an asset, damages are measured by the difference in price between what was paid and what should have been paid); *Donovan v. Bierwirth*, 754 F.2d 1049, 1055 (2d Cir. 1985) (citing RESTATEMENT (SECOND) TRUSTS § 205, comment (e) as controlling when ERISA claim is that stock price was inflated or manipulated from hidden information).

B. Directors and Officers and the Duty to Monitor

Even when they do not sit on plan committees, directors and officers are often named in employer stock litigation if they appoint committee members. This is the “duty to monitor” claim, which asserts that the directors or officers breached their duties regarding the monitoring of those appointees. This is often properly viewed as a derivative or secondary claim; if there was no breach by the appointee, there was nothing to monitor and correct. This duty to monitor claim is also often coupled with co-fiduciary claims made against all defendants.⁵⁵

In *Woods v. Southern Co.*,⁵⁶ a district court rejected an attempt to use plan terms to avoid this claim. In *Woods*, the plan was amended to name the various employment positions (e.g., V.P. of HR) that would be fiduciaries.⁵⁷ The court reasoned that because the person hired for that position has fiduciary duties, the hiring decision (and the monitoring of that person’s job performance) triggers fiduciary duties on the part of the company/employer.⁵⁸

The first question is whether a person’s mere status as a director or officer makes the person a fiduciary. The answer is no. Plaintiffs must show something more: (1) that an officer or director was appointed as a fiduciary for the fiduciary conduct at issue, or (2) that the officer or director *exercised* discretionary authority or control over the fiduciary conduct at issue.⁵⁹ If, however, a director

⁵⁴ See *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 125 S.Ct. 1627 (2005); cf. *Nelson v. Hodowal*, 512 F.3d 347, 351 (7th Cir. 2008) (suggesting loss causation requirements may apply to ERISA claim).

⁵⁵ The co-fiduciary claim arises under § 405(a) of ERISA, 29 U.S.C. § 1105(a). Under § 405(a)(1) and (a)(3) the plaintiffs must prove that the fiduciary had actual knowledge of the breach by the other fiduciary and either knowingly (i) participated in, (ii) undertook to conceal, or (iii) failed to take reasonable efforts to remedy the breach. Under § 405(a)(2) plaintiffs must show that the fiduciaries own breach enabled another fiduciary to commit a breach. See, e.g., *In re Sprint Corp. ERISA Litig.*, 33 EB Cas. 2196, 2004 WL 2182186, at * 4 to *6 (D.Kan. Sept. 24, 2004) (refusing to dismiss co-fiduciary claims against directors who appointed plan committees).

⁵⁶ 396 F. Supp. 2d 1351, 1371-72 (N.D.Ga. 2005).

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ E.g., *In re WorldCom Inc. ERISA Litig.*, 263 F. Supp. 2d 745, 757-58 (S.D.N.Y. 2003); *Henry v. Champlain Enters., Inc.*, 288 F. Supp. 2d 202, 222 (N.D.N.Y. 2003) (director not fiduciary for ESOP transaction simply because of status as director), *reversed and remanded on other grounds*, 445 F.3d 610 (2d Cir. 2006); *In re RCN Litig.*, No. 04 Civ. 5068, 2006 WL 753149, at *5 (D.N.J. Mar. 21, 2006) (concluding that

or officer appoints plan committee members,⁶⁰ then plaintiffs typically argue that this appointment power encompasses a “duty to monitor” that itself imposes some latent duty regarding plan disclosures and plan investments. Courts have construed these duties narrowly and have generally rejected the contention that the appointment of fiduciaries makes one responsible for the disclosure or investment functions of those appointees.⁶¹ The courts, however, generally have concluded that the duty to appoint encompasses some form of a duty to monitor those appointees, and have been reluctant to define the precise contours of this duty at the motion to dismiss stage.⁶²

the compensation committee, a subset of the board of directors, was not a fiduciary as per the plan documents, and thus plaintiffs must show they exercised fiduciary function); *In re Calpine Corp. ERISA Litig.*, 2005 WL 1431506, at *3 (N.D.Cal. Mar. 31, 2005) (directors not fiduciaries simply because of status as directors; must show they also exercised fiduciary function); *In re AOL Time Warner, Inc. Secs. and ERISA Litig.*, 2005 WL 563166, at *4 (S.D.N.Y. Mar. 10, 2005) (same for officers); *Sommers Drug Employee Profit Sharing Plan v. Corrigan Enters.*, 793 F.2d 1456, 1459-60 (5th Cir. 1986) (cannot infer from that one is fiduciary from status as officer or director that controlled decisions and actions of the appointed fiduciaries); *Cosgrove v. Circle K Corp.*, 884 F. Supp. 2d 350, 353 (D.Ariz. 1995) (CEO’s involvement in transaction on behalf of employer who was purchasing assets from the plan does not make him a fiduciary unless he sought to unduly influence or dominate trustees’ decision).

⁶⁰ A director or officer can undertake duties beyond the mere appointment and removal of fiduciaries. *See Rankin v. Rots*, 278 F. Supp. 2d 853, 871-72 (E.D.Mich. 2003) (court relied on plan terms that did not clearly allocate fiduciary authority and imposed duties on directors greater than the duty to appoint and remove fiduciaries); *Newton v. Van Otterloo*, 756 F. Supp. 1121, 1130-32 (N.D.Ind. 1991) (CEO became fiduciary by influencing ESOP committee’s actions); *Keach v. United States Trust Co.*, 234 F. Supp. 2d 872, 882-83 (C.D.Ill. 2002) (although nominally only appointed ESOP trustee, corporate officers may have exercised “de facto” control over transaction because, among other things, they conceived of concept, solicited valuation opinions, set up structure of transaction, and appointed new trustee to put transaction in place).

⁶¹ *See, e.g., Crowley v. Corning, Inc.*, 234 F. Supp. 2d 222, 229-30 (W.D.N.Y. Dec. 9, 2002), *aff’d on motion to amend*, 2004 WL 763873 (W.D.N.Y. Jan. 14, 2004) (directors’ fiduciary powers limited to appointing, retaining, and removing committee members and these powers do *not* include the power to control investment options or to communicate plan information); *In re Williams Cos. ERISA Litig.*, 271 F. Supp. 2d 1328, 1338-39 (N.D.Okla. 2003), *reconsideration denied*, 2003 WL 22794417, at *1 n. 1 (N.D.Okla. Oct. 27, 2003) (same); *In re Sprint Corp. ERISA Litig.*, 2004 WL 1179371, at *17-18 (D.Kan. May 27, 2004) (same); *In re Dynegy Inc. ERISA Litig.*, 309 F. Supp. 2d 861, 900-04 (S.D.Tex. 2004) (same; absent allegations exercised *de facto* control over appointees or participated in or had notice of breaches by appointees, fiduciary duty is limited to power to appoint and remove); *In re JDS Uniphase Corp. ERISA Litig.*, 2005 WL 1662131, at *3-5 (N.D.Cal. July 14, 2005) (same).

⁶² *See e.g., In re RCN Litig.*, No. 04 Civ. 5068, 2006 WL 753149, at *5 (D.N.J. Mar. 21, 2006) (concluding that plaintiffs’ allegations concerning the company and board of

The DOL itself has provided mixed guidance in this area, with its overarching view being that the appointing fiduciary must follow some type of procedure to periodically review the performance of the appointee.⁶³ Within limits, the courts generally have followed this guidance.⁶⁴ When courts have recognized a *breach* of any duty to monitor, it has generally been in the context of the appointing fiduciary knowing of and participating in fraud or self-dealing.⁶⁵

directors' duty to monitor were sufficient to withstand a motion to dismiss); *Howell v. Motorola*, 337 F. Supp. 2d 1079, 1097-99 (N.D.Ill. 2004) (concluding that plaintiffs' allegations concerning defendants' duty to monitor were sufficient to withstand a motion to dismiss); *In re Electronic Data Sys. Corp. "ERISA" Litig.*, 305 F. Supp. 2d 658, 671 (E.D.Tex. 2004) (concluding that although the duty to monitor appointees is of a limited scope, at the motion to dismiss stage the court will not define the scope of this duty); *Kling v. Fidelity Mgmt. Trust Co.*, 323 F. Supp. 2d 132, 142-45 (D.Mass. 2004) (appointment power includes a duty to monitor; may also be liable as co-fiduciary for breaches of appointees); *Cokenour v. Household Int'l, Inc.*, 2004 WL 725973, at *8-9 (N.D.Ill. Mar. 31, 2004) (denying a motion to dismiss to the extent that the claim was based on the fiduciaries' duty to monitor the investment and administrative committees, but rejecting any claim that they had a duty to disclose information to the committees); *In re ADC Telecomms. Inc. ERISA Litig.*, 2004 WL 1683144, at *7 (D.Minn. July 26, 2004) (finding that plaintiffs' "broad allegations under the rubric of the ill-defined and limited duty to monitor" were sufficient to withstand a motion to dismiss); *In re JDS Uniphase Corp. ERISA Litig.*, 2005 WL 1662131, at *10 (N.D.Cal. July 15, 2005) (concluding that plaintiffs' allegations concerning defendants' duty to monitor were sufficient to withstand a motion to dismiss); *In re Syncor ERISA Litig.*, 351 F.Supp.2d 970, 984-85 (C.D.Cal. 2004) (holding that defendants cannot escape a duty to monitor by stating that the underlying administrative committee complied with the plan terms).

⁶³ See 29 C.F.R. § 2509.75-8 (compare D-4 Q & A (stating "appoint and remove" liability is limited to just those duties) with FR-17 Q & A (suggesting there is some duty at reasonable intervals to check the performance of the appointed fiduciary)).

⁶⁴ *In re Westar, Inc., Energy ERISA Litig.*, 2005 WL 2403832, at *23-25 (D.Kan. Sept. 29, 2005) (applying same); *Cf. In re Williams Cos. ERISA Litig.*, 2003 WL 22794417, at *1 n. 1 (N.D.Okla. Oct. 27, 2003) (rejecting DOL's amicus claim that directors as appointing fiduciaries have continuous duty to monitor appointees); *Newton v. Van Otterloo*, 756 F. Supp. 1121, 1132 (N.D.Ind. 1991) (no breach of duty to monitor appointees absent notice of "possible misadventure" by appointees).

⁶⁵ See *Leigh v. Engle*, 727 F.2d 113, 133-36 (7th Cir. 1984) (discretionary authority over selection and retention of plan fiduciaries includes duty to monitor activities and to act when knew of and profited from use of plan assets to support corporate control contests). For other examples of the "knowledge of fraud" problems, see *Canale v. Yegan*, 782 F. Supp. 963, 967-69 (D.N.J. 1992) (fiduciaries have duty to act, including suing themselves, based on fraud they committed in their corporate roles); *In re Enron Corp. Secs., Derivative & "ERISA" Litig. (Tittle v. Enron Corp.)*, 284 F. Supp. 2d 511, 660-662 (S.D.Tex. 2003) (fiduciaries cannot ignore or conceal internal warnings of massive fraud at the company).

Although the rule remains that a director's or officer's appointment power does not generally trigger a fiduciary duty to disclose,⁶⁶ this rule is subject to challenge in two circumstances. The first involves allegations of potential self-dealing or undue influence over the fiduciaries. For example, one court concluded that a director/CEO may have been a fiduciary with disclosure obligations by exercising "*de facto*" control over an ESOP transaction involving the purchase of his shares, as he conceived of the concept, solicited the ESOP valuation opinions, set up the structure of the transaction, and appointed the new trustee to put in place the transaction.⁶⁷ The second involves substantial factual allegations that the director or officer, who is a fiduciary for some purpose (e.g., either by appointing fiduciaries or by becoming a *de facto* fiduciary), either knew of or participated in massive fraud that harmed the plan.⁶⁸

⁶⁶ See, e.g., *In re Williams Cos. ERISA Litig.*, 271 F. Supp. 2d 1328, 1339 (N.D.Okla. 2003) (directors had no duty to communicate plan information); *Crowley v. Corning, Inc.*, 234 F. Supp. 2d 222, 229-30 (W.D.N.Y. 2002), *aff'd on motion to amend*, 2004 WL 763873 (W.D.N.Y. Jan. 14, 2004) (directors' limited appointment fiduciary duties do not include power to control investment options or to communicate plan information); *Hull v. Policy Mgmt. Sys. Corp.*, 2001 WL 1836286, at *4-8 (D.S.C. Feb. 9, 2001) (director's duty to appoint does not extend to duties to disclose); *In re Dynegy Inc. ERISA Litig.*, 309 F. Supp. 2d 861, 900-04 (S.D.Tex. 2004) (absent allegations defendant exercised *de facto* control over appointees or participated in or had notice of breaches by appointees, fiduciary duty is limited to power to appoint and remove). Some courts, however, have also allowed these claims to go forward because of the low pleading standards applied to a motion to dismiss. See *In re Electronic Data Sys. Corp. ERISA Litig.*, 305 F. Supp. 2d 658, 672 (E.D.Tex. 2004); *Pennsylvania Fed.*, 2004 WL 228685, at *5.

⁶⁷ See *Keach v. United States Trust Co.*, 234 F. Supp. 2d 872, 882-83 (C.D.Ill. 2002). The court found after trial that the CEO and other *Keach* defendants did not commit a fiduciary breach. *Keach v. United States Trust Co.*, 313 F. Supp. 2d 818 (C.D. Ill. 2004), *aff'd*, 419 F.3d 626 (7th Cir. 2005).

⁶⁸ See *Community Bancshares v. Patterson*, 547 F. Supp. 2d 1230 (N.D.Ala. 2008) (ESOP fiduciary breached fiduciary duty by not informing other fiduciaries of his fraud while ESOP fiduciary and CEO of the company); *In re WorldCom, Inc. ERISA Litig.*, 263 F. Supp. 2d 745, 764-65 (S.D.N.Y. 2003) (CEO not assumed to have forgotten information he learned in his corporate role and has duty to tell other fiduciaries of material information he had as to the prudence of investing in employer securities); *Rankin v. Rots*, 278 F. Supp. 2d 853, 873-78 (E.D.Mich. 2003) (adopting *WorldCom* analysis); *In re Sears, Roebuck & Co. ERISA Litig.*, 2004 WL 407007, at *6 (N.D.Ill. Mar. 3, 2004) (adopting *WorldCom* analysis); *Dynegy Inc.*, 309 F. Supp. 2d at 879-82 (adopting *WorldCom* analysis); *Enron Corp.*, 284 F. Supp. 2d at 555-67 (special circumstances and extreme impact of Enron fraud may have triggered duties to disclose; no conflict with securities laws because should make as part of public disclosure to correct the fraud).

C. Company Status as a Plan Fiduciary

Whether a company is a plan fiduciary ought to be determinable simply by looking to the plan language. If the company is named a fiduciary as to the matters at issue in the complaint, it is a fiduciary; if it is not so named, it is not. Plaintiffs, however, have pursued aggressively theories asserting the company is a fiduciary, with the most common one being that the company is such under *respondeat superior* principles for the fiduciary acts of its directors, officers, or employees. The U.S. Supreme Court held, however, in *National Labor Relations Board v. Amax Coal Co.*,⁶⁹ that when an employee is acting in a fiduciary capacity, that employee is barred by law from acting as an agent or representative of the employer. Simply put, when a director, officer, or employee puts on his fiduciary “hat” to act in a fiduciary capacity, he is *not* acting as an agent or representative of or on behalf of the employer.⁷⁰

Despite the clarity of the *Amax Coal* ruling, and despite the fact that this fiduciary/corporate distinction is a fundamental structural part of ERISA, the courts have struggled with this issue in employer stock litigation, reaching widely disparate results.⁷¹ Much of this confusion seems to be caused by failing to

⁶⁹ 453 U.S. 322, 331-32 (1981).

⁷⁰ *Id.*

⁷¹ Compare *In re Bank of America Corp. Securities, Derivative and ERISA Litig.*, 2010 WL 3448197, at *13 (S.D.N.Y. Aug. 27, 2010) (dismissing *respondeat superior* claim for failure to plead sufficient facts that company exercised *de facto* control over ERISA fiduciary employees); *In re Beazer Homes USA, Inc. ERISA Litig.*, 2010 WL 1416150, at *5 (N.D.Ga. Apr. 2, 2010) (dismissing *respondeat superior* claim as not cognizable under ERISA); *In re Bausch & Lomb, Inc. ERISA Litig.*, 2008 WL 5234281, at *11 (W.D.N.Y. Dec. 12, 2008) (dismissing *respondeat superior* claim because no primary breach claim survived dismissal and holding that Second Circuit does not recognize a *respondeat superior* fiduciary claim); *Halaris v. Viacom, Inc.*, 2008 WL 3855044 (N.D.Tex. Aug. 19, 2008) (holding that company was improper party because plaintiffs failed to allege sufficiently that company was *de facto* fiduciary); *In re Williams Cos. ERISA Litig.*, 271 F. Supp. 2d 1328, 1337-38 (N.D.Okla. 2003) (rejecting claim that a company was a fiduciary because board was allegedly an agent of the company), with *DiFelice v. US Airways, Inc.*, 397 F. Supp. 2d 758 (E.D.Va. 2005) (concluding co-fiduciary liability provisions of § 405(a) of ERISA, 29 U.S.C. § 1105(c), not common law agency principles, define whether a company is liable for the acts of its employees); *Graden v. Conexant Systems, Inc.*, 574 F. Supp. 2d 456, 469-70 (D.N.J. 2008) (permitting claim to survive low pleading threshold because sufficient facts stated that plan sponsor may have exercised authority and control with plan administration and plan assets); *In re AOL Time Warner, Inc. Secs. and ERISA Litig.*, 2005 WL 563166, at *4 & fn.4 & 5 (S.D.N.Y. Mar. 10, 2005) (rejecting *respondeat superior* theory, but finding allegation that company exercised “ultimate control” over fiduciary functions sufficient); *Smith v. Delta Air Lines, Inc.*, 422 F. Supp. 2d 1310 (N.D.Ga. 2006) (same); *Kling v. Fidelity Mgmt. Trust Co.*, 323 F. Supp. 2d 132, 146-47 (D.Mass. 2004) (concluding *respondeat superior* liability applies); *In re Cardinal Health, Inc. ERISA Litig.*, 424 F.

distinguish the “who is a fiduciary” inquiry from the “who pays for the breach” issue.⁷² Notably, a more principled approach to this issue was stated long ago by the Fifth Circuit in *Sommers Drug Employee Profit Sharing Plan v. Corrigan Enterprises*:⁷³ A party does not become the fiduciary for the acts of another *unless* that party usurps the fiduciary function by exercising de facto control over it.

D. Directed Trustees and Plan Investments in Employer Stock

Section 403(a) of ERISA, 29 U.S.C. § 1103(a), requires all assets of a pension plan to be held in trust by a trustee. Section 403(a)(1) of ERISA, 29 U.S.C. § 1103(a)(1), however, allows a plan to designate the trustee as a “directed trustee” – i.e., the trustee is relieved of discretionary fiduciary duties regarding plan assets as long as the trustee is following “proper direction.” This approach allows plan assets to be under the custody and control of qualified, independent financial institutions, without subjecting the plan and its participants to the significant expense that would otherwise arise from the trustee being subjected to the full panoply of ERISA fiduciary duties.

Supp. 2d 1002 (S.D. Ohio 2006) (same); *Dynegey Inc.*, 309 F. Supp. 2d at 904-06 (assuming company a fiduciary because its directors act in a fiduciary capacity and attributing knowledge of plan committee members fiduciary conduct to corporation because they are its agents); *Howell v. Motorola, Inc.*, 337 F. Supp. 2d 1079, 1093-95 (N.D. Ill. 2004) (denying motion to dismiss on the *respondeat superior* theory that the company exercised control over committee members); *In re Reliant Energy ERISA Litig.*, 336 F. Supp. 2d 646, 657-58 (S.D. Tex. 2004) (denying motion to dismiss on *respondeat superior* theory that company exercised *de facto* control over benefit committee members, but dismissing plaintiff’s conclusory allegation that company was a fiduciary because its board is allegedly a fiduciary); *In re Tyco International, Ltd. MDL*, No. 02-1335-PB, 2004 U.S. Dist. LEXIS 24272, at *14-16 (D.N.H. Dec. 2, 2004) (concluding employer could be liable for fiduciary breaches of its employees under certain circumstances, thus denying defendants’ motion to dismiss to develop a factual record).

⁷² The majority view is that ERISA imposes personal liability for a breach. *See Kayes v. Pacific Lumber Co.*, 51 F.3d 1449, 1461-68 (9th Cir. 1995) (ERISA imposes personal liability); *Muscemi v. Schwegmann Giant Super Markets*, 332 F.3d 339, 350-51 (5th Cir. 2003) (same). *But see Confer v. Custom Eng’g. Inc.*, 952 F.2d 34, 36-38 (3d Cir. 1991) (individual officers not personally liable when acting through corporate form). The ERISA duty does not negate duties corporations may owe under corporate by-laws and corporate law to indemnify an individual fiduciary for this liability; moreover, the use of company (not plan) funds to indemnify a breach generally does not implicate ERISA. 29 C.F.R. § 2509.75-4; *but see* 572 F.3d 1067, 47 EB (BNA) Cases 1449 (9th Cir. 2009) (affirming injunction barring corporate indemnification when wholly owned ESOP company was in liquidation with funds held in escrow to distribute to the participants – using these funds to pay indemnification was “tantamount” to using plan funds).

⁷³ 793 F.2d 1456, 1459-60 (5th Cir. 1986).

Courts nonetheless struggled with whether and how directed trustees fit within ERISA fiduciary obligations regarding investments in employer stock.⁷⁴ This uncertainty led to plaintiffs routinely adding directed trustees (typically large financial institutions) as named defendants to employer stock lawsuits. On December 17, 2004, however, the DOL issued guidance articulating its views on the duties of a directed trustee in relation to plan investments in publicly traded employer stock.⁷⁵ The DOL's guidance states that it believes directed trustees are fiduciaries, but with "significantly narrower" duties than discretionary trustees based on ERISA § 403(a), which statutorily requires a directed trustee to follow directions that are "proper."⁷⁶ Pursuant to ERISA § 403(a)(1), a direction is "proper" if it is "made in accordance with the terms of the plan,"⁷⁷ and "not contrary to [ERISA]." In determining whether the direction is "not contrary to ERISA," the DOL notes that a directed trustee does not have an independent obligation to determine or second-guess the prudence of every direction.⁷⁸ Rather, the DOL limits a directed trustee's duty to question directions to narrowly circumscribed circumstances, depending on whether the directed trustee is in the possession of material, non-public information.⁷⁹

In the unusual circumstance in which a directed trustee does possess material, non-public information on a company, the DOL opines that the directed trustee has a duty to inquire into whether the named fiduciary knows of and has

⁷⁴ Courts have also struggled with the scope of a directed trustee's duties in the context of traditional ESOP transactions, such as those involving purchases of stock from company insiders. *See* *Beam v. HSBC Bank USA*, 2003 WL 22087589, at *2-3 (W.D.N.Y. Aug. 19, 2003) (ESOP stock sale by insiders three years before company went bankrupt; denied motion pending further discovery on what directed trustee knew or should have known). *Cf.* *Beachum v. Rockford Prods. Corp.*, 2003 WL 1562561, at *2 (N.D.Ill. Mar. 24, 2003) (because directed trustee did not have responsibility or authority over ESOP transaction and employer stock the directed trustee is not a fiduciary for those activities; motion to dismiss granted).

⁷⁵ DOL Field Assistance Bulletin No. 2004-03 (Dec. 17, 2004) (Fiduciary Responsibilities of Directed Trustees).

⁷⁶ *Id.* at p. 2.

⁷⁷ Regarding the "consistent with plan terms" provision, the DOL stated that the directed trustee has a duty to request and review all of the documents and instruments governing the plan relevant to the directed trustee's duties. If the relevant plan documents are ambiguous, the directed trustee should request a clarification from the fiduciary responsible for interpreting the plan; and if the directed trustee does so, it may rely on that interpretation. *Id.* at p. 3.

⁷⁸ *Id.* at p. 4.

⁷⁹ *Id.*

considered this information.⁸⁰ The DOL uses as illustrations a directed trustee's knowledge of non-public facts or non-public analysis demonstrating that the company's financial statements are materially false or inaccurate.⁸¹ The DOL further states, however, that this knowledge will *not* be imputed across an organization if the organization maintains procedures designed to prevent the illegal disclosures of such information under securities, banking, or other laws.⁸² Regarding the far more common situation in which a directed trustee is *not* privy to material, non-public information, the DOL fully embraced the principle that the markets are efficient, and that the directed trustee is entitled to rely on those markets when following its directions regarding investments in employer stock. The Bulletin states:

Duty to act on public information. Absent material non-public information, a directed trustee, given its limited fiduciary duties as determined by statute, will rarely have an obligation under ERISA to question the prudence of a direction to purchase publicly traded securities at the market price solely on the basis of publicly available information. Three considerations counsel in favor of this view: (1) markets generally are assumed to be efficient so that stock prices reflect publicly available information and known risks; (2) in the case of employer securities, the securities laws impose substantial obligations on the company, its officers, and its accountants to state their financial records accurately; and (3) ERISA section 404 requires the instructing fiduciary to adhere to a stringent standard of care. Furthermore, because stock prices fluctuate as a matter of course, even a steep drop in a stock's price would not, in and of itself, indicate that a named fiduciary's direction to purchase or hold such stock is imprudent and, therefore, not a proper direction.⁸³

⁸⁰ *Id.*

⁸¹ *Id.* at pp. 4-5.

⁸² *Id.* at p. 5. The DOL declined to opine on the affect of procedures designed to limit the cross-organizational disclosure of information when those procedures are not based on legal requirements. *Id.* at n.2.

⁸³ *Id.* at p. 5.

Instead, the DOL limited any duty on the part of directed trustees to question plan directions based on public information to “limited, extraordinary circumstances” involving “clear and compelling public indicators” that the direction given was not itself prudent.⁸⁴ The DOL limited these public indicators to those that seriously question the company’s very viability as a going concern,⁸⁵ or that disclose that the company’s officers have been formally charged by state or federal regulators with financial irregularities; an investigation is insufficient.⁸⁶

The courts have followed the DOL’s guidance. In *In re WorldCom, Inc. ERISA Litigation*,⁸⁷ the district court applied the DOL’s guidance to grant summary judgment to Merrill Lynch, the directed trustee of WorldCom’s 401(k) plan. The district court reasoned that, prior to WorldCom’s announcement of its massive accounting restatement and NASDAQ freeze, there was no “reliable public information that call[ed] into serious question [WorldCom’s] short-term viability as a going concern.”⁸⁸ Prior to that, sophisticated investors (including pension funds and certain of Merrill Lynch’s own mutual funds) continued to invest in WorldCom based on a belief that the company’s stock was underpriced.⁸⁹

In *DiFelice v. US Airways, Inc.*,⁹⁰ the district court applied the DOL’s guidance to dismiss the claims against the directed trustee at the motion to dismiss stage. In *US Airways*, the company publicly and extensively commented on its increasing financial distress, including a failed merger with United Airlines in July 2001, and that bankruptcy may be inevitable absent major costs concessions and government loans following the September 11, 2001, terrorist attacks. US Airways eventually declared bankruptcy in August 2002.

The district court first analyzed whether a directed trustee’s discretion regarding managing cash liquidity of a company stock fund somehow made the

⁸⁴ *Id.* at pp. 5-6.

⁸⁵ *Id.* The DOL noted that mere public speculation about a company’s viability was insufficient, and contrasted this with 8-K or bankruptcy filings by the employer calling its own viability into question. *Id.* at pp. 5-6, n. 5. The DOL also noted that the fact of bankruptcy would not itself be dispositive, as the circumstances of the bankruptcy could mean equity holders may still receive value for their investments. *Id.* at p. 6, n.7.

⁸⁶ *Id.* at p. 6, n.7.

⁸⁷ 354 F. Supp. 2d 423 (S.D.N.Y. 2005).

⁸⁸ *Id.* at 449.

⁸⁹ *Id.* at 449, n.26.

⁹⁰ 397 F. Supp. 2d 735, 746 (E.D.Va. 2005).

directed trustee a discretionary fiduciary regarding investing that stock fund. The court held no, reasoning that the discretion regarding cash management was granted for a limited, specific purpose – to maintain fund liquidity, not manipulate investment returns – while the discretion whether to offer the stock fund was specifically allocated to the plan fiduciaries under the plan documents.⁹¹ The district court then addressed the appropriate standard for judging a directed trustee’s exercise of its fiduciary duties, concluding that those duties are controlled and cabined by ERISA § 403(a):

By including § 403(a) in ERISA, Congress plainly meant to create a subset of ERISA fiduciaries with a statutorily defined duty different from and more narrowly circumscribed than the general duty of ordinary care imposed on other ERISA fiduciaries by § 404(a). If § 403(a) were read to impose a duty of ordinary care on directed trustees to consider the financial merits of a named fiduciary's directions concerning plan investment options and follow only prudent directions, it takes little imagination to see the disputes and litigation such an arrangement would spawn. Congress plainly did not intend such a result. Instead, as the plain language of § 403(a) makes clear, and as is confirmed in the legislative history, Congress intended that directed trustees defer to the investment judgments of the named fiduciary and not second guess the wisdom of these judgments.⁹²

The court then applied this standard and the DOL’s guidance to conclude that a directed trustee who only possesses publicly available information has a duty to challenge a direction only after the named fiduciary files for bankruptcy, and even then only “under circumstances which make it unlikely that there would be any distribution to equity-holders with any value.”⁹³ Public information on US Airways’ failed merger with United Airlines and statements that US Airways may enter bankruptcy were insufficient to warrant objecting to the direction to continue to include company stock as an investment option.⁹⁴ Finally, the court

⁹¹ *Id.* at 749.

⁹² *Id.* at 748-49.

⁹³ *Id.* at 752.

⁹⁴ *Id.* at 756-57. *See also* Summers v. UAL Corp., 2005 WL 2648670 (N.D.Ill. 2005) (granting summary judgment to directed trustee; CEO’s open letter to employees stating company may perish next year absent certain changes in its business did not mean company faced imminent collapse), *affirmed*, 453 F.3d 404 (7th Cir. 2006); *In re General*

rejected plaintiff's contention that a directed trustee's duties should be judged by how an affiliated mutual fund makes investments, pointing out that:

As a directed trustee, Fidelity's primary duty was to follow the directions of the named fiduciary and of the plan participants, except in extraordinary circumstances not alleged in the complaint. As an active fund manager, Fidelity (or any mutual fund manager) will presumably decrease its holdings anytime it thinks the odds the stock price will decline are greater than the chances the stock price will increase. To conflate these two roles is to misunderstand Fidelity's role as a directed trustee and to require Fidelity to assume responsibilities it was not paid for and had not accepted.⁹⁵

III. THE PRUDENT INVESTMENT CLAIMS

A. *The Settlor-Fiduciary Distinction Regarding Plan Investments*

The rules relating to and impacting investments in employer stock are often set by the terms of the plan, e.g., whether the employer stock fund must be offered as an investment option; whether the employer match must be invested in that fund; and how long that match must remain in that fund. This is settlor conduct, in which the employer as plan sponsor is able to act in its corporate interests, free of fiduciary duties.⁹⁶ This settlor conduct includes using the plan terms to define the investment options available under the plan.⁹⁷ As discussed

Motors ERISA Litig., 2006 WL 897444, at *17-20 (E.D.Mich. Apr. 6, 2006) (granting directed trustee's motion to dismiss).

⁹⁵ *DiFelice*, 397 F. Supp. 2d at 757.

⁹⁶ *E.g.*, *In re Sprint Corp. ERISA Litig.*, 2004 WL 1179371, at *8 (D.Kan. May 27, 2004) (defendants act in settlor capacity when setting plan terms regarding company stock fund). *See also* *Kuper v. Quantum Chemical Corp.*, 66 F.3d 1447, 1456-57 (6th Cir. 1995) (decision to have trust-to-trust transfer of ESOP assets in sold division is settlor decision); *Steinman v. Hicks*, 352 F. 3d 1101, 1105 (7th Cir. 2003) (observing that a trust-to-trust transfer is not fiduciary act). Prior to the *Steinman* ruling, a district court in the Seventh Circuit applied a contrary rule. *See Nelson v. IPALCO Enters., Inc.*, 2003 WL 402253, at *6-7 (S.D.Ind. Feb. 13, 2003) (in merger, plan amendment converting existing plan assets from the acquiring to the acquired company's stock was a fiduciary act), *aff'd sub nom.*, 512 F.3d 347 (7th Cir. 2008). *See also Eaves v. Penn*, 587 F.2d 453, 457-59 (10th Cir. 1978) (in ESOP case involving the use of pre-existing plan assets in a self-dealing transaction, court held that person who recommended and designed the ESOP was a fiduciary because he received "indirect" compensation for his advice).

⁹⁷ *See, e.g.*, *Tatum v. R.J. Reynolds Tobacco Co.*, 294 F. Supp. 2d 776, 782-84 (M.D.N.C. 2003) (applying rule to amendments requiring plan to divest of former

below, making the employer stock fund an ESOP or a mandatory investment option in an eligible individual account plan (“EIAP”) typically triggers the presumption that it is prudent to offer this fund.

B. The Standard of Prudence Regarding Investments in Employer Stock

Because, prior to the 2006 Pension Protection Act, employer matches were invested often in the employer stock fund, this fund frequently constituted a substantial part of the investments of the 401(k) or like plan, e.g., for plans that offer such funds, as of 2003 a survey found that employer stock constituted on average 30 percent of a typical 401(k) plan’s investments.⁹⁸ Although the employer stock fund has a statutory exemption from any fiduciary duty to diversify to avoid the risk of large losses,⁹⁹ plaintiffs nonetheless often argue that the size of this investment, coupled with the inherent risk of investment in a single stock, warrants imposing an enhanced duty to investigate the prudence of this investment. Most courts have suggested that there is no such enhanced duty.¹⁰⁰ Other courts have, however, suggested that plan terms and exceptional facts may trigger such duties.¹⁰¹

employer’s stock after subsidiary was spun-off), *rev’d other grounds*, 392 F.3d 636 (4th Cir. 2004) (noting rule but concluding plan amendments did not require elimination of the stock fund).

⁹⁸ See Patrick J. Purcell, *Employer Stock in Retirement Plans*, BENEFITS Q. 51, 54 table 1 (2d quart. 2003) (collecting survey data).

⁹⁹ See ERISA § 404(a)(2), 29 U.S.C. § 1104(a)(2).

¹⁰⁰ E.g., *Hull v. Policy Mgmt. Sys. Corp.*, 2001 WL 1836286, at *9 (D.S.C. Feb. 9, 2001) (holding ERISA does not impose a different standard of care regarding investments in company stock as opposed to other stock). See also *Thompson v. Avondale*, 2003 WL 359932, at *19 (E.D.La. Feb. 14, 2003) (in access-to-information-claim, court held it was proper to treat ESOP as any other third-party shareholder) and at *14 (fiduciaries are not charged to be smarter than or to out-guess the market on company value); *Howell v. Motorola, Inc.*, 337 F. Supp. 2d 1079, 1089-92 (N.D.Ill. 2004) (no reason plan committee members knew or should have known of massive fraud inflicted on the company by a major customer); *Crowley v. Corning Inc.*, 234 F. Supp. 2d 222, 230 (W.D.N.Y. 2003) (no reason plan committee members knew or should have known company filings were false or misleading); *Dynegy Inc.*, 309 F. Supp. 2d at 880-82 (allowing claim to go forward, but noting that plaintiffs will have to prove committee defendants had access to information from which they knew or should have known the company SEC filings were false).

¹⁰¹ See *Keach v. United States Trust Co.*, 240 F. Supp. 2d 840, 845 (C.D.Ill. 2002) (drop in ESOP value should have triggered some type of investigation as to the cause and possible recovery of lost assets); *In re Williams Cos. ERISA Litig.*, 271 F. Supp. 2d 1328, 1343 (N.D.Okla. 2003) (assuming company stock fund was not a mandatory plan investment option and that stock price was fraudulently inflated, can be breach of duty to fail to address whether need to eliminate company stock fund); *Patten v. Northern Trust*

The courts that have suggested there *may* be such an enhanced duty have done so at the motion to dismiss stage or, as in *Keach v. United States Trust Co.*,¹⁰² have concluded ultimately that there was no such breach of this claimed duty. It is difficult to square an enhanced duty to investigate investments in employer stock with the fact that a fiduciary is obligated to follow the plan terms requiring these investments absent, at minimum, extraordinary intervening circumstances. Nor could such a duty be squared with the fact that *any* investment in a single employer's stock entails substantial risk, yet Congress encourages such investments while admonishing courts not to create rules that impede these investments.¹⁰³ Finally, to establish a fiduciary breach, the plaintiff would have to show that the investigation would have required the fiduciary to override the plan terms.¹⁰⁴

The investigation question thus leads to what is often the key issue in the prudence claims: When, if ever, should the presumption of prudence regarding investments in employer stock be overridden? ERISA specifically exempts fiduciaries from the duty to diversify investments in employer securities for EIAPs.¹⁰⁵ EIAPs include ESOPs and profit-sharing, stock bonus, thrift, or savings plans.¹⁰⁶ In addition, both the Internal Revenue Code and ERISA, through these exemptions from diversification and numerous other provisions, specifically encourage employee ownership by encouraging EIAPs to invest in employer stock.¹⁰⁷ Finally, as detailed below, a fiduciary may be liable if he

Co., 703 F. Supp. 2d 799, 809-10(N.D.Ill. 2010) (same); *In re Hartford Financial Services Group*, 2010 WL 135186, at *2 (D.Conn. Jan. 13, 2010) (same); *WorldCom, Inc.*, 263 F. Supp. 2d at 763 (same); *Enron Corp.*, 284 F. Supp. 2d at 665-70 (when savings plan imposed a duty to diversify, fiduciaries had duty to investigate large concentration of plan assets invested in employer stock); *but see In re Constellation Energy Group, Inc.*, 2010 WL 3221821, at *5 (D.Md. Aug. 13, 2010) (regardless of whether duty to diversify is present, prudent investment claim fails where plaintiff merely alleges that adoption of risky business model makes stock fund imprudent).

¹⁰² 240 F. Supp. 2d 840 (C.D.Ill. 2002).

¹⁰³ *See, e.g.,* *Donovan v. Cunningham*, 716 F.2d 1455, 1466 n. 24 (5th Cir. 1983); *Moench v. Robertson*, 62 F.3d 553, 568-69 (3d Cir. 1995).

¹⁰⁴ *E.g.,* *Wright v. Oregon Metallurgical Corp.*, 360 F. 3d 1090, 1098-99 (9th Cir. 2004); *Kuper v. Quantum Chemical Corp.*, 66 F.3d 1447, 1459 (6th Cir. 1995).

¹⁰⁵ *See* ERISA § 404(a)(2), 29 U.S.C. § 1104(a)(2).

¹⁰⁶ *See* ERISA § 407(d)(3), 29 U.S.C. § 1107(d)(3).

¹⁰⁷ *See, e.g.,* *Wright*, 360 F. 3d at 1097-98 & n. 3 (9th Cir. 2004) (noting same); *Foltz v. U.S. News & World Report*, 865 F.2d 364, 373-74 (D.C. Cir. 1989) (noting same). Congress has provided plan participants unique tax advantages regarding plan

overrides those plan terms or participants' directions requiring those investments, and the plan participants are harmed subsequently through a rise in the price of the employer stock. Rather, a fiduciary is generally obligated to follow plan terms on investments in employer stock, because the fiduciary duty is to provide the benefits owed pursuant to the plan terms, not to seek to try to maximize pecuniary returns.¹⁰⁸ The courts have thus struggled with whether, if ever, a fiduciary has a fiduciary duty of prudence to override plan terms regarding an EIAP's investments in employer stock.¹⁰⁹

The seminal case on the prudence issue is the Third Circuit's decision in *Moench v. Robertson*,¹¹⁰ which held that investments in employer stock are

investments in employer stock. These unique advantages include lowered taxes on plan distributions made in kind in employer stock, I.R.C. § 402(e)(4)(B), the ability to receive a full distribution without having to sell a portion of the securities to satisfy any withholding obligation, I.R.C. § 3405(e)(8), and the ability to receive cash dividends attributable to employer stock held in certain types of retirement plans even before a participant is otherwise eligible for normal distributions from the plan. I.R.C. § 404(k)(2).

Congress also offers special incentives under ERISA and the I.R.C. to plan sponsors/employers to include their stock in these plans. Companies can contribute stock in-kind (unlike any other type of property) without violating ERISA's "prohibited transaction" rules. ERISA § 408(e), 29 U.S.C. § 1108(e); I.R.C. § 4975(d)(13). Companies can, in certain instances, avoid recognizing gain or loss when they make contributions of company stock. I.R.C. §§ 409(m) & 1032. Unlike dividends generally, dividends paid on employer stock contributed to the plan can be tax deductible to the company. I.R.C. § 404(k). So favored is company stock that plans are granted a special exception from prohibited transaction rules in order to allow the plan to borrow from the employer to finance the acquisition of this stock. Treas. Reg. § 54.4975.

¹⁰⁸ *E.g.*, *Pennsylvania Fed.*, 2004 WL 228685, at *4; *Wright*, 360 F.3d at 1100; *Foltz*, 865 F.2d at 373.

¹⁰⁹ Courts apply this presumption not just to ESOPs, but to all "eligible individual account plans" designed to invest in employer stock. *See, e.g.*, *Edgar v. Avaya, Inc.*, 503 F.3d 340, 347 (3d Cir. 2007); *Wright*, 360 F. 3d at 1097-98 at n. 3; *In re Beazer Homes USA, Inc. ERISA Litig.*, 2010 WL 141650, at *5 (N.D.Ga. Apr. 2, 2010); *Landgraff v. Columbia/HCA Healthcare Corp. of America*, 2000 WL 33726564, at *6 (M.D.Tenn. May 24, 2000), *aff'd*, 30 Fed. Appx. 366 (6th Cir. Feb. 7, 2002); *Steinman v. Hicks*, 252 F. Supp. 746, 758 (C.D.Ill. 2003), *aff'd*, 352 F.3d 1101 (7th Cir. 2003); *Pennsylvania Fed.*, 2004 WL 228685, at *7; *In re Calpine Corp. ERISA Litig.*, 2005 WL 1431506, at *4-5 (N.D.Cal. Mar. 31, 2005); *but see DiFelice v. US Airways, Inc.*, 397 F. Supp. 2d 735 (E.D.Va. 2005) (suggesting that presumption may not apply to a 401(k) plan); *In re Westar Energy, Inc.*, ERISA Litig., 2005 WL 2403832, at *19 (D.Kan. Sept. 29, 2005) (same).

¹¹⁰ 62 F.3d 553, 571-72 (3d Cir. 1995).

presumed to be prudent, but that this presumption can be overcome if a fiduciary is faced with knowledge of changed circumstances such as the impending collapse of the employer.¹¹¹ As the *Moench* court explained:

[B]y subjecting an ERISA fiduciary's decision to invest in employer stock to strict judicial scrutiny, we essentially would render meaningless the ERISA provision excepting ESOPs from the duty to diversify. Moreover, we would risk transforming ESOPs into ordinary pension benefit plans, which then would frustrate Congress' desire to encourage employee ownership. After all, why would an employer establish an ESOP if its compliance with the purpose and terms of the plan could subject it to strict judicial second-guessing? Further still, basic principles of trust law require that the interpretation of the terms of the trust be controlled by the settlor's intent. That principle is not well served in the long run by ignoring the general intent behind such plans in favor of giving beneficiaries the maximum opportunities to recover their losses.¹¹²

The *Moench* court thus developed a presumption of prudence regarding investments in employer stock, that could be overcome only if the plaintiffs could show that extraordinary changed circumstances meant such investments were no longer consistent with the settlor's intent:

In attempting to rebut the presumption, the plaintiff may introduce evidence that "owing to circumstances not known to the settlor and not anticipated by him [the making of such investment] would defeat or substantially impair the accomplishment of the purposes of the trust." As in all trust cases, in reviewing the fiduciary's actions, the court must be governed by the intent behind the trust--in other words, the plaintiff must show that the ERISA fiduciary could not have believed reasonably that continued adherence to the ESOP's direction was in keeping with the settlor's

¹¹¹ *Id.* at 572 (reasoning plan language providing "primarily invest in" gave some discretion to diversify in these extraordinary circumstances).

¹¹² *Id.* at 570.

expectations of how a prudent trustee would operate.¹¹³

In contrast, several courts have held that there is no duty to override plan terms when those plan terms mandate that all investments must be in employer stock,¹¹⁴ and several courts have also called into question *Moench's* reasoning imposing this limited duty.¹¹⁵ However, to date *Moench* remains the prevailing view.

Although several public company employer stock cases have settled in the \$30 to \$80 million range, the authors are unaware of any case in which a judgment for the plaintiffs was entered on the “fiduciary override” claim,¹¹⁶ while numerous courts have applied the *Moench* presumption to rule for defendants.¹¹⁷

¹¹³ *Id.* at 571 (quoting RESTATEMENT (SECOND) TRUSTS § 227, comment g).

¹¹⁴ See *In re Wachovia Corp. ERISA Litig.*, 2010 WL 3081359, at *9 (W.D.N.C. Aug. 6, 2010); *Lanfeer v. Home Depot, Inc.*, -- F. Supp. 2d --, 2010 WL 2427413, at *9-*11 (N.D.Ga. June 7, 2010) (no duty to diversify and therefore no breach of fiduciary duty of prudence); *In re Citigroup ERISA Litig.*, 2009 WL 2762708, *7-8 (S.D.N.Y. Aug. 31, 2009); *Nelson v. IPALCO Enters., Inc.*, 2003 WL 402253, at *7-8 (S.D. Ind. Feb. 13, 2003) (distinguishing *Moench* as based on “primarily invest” language), *aff'd sub nom.*, 512 F.3d 347 (7th Cir. 2008); *Dynegy Inc.*, 309 F. Supp. 2d at 890-92 & n. 52 (because investment of employer match was design feature of the plan, the plan committee members breached no fiduciary duties regarding this match).

¹¹⁵ See *Wright*, 360 F. 3d at 1097 (“Interpreting ERISA’s prudence requirement to subject EIAPs to an albeit tempered duty to diversify arguably threatens to eviscerate congressional intent and the guiding rationale behind EIAPs themselves.”); *In re McKesson HBOC, Inc. ERISA Litig.*, 2002 WL 31431588, at *5 (N.D.Cal. Sept. 30, 2002) (“If there is no duty to diversify ESOP plan assets under the statute, it logically follows that there can be no claim for breach of fiduciary duty arising out of a failure to diversify, or in other words, arising out of allowing the plan to become heavily weighted in company stock”). *But see* *Steinman v. Hicks*, 352 F.3d 1101, 1106 (7th Cir. 2003) (Posner, J.) (citing *Moench*; general duty of prudence could trigger a duty to diversify in extreme circumstances).

¹¹⁶ See *DiFelice v. U.S. Airways, Inc.*, 497 F.3d 410 (4th Cir. 2007) (affirming district court’s judgment for defendants after trial on the merits holding that defendants did not breach their fiduciary duties in not overriding the terms of the plan and divesting the plan of the company stock fund prior to the company filing for bankruptcy); *Nelson v. IPALCO Enters., Inc.*, 480 F. Supp. 2d 410 (S.D.Ind. 2007) (holding no duty to override plan terms and divest plan of company stock fund after conclusion of trial on the merits), *affirmed*, *Nelson v. Hodowal*, 512 F.3d 347 (7th Cir. 2008).

¹¹⁷ See *Edgar v Avaya, Inc.*, 503 F.3d 340 (3d Cir. 2007) (Presumption not overcome by claim hid information that resulted in 25% drop in stock price; not type of dire circumstances that would compel fiduciaries to override plan terms); *Kuper v. Quantum Chemical Corp.*, 66 F.3d 1447, 1459–60 (6th Cir. 1995) (affirming summary judgment;

adopting *Moench* presumption, inside knowledge of company's financial woes and 80 percent drop in stock price does not override this presumption: during the transfer period at issue, the stock price was fluctuating and several investment advisors were advising to invest in the stock); *Wright*, 222 F. Supp. 2d at 1233-34 (granting motion to dismiss; the presumption is overcome only if the fiduciary knows there is going to be an "impending collapse" of the company; here the company was still financially viable and continuing to pay dividends); *In re Bank of America Securities, Derivative & ERISA Litig.*, 2010 WL 3448197, at *20-1 (S.D.N.Y. Aug. 27, 2010) (presumption not overcome where allegations are only that stock declined 83%); *In re Lehman Brothers Securities and ERISA Litig.*, 683 F. Supp. 2d 294, 301-02 (S.D.N.Y. 2010) (presumption not overcome where allegations did not tie bankruptcy to knowledge of fiduciary of imminent collapse); *In re Wachovia Corp. ERISA Litig.*, 2010 WL 3081359, at *12-13 (W.D.N.C. Aug. 6, 2010) (presumption not overcome where company acquired and offered value to acquiring company); *Herrera v. Wyeth*, 2010 WL 1028163, at *6 (S.D.N.Y. Mar. 17, 2010) (presumption not overcome where stock decline was only 21%), 2010 WL 3469681 (S.D.N.Y. Aug. 23, 2010) (presumption not overcome with allegations that officers engaged in insider trading); *Wright v. Medtronic, Inc.*, 2010 WL 1027808, at *6 (D.Minn. Mar. 17, 2010) (presumption not rebutted where allegations tied to litigation charge incurred by company); *Harris v. Amgen, Inc.*, 2010 WL 744123, at *9-*12 (Mar. 2, 2010) (to overcome presumption where allegations did not allege that company was in dire condition); *Lanfer v. Home Depot, Inc.*, -- F. Supp. 2d --, 2010 WL 2427413, at *13 (N.D.Ga. June 7, 2010) (same); *Johnson v. Radian Group, Inc.*, 2010 WL 213562, at *11-12 (E.D.Pa. May 26, 2010) (same); *In re Dell, Inc. ERISA Litig.*, 563 F. Supp. 2d 681 (W.D.Tex. 2008) (same); *In re RadioShack Corp. ERISA Litig.*, 547 F. Supp. 2d 606 (N.D.Tex. 2008) (same); *In re Bausch & Lomb, Inc. ERISA Litig.*, 2008 WL 5234281 (W.D.N.Y. Dec. 12, 2008) (same); *Crowley v. Corning, Inc.*, 234 F. Supp. 2d 222, 230 (W.D.N.Y. 2002) (granting motion to dismiss; no specific facts were alleged to overcome the presumption or that the fiduciary actually possessed any nonpublic adverse information); *In re Duke Energy ERISA Litigation*, 281 F. Supp. 2d 786, 793-94 (W.D.N.C. June 23, 2003) (granting motion to dismiss; absent an impending collapse of the company, the presumption not overcome); *Steinman v. Hicks*, 252 F. Supp. 2d 746 (C.D.Ill. 2003), *aff'd*, 352 F. 3d 1101 (7th Cir. 2003) (summary judgment for the defendants; the company was sound, and no duty to diversify exists simply because the plan has been terminated); *Landgraff v. Columbia/HCA Healthcare Corp.*, 2000 U.S. Dist. LEXIS 21831, at *39-61 (M.D. Tenn. May 24, 2000), *aff'd*, 30 Fed. Appx. 366 (6th Cir. Feb. 7, 2002) (judgment for the defendants after trial; although the committee did not meet procedural prudence, there was no violation of substantive prudence because even had they fully investigated the company's financial status, they would have continued to invest in company stock because the company was sound financially: net assets, cash flows, and income increased during period; independent financial analysts supported the stock; investment managers and insiders continued to invest in stock; and workforce demographics suggested that a long-term investment strategy should be followed.); *In re Calpine ERISA Litig.*, (N.D.Cal. Mar. 31, 2005) (granting motion to dismiss and finding that absent impending collapse of the company the presumption was not overcome); *In re McKesson HBOC, Inc.*, ERISA Litig., 391 F. Supp. 2d 812, 829-33 (N.D.Cal. 2005) (dismissing diversification claims on a motion to dismiss because even if *Moench* applied, plaintiffs failed to plead any allegations concerning an imminent collapse); *Smith v. Delta Air Lines, Inc.*, 422 F. Supp. 2d 1310, 1327-28 (N.D.Ga. 2006)

The Third Circuit itself recently strongly supported application of *Moench* at the motion to dismiss stage in *Edgar v. Avaya, Inc.*¹¹⁸ In *Edgar*, the plaintiff brought a class action suit alleging the defendants breached various fiduciary duties under ERISA by offering participants in three employee pension benefit plans the option of investing in Avaya common stock. Plaintiff filed the class action after the price of the stock declined from \$10.69 to \$8.01 per share, following Avaya's announcement that it would not meet its previously forecasted earnings goals for the 2005 fiscal year.¹¹⁹ The Third Circuit concluded the plaintiff failed to plead facts sufficient to overcome the *Moench* presumption. The court was unimpressed with plaintiff's fraud characterization, reasoning that simply alleging corporate officers knew of adverse information that would negatively impact the stock was insufficient to establish the type of dire circumstances needed to overcome *Moench*.¹²⁰ This view is not universal, though.¹²¹

(dismissing claim when fiduciary appointed an independent fiduciary one year before company declared bankruptcy).

¹¹⁸ 503 F.3d 340 (3d Cir. 2007).

¹¹⁹ *Id.* at 342-44.

¹²⁰ *Id.* at 348-49. *See also, e.g., In re Lehman Brothers Securities and ERISA Litig.*, 283 F. Supp. 2d 294, (S.D.N.Y. 2010) (same); *Gearren v. McGraw-Hill Cos.*, 690 F. Supp. 2d 254, 270 (S.D.N.Y. 2010) (same); *Herrera v. Wyeth*, 2010 WL 3469681 (S.D.N.Y. Aug. 23, 2010) (same); *Wright v. Medtronic, Inc.*, 2010 WL 1027808, at *6 (D.Minn. Mar. 17, 2010) (same); *In re Huntington Bancshares Inc. ERISA Litig.*, 620 F. Supp. 2d 842,849-853 (S.D. Oh. 2009) (same); *In re Harley Davidson, Inc., Sec. Litig.*, 660 F. Supp. 2d 953, 966-967 (E.D. Wis. 2009) (same); *In re Avon Products, Inc. ERISA Litigation*, 2009 WL 884687, at *10-*11, 46 EB (BNA) Cases 1786 (S.D.N.Y. Mar. 30, 2009) (adopting Report and Recommendations of Mag. Judge Dolinger); 2009 WL 848083, 46 EB (BNA) Cases 1769 (S.D.N.Y. Mar. 3, 2009) (Report and Recommendations of Mag. Judge Dolinger) (same); *Shirk v. Fifth Third Bancorp.*, 2009 WL 692124, 46 EB (BNA) Cases 2502 (S.D. Ohio Jan. 29, 2009).; *In re Dell, Inc. ERISA Litig.*, 563 F. Supp. 2d 681, 45 EB (BNA) Cases (BNA) 1346 (W.D. Tex. 2008) (same); *In re RadioShack Corp. ERISA Litig.*, 547 F. Supp. 2d 606, 43 EB (BNA) Cases (BNA) 2059 (N.D. Tex. 2008) (same); *In re Bausch & Lomb, Inc. ERISA Litig.*, 2008 U.S. Dist. LEXIS 106269 (W.D.N.Y. Dec. 12, 2008) (same).

¹²¹ *See, e.g., In re Syncor ERISA Litig.*, 516 F.3d 1095, 1102-03 (9th Cir. 2008) (noting that evidence that stock was fraudulently inflated and that fiduciaries knew or should have known of fraud sufficient to create a genuine issue of material fact on a prudence claim); *In re Ford Motor Co. ERISA Litig.*, 2008 WL 5377955, at *3-9 (E.D. Mich. Dec. 22, 2008) (declining to dismiss prudent investment claims because plaintiffs pled impending collapse of Ford); *In re Fremont Gen. Corp. Litig.*, 564 F. Supp. 2d 1156, 1158 (C.D. Cal. 2008) (refusing to dismiss claims because plaintiffs pled sufficiently dire straits of company); *In re Pfizer, Inc. ERISA Litig.*, 2009 WL 749545, at *11-*12 (S.D.N.Y. Mar. 20, 2009) (declining to dismiss prudent investment claim because plaintiffs' pled sufficient facts that inquiry should have been made); *Jones v. NovaStar*, 2009 WL 331553, at *6 (W.D. Mo. Feb. 11, 2009) (same); *Morrison v. MoneyGram*

In *Pugh v. Tribune Co.*,¹²² the Seventh Circuit joined the Third Circuit in applying the *Moench* presumption at the motion to dismiss stage. In *Pugh*, plaintiffs brought class action suits under ERISA and federal securities laws. In the ERISA suit, plaintiffs alleged that defendants breached various fiduciary duties by offering participants the option of investing in Tribune common stock. Both the securities and ERISA suits were filed after the price of the stock declined from \$47.27 to \$39.72 after a series of announcements linked to an investigation that revealed that circulation numbers for two newspapers at subsidiaries were inflated over several years.¹²³ The Seventh Circuit affirmed the district court's dismissal of the ERISA suit, concluding that (i) the fiduciaries properly relied on the corporation's investigation and reporting of the fraud at the subsidiary, and (ii) that the plaintiffs' claims of fraud impacting 2% of a company's revenues were insufficient to overcome the *Moench* presumption.¹²⁴

The Seventh Circuit also rejected plaintiffs' claim that the ERISA fiduciaries had a duty to investigate and to uncover the fraud at an earlier time. The court observed that "ERISA imposes no duty on plan fiduciaries to continuously audit operational affairs," reasoning instead that a duty to investigate arises only when there is some "red flag" of possible misconduct.¹²⁵ In *Pugh* the red flag was a February 2004 advertiser lawsuit. In response, Tribune commenced an investigation that eventually ferreted out and disclosed the fraud. The court reasoned that the fiduciaries had no duty to commence an independent investigation in light of this, and that Tribune was entitled to a reasonable amount of time to investigate until it had a full story to disclose.¹²⁶ As the court explained in dismissing the parallel securities lawsuit: "Taking the time necessary to get things right is both proper and lawful. Managers cannot tell lies but are entitled to investigate for a reasonable time, until they have a full story to reveal."¹²⁷

International, Inc., 607 F. Supp. 2d 1003, 1052-1054 (D. Minn. 2009) (same);
Shanehchian v. Macy's, Inc., 2009 WL 2524562 (S.D. Ohio Aug. 14, 2009) (same).

¹²² 521 F.3d 686 (7th Cir. 2008).

¹²³ *Id.* at 690-92.

¹²⁴ *Id.* at 700-02.

¹²⁵ *Id.* at 700.

¹²⁶ *Id.* at 700.

¹²⁷ *Id.* at 695. District courts have applied the *Moench* presumption to grant motions to dismiss. *See, e.g., In re Bank of America Securities, Derivative & ERISA Litig.*, 2010 WL 3448197, at *19 (S.D.N.Y. Aug. 27, 2010) (same); *In re Wachovia Corp. ERISA Litig.*, 2010 WL 3081359, at *12-13 (W.D.N.C. Aug. 6, 2010) (same); *Gearren v. McGraw-Hill Cos.*, 690 F. Supp. 2d 254, 269-70 (S.D.N.Y. 2010) (same); *In re Huntington Bancshares Inc. ERISA Litig.*, 620 F. Supp. 2d 842, 849-853 (S.D. Oh. 2009); *Benitz v. Humana, Inc.*, 2009 WL 3166651 (W.D. Ky. Sept. 30, 2009); *In re Harley*

Pugh provides a possible roadmap for fiduciaries to lawfully comply with their fiduciary duties under the difficult circumstances in which a company is facing allegations of fraud or other misconduct. Specifically, *Pugh* suggests that fiduciaries *can* rely on the corporate investigation and reporting process unless they have some reason to believe it is broken. In *Pugh* the fiduciaries could reasonably rely on the fact that the company had commenced an investigation, and was timely reporting the fraud as the facts were uncovered.

Although not at the motion to dismiss stage, the Fifth Circuit applied the *Moench* presumption in *Kirschbaum v. Reliant Energy, Inc.*,¹²⁸ to affirm dismissal of plaintiffs' prudent investment claim at the summary judgment phase. With respect to the prudent investment claim, the court held that ERISA bars any claim that the plan became too heavily invested in Reliant stock. The claim was based on the notion that the concentration became too risky as Reliant's business changed from a power utility to an energy trading operation. The court reasoned that this was simply a variant of a failure to diversify claim, which is precluded by ERISA § 404(a)(2). As the court explained, [d]espite the risks inherent in concentrating plan assets in any one security," ERISA § 404(a)(2) statutorily exempts qualifying employer securities from any duty to diversify to avoid the risk of large loss.¹²⁹

Nonetheless, many courts, including the First Circuit in *LaLonde v. Textron, Inc.*,¹³⁰ have permitted claims to survive motions to dismiss, stating that the *Moench* presumption does not mandate dismissal when plaintiffs allege some

Davidson, Inc., Sec. Litig., 660 F. Supp. 2d 953, 965-967 (E.D.Wis. 2009); Johnson v. Radian Group, Inc., 2009 WL 2137241, at *13-*15 (E.D. Pa. July 16, 2009); *In re Avon Products, Inc. ERISA Litigation*, 2009 WL 884687, at *10-*11 (S.D.N.Y. Mar. 30, 2009) (adopting Report and Recommendations of Mag. Judge Dolinger); 2009 WL 848083 (S.D.N.Y. Mar. 3, 2009) (Report and Recommendations of Mag. Judge Dolinger); Graden v. Conexant Systems, Inc., 574 F. Supp. 2d 456, 462-64 (D.N.J. 2008) (applying presumption at dismissal stage for time period when plan language required stock fund to be offered); *In re Huntington Bancshares, Inc. ERISA Litig.*, 2009 WL 330308, at *5-*7 (S.D. Ohio Feb. 9, 2009) (applying presumption at dismissal stage and granting motion to dismiss); *In re Dell, Inc. ERISA Litig.*, 563 F. Supp. 2d 681, 693-94 (W.D. Tex. 2008) (same); *In re RadioShack Corp. ERISA Litig.*, 547 F. Supp. 2d 606, 611-14 (N.D. Tex. 2008) (same); *In re Bausch & Lomb, Inc.*, 2008 WL 5234281, at *4-*6 (W.D. N.Y. Dec. 12, 2008) (same); *Halaris v. Viacom, Inc.*, 2008 WL 3855044, at *2 (N.D. Tex. Aug. 19, 2008) (same).

¹²⁸ 526 F.3d 243 (5th Cir. 2008).

¹²⁹ *Id.* at 253-56.

¹³⁰ 369 F.3d 1, 6-7 (1st Cir. 2004).

serious, allegedly hidden problem with the company.¹³¹ Some courts, however, have drawn distinctions between those allegedly “in the know” on the alleged misconduct versus those who were not, dismissing the claims against the latter group.¹³²

¹³¹ See *Crocker v. KV Pharmaceutical Co.*, -- F. Supp. 2d --, 2010 WL 1257671, at *20-1 (E.D.Mo. Mar. 24, 2010) (declining to dismiss the prudent investment claim because pled sufficient facts that company was in dire financial conditional); *Dann v. Lincoln National Corp.*, -- F. Supp. 2d --, 2010 WL 1644276, at *8 (E.D.Pa. Apr. 20, 2010) (declining to dismiss prudent investment claim because plaintiff pled sufficient dire circumstances); *In re Syncor ERISA Litig.*, 351 F. Supp. 2d 970, 981–82 (C.D.Cal. 2004) (“serious mismanagement” of company arising out of bribery scheme was sufficient to overcome presumption on a motion to dismiss); *In re Polaroid ERISA Litig.*, 362 F. Supp. 2d 461, 474–76 (S.D.N.Y. 2005) (recognizing presumption but holding plaintiffs stated sufficient facts in light of allegations that defendants knew of impending collapse of the company); *In re Honeywell Int’l ERISA Litig.*, 2004 WL 3245931, at *11 (D.N.J. June 14, 2004) (inflation of stock by fraud may be enough to overcome presumption); *In re JDS Uniphase Corp. ERISA Litig.*, 2005 WL 1662131, at *6–8 (N.D.Cal. July 14, 2005) (allegations that insiders knew of serious, undisclosed setbacks facing company sufficient to survive a motion to dismiss); *In re Westar, Inc., Energy ERISA Litig.*, 2005 WL 2403832, at *18-21 (D.Kan. Sept. 29, 2005) (presumption may be overcome by serious mismanagement and self-dealing by corporate officers); *In re Ford Motor Co. ERISA Litig.*, 590 F. Supp. 2d 883, 891-893 (E.D.Mich. 2008) (declining to dismiss prudent investment claims because plaintiffs pled impending collapse of Ford); *In re Fremont General Corp. Litig.*, 564 F. Supp. 2d 1156, 1158 (C.D.Cal. 2008) (refusing to dismiss claims because plaintiffs pled sufficiently dire straits of company).

An issue has also arisen as to whether the *Moench* presumption of prudence should be applied at the motion to dismiss stage. Two circuit courts have recently analyzed this issue and ruled it should. See *Wright*, 360 F.3d at 1098–99 (absent allegations of impending collapse, presumption is not overcome and plaintiffs thus fail to allege claim); *Edgar*, 503 F.3d at 349 (same). Several district courts have likewise applied this presumption to grant motions to dismiss. See, e.g., *Duke Energy*, 281 F. Supp. 2d at 793–94; *In re McKesson, HBOC, Inc. ERISA Litig.*, 2002 U.S. Dist. LEXIS 19473, at *15–18 (N.D.Cal. Sept. 30, 2002). In contrast, several district courts (which did not have the benefit of the rulings in *Wright* and *Edgar*) treated the presumption as an evidentiary issue that could not be applied at the motion to dismiss stage. See *In re Electronic Data Sys. Corp. ERISA Litig.*, 305 F. Supp. 2d 658, 668–70 (E.D.Tex. 2004); *In re Xcel Energy, Inc., Secs., Derivative & “ERISA” Litig.*, 312 F. Supp. 2d 1165, 1180 (D.Minn. 2004); *Pennsylvania Fed’n*, 2004 U.S. Dist. LEXIS 1987, at *21–24 (also noting conflicting state of law on issue).

¹³² See, e.g., *Pugh*, 521 F.3d at 701-02 (noting plaintiffs’ allegations did not support claim that committee members knew or should have known of any fraud); *In re Syncor ERISA Litig.*, 351 F. Supp. 2d 970, 983 (C.D.Cal. 2004) (no factual allegations that committee defendants knew or should have known of bribery scheme at center of case); *Howell v. Motorola, Inc.*, 337 F. Supp. 2d 1079, 1089–92 (N.D.Ill. 2004) (no reason plan committee members knew or should have known of massive fraud inflicted on the company by a major customer).

Any decision to sell employer stock does not occur in a vacuum. Under standard plan terms for EIAPs and ESOPs (and often because of tax considerations applicable to the ESOP), the fiduciaries are obligated to invest the employer stock fund “primarily” in employer stock. If it is determined that the plan should consider divesting itself of part or all of this stock, the general practice is for the employer to amend the plan to grant that discretion to the plan fiduciaries or to a specially appointed independent fiduciary. The courts have generally agreed any following divestment was prudent.¹³³ Courts have also held or noted, however, that a fiduciary who divests an EIAP of employer stock in violation of plan terms or participant direction exposes himself to risk of suit.¹³⁴ At least one court has gone further to note that the sell-off of an employer’s stock could itself cause a stock price decline, thereby harming the plan and spurring litigation;¹³⁵ in other cases, participants have sued precisely because they were required to divest their employer stock investments when that stock subsequently rebounded.¹³⁶ In the context of a company facing severe financial distress, a court has approved an independent fiduciary’s closing and selling off of an employer stock fund as prudent.¹³⁷

¹³³ See, e.g., *Thompson v. Avondale, Indus. Inc.*, 2003 WL 359932, at *11-12 (E.D.La. Feb.14, 2003) (decision to diversify was prudent: retained expert advice; stock had been volatile and business was very risky because it depended on one major client, the Navy; and older age of participants made them less able to weather a downturn).

¹³⁴ E.g., *Edgar*, 503 F.3d at 348-49; *Kuper v. Iovenko*, 66 F.3d 1447, 1459 (6th Cir. 1995); *LaLonde v. Textron, Inc.*, 270 F. Supp. 2d 272, 280 (D. R.I. 2003), *aff’d in part, rev’d in part*, 369 F.3d 1 (1st Cir. 2004); *Schoenholtz v. Doniger*, 657 F. Supp. 899, 909 (S.D.N.Y. 1987) (rejecting argument that would have been imprudent to invest in employer stock). See also, e.g., *Montgomery v. Aetna Plywood, Inc.*, 39 F. Supp. 2d 915, 929, 934 (N.D.Ill. 1998) (imposing over \$7 million judgment for selling closely held ESOP’s stock at too low a price, e.g., court suggested stock was valued when company was at a low point in its business and the business cycle).

¹³⁵ *LaLonde*, 270 F. Supp. 2d at 280.

¹³⁶ See, e.g., *Bunch v. W.R. Grace & Co.*, 553 F.3d 1 (1st Cir. 2009) (affirming summary judgment that defendants did not breach fiduciary duties for divesting plan of company stock); *Tatum v. R.J. Reynolds Tobacco Co.*, 392 F.3d 636 (4th Cir. 2004); *Noa v. Keyser*, 519 F. Supp. 2d 481 (D.N.J. 2007).

¹³⁷ *DiFelice v. US Airways*, 397 F. Supp. 2d 758, 36 EB Cases (BNA) 1204 (E.D. Va. 2005). In *DiFelice* the company filed for bankruptcy approximately one and a half months after this appointment. Upon its appointment, the independent fiduciary prohibited further purchases of stock, and subsequently sought to start selling the stock held. Because of market and potential legal restrictions, the independent fiduciary was unable to sell more than a small percentage of the stock held prior to the bankruptcy filing. The district court granted the independent fiduciary’s motion to dismiss, reasoning that these actions were prudent under the circumstances, i.e., a quick sale may have further depressed the stock price, and there was at least some chance the stock could have

Recently, in this “reverse stock drop” context, the First Circuit in *Bunch v. W.R. Grace & Co.*,¹³⁸ affirmed summary judgment in favor of W.R. Grace and State Street Bank & Co., concluding that neither had breached its fiduciary duty in connection with State Street’s decision, as the independent investment manager, to divest the Grace plan of company stock. In so holding, the court rejected plaintiffs’ attempt to use *Moench’s* rebuttable presumption of prudence as a sword against the prudent fiduciary, i.e., the court rejected plaintiffs’ argument that State Street’s decision to divest the plan of company stock was wrong because there is a presumption of prudence in investing in company stock.¹³⁹

Finally, although the rulings in *Summers v. State Street Bank & Trust Co.*¹⁴⁰ and *DiFelice v. US Airways*¹⁴¹ took two different approaches in analyzing the risk/prudence issue, both decisions underscore the difficulties inherent in proving these types of claims when there is no proof of fraud. As previously discussed in Section II(D), *supra*, *DiFelice v. US Airways* involved a publicly-traded company that extensively commented on its increasing financial distress, and eventually declared bankruptcy in August 2002. In *US Airways* the employee-participants had complete discretion whether to invest in US Airways stock or in the other investment options offered by the 401(k) plan. The case was tried on the sole issue whether the plan fiduciaries breached a fiduciary duty of prudence to sell off US Airways stock at some point prior to this bankruptcy.¹⁴² The district court in *DiFelice* adopted and applied modern portfolio theory (MPT) to analyze the prudence of employer stock as an investment option in participant-directed 401(k) plans.¹⁴³ Under MPT, investment of a portion of a plan’s assets in a high risk security is appropriate as part of a portfolio, at least as long as this stock remained viable. The court defined viable for this purpose as a security with at least some chance of not becoming worthless through the company’s bankruptcy. The court also grounded this ruling on the notion that Congress meant for employer stock to be a favored investment option despite the risk

rebounded if loan guarantees and cost concessions were granted. *Id.* at 781. *See also Smith v. Delta Airlines Inc.*, 422 F. Supp. 2d 1310, 1333 (N.D. Ga. 2006) (in granting motion to dismiss noting with approval investment committee’s appointment of an independent fiduciary to manage the stock fund).

¹³⁸ 553 F.3d 1 (1st Cir. 2009).

¹³⁹ *Id.* at 10.

¹⁴⁰ 453 F.3d 404 (7th Cir. 2006).

¹⁴¹ 436 F. Supp. 2d 756 (E.D. Va. 2006), *affirmed*, 497 F.3d 410 (4th Cir. 2007).

¹⁴² *Id.* at 757-58.

¹⁴³ *Id.*

inherent in any investment in a single company's stock.¹⁴⁴

On appeal, the Fourth Circuit affirmed the district court's judgment, but rejected the application of the modern portfolio theory.¹⁴⁵ The Fourth Circuit agreed that despite the risk associated with company stock, it is still a favored investment option under ERISA.¹⁴⁶ However, the Fourth Circuit held that, in a participant-directed plan, each investment option should be evaluated for prudence on its own rather than apply modern portfolio theory.¹⁴⁷

Unlike *US Airways*, in *Summers v. State Street Bank & Co.*,¹⁴⁸ subject to certain, limited exceptions, the employee-participants were unable to direct their investments, and instead were required to have their ESOP money invested in United Airlines stock. Plaintiffs claimed that a letter from United's CEO stating that, absent a major change in its business after the terrorist attack of 9/11, the airline may go bankrupt, triggered a fiduciary duty of prudence to sell off United Airlines' stock because bankruptcy was allegedly inevitable at this point.¹⁴⁹ Writing for the Seventh Circuit, Judge Posner flatly rejected the notion that ERISA fiduciaries had any duty to – or that they even could – outsmart the market regarding United's future business and stock performance.¹⁵⁰

The Seventh Circuit posited a potentially different way of analyzing prudence focused on shareholder risk, not guesses as to future business and market performance. The court agreed that Congress meant for ESOP investments to be undiversified and that, because of the risk posed by lack of diversification, these investments are inherently risky. The court also concluded, though, that ERISA imposes some form of a duty of prudence on these investments, and that the employee-participants probably would not elect to accept this undiversified risk, particularly since the risk of poor business performance threatened not just their retirement savings but also their jobs and other benefits. In exploring how fiduciaries can assess risk, the court analyzed the correlation between the company's debt-to-equity ratio and that ratio's impact on the shareholder's stake in the company's value, indicating that fiduciaries should

¹⁴⁴ *Id.* at 788-89.

¹⁴⁵ 497 F.3d 410, 420-24 (4th Cir. 2007).

¹⁴⁶ *Id.*

¹⁴⁷ *Id.* at 423-24.

¹⁴⁸ 453 F.3d 404 (7th Cir. 2006).

¹⁴⁹ *Id.* at 405-6.

¹⁵⁰ *Id.* at 410-11.

focus on the magnitude of risk (including risk of bankruptcy) when shareholder value becomes small in relation to the company's debt.¹⁵¹

C. Section 404(c) of ERISA as a Defense to Fund Selection

Section 404(c) of ERISA, 29 U.S.C. § 1104(c), supplies an affirmative defense to a fiduciary breach if the participant exercised control over his account in making his investment directions. As the House Conference Report explained regarding the purposes of ERISA § 404(c), "if the participant instructs the plan trustee to invest the full balance of his account in, e.g., a single stock, the trustee is not liable for any loss because of a failure to diversify or because the investment does not meet the prudent man standards."¹⁵²

The causal basis for a loss of 401(k) or like investments in employer stock typically consists of two elements: (i) the employer stock fund must be offered as a plan investment option; and (ii) the participant must direct his money into that fund.¹⁵³ Although the legislative history and statutory structure of Section 404(c) and the Third Circuit's *Unisys Savings Plan*¹⁵⁴ case suggest that Section 404(c) can be a defense to relieve a fiduciary of liability regarding the selection or retention of the employer stock fund, the DOL takes the position that it does not.¹⁵⁵ Other recent employer stock cases have followed the DOL's guidance on this issue.¹⁵⁶ In contrast, in *Unisys*,¹⁵⁷ the court held that one allegedly imprudent investment alternative combined with a multitude of unassailable ones does not impair the Section 404(c) defense. *Unisys* is consistent with the authority from

¹⁵¹ *Id.* at 410-12.

¹⁵² H.R. CONF. REP. NO. 1280, *reprinted in* 1974 U.S.C.C.A.N. 5086.

¹⁵³ Plan funds that must be invested and held in an employer stock fund (typically through an employer match or in a traditional ESOP) are not participant-directed, and thus are not eligible for the ERISA § 404(c) defense.

¹⁵⁴ *In re Unisys Sav. Plan Litig.*, 74 F.3d 420, 445 (3d Cir. 1996) (holding that § 404(c) is a defense to claim that fiduciary breached his duty in making investment selection).

¹⁵⁵ *See* 57 F.R. 46906, 46924 & n. 27 (October 13, 1992) (in preamble to Section 404(c) regulations concluding that Section 404(c) protection does not extend to the selection of the investment alternatives, reasoning that such selection is not a direct or necessary result of a participant direction).

¹⁵⁶ *See DiFelice*, 497 F.3d at 418 n.3 (dicta); *Enron Corp.*, 284 F. Supp. 2d at 578-79.

¹⁵⁷ 1997 WL 732473, at * 2, *31 (E.D.Pa. Nov. 24, 1997) ("[e]ven if there was a finding of fiduciary breach in the first instance [by including one imprudent fund], . . . ERISA section 404(c) absolves Unisys from plaintiffs' claims of fiduciary breach" where 401(k) plan had six different investment options), *aff'd*, 173 F.3d 145 (3d Cir. 1999).

the DOL and the courts that ERISA adopted modern portfolio theory for analyzing plan investments.¹⁵⁸

In *Langbecker v. Electronic Data Systems Corp.*,¹⁵⁹ the Fifth Circuit also rejected the DOL's position that Section 404(c) may never be a defense to selection or retention of a plan investment option. In rejecting the DOL's position, the Fifth Circuit applied the statutory language and the text of the DOL's regulation to conclude the applicability of the Section 404(c) defense will depend on the particular facts and circumstances at issue.¹⁶⁰ Finally, in *Jenkins v. Yager*,¹⁶¹ the Seventh Circuit ruled that the Section 404(c) defense is only a safe harbor, and that participants may still be responsible for their investment choices even if Section 404(c) does not apply.

IV. THE DISCLOSURE AND *VARITY* CLAIMS

Disclosure claims are based on the notion that the fiduciary had an affirmative duty to disclose certain material information related to plan investments.¹⁶² *Varity* claims are premised on the notion that the fiduciary made, in a fiduciary capacity, affirmative material misrepresentations regarding plan investments. These claims raise a host of issues as to whether they are properly

¹⁵⁸ *Cf. e.g.*, *Laborers Nat'l Pension Fund v. N. Trust Quantitative Advisors, Inc.*, 173 F.3d 313, 321-23 (5th Cir. 1999) (approving under modern portfolio theory highly risky investment in derivatives of interest-only, mortgage-backed securities). In its Section 404(c) regulation, the DOL requires that a portfolio of investments with diverse risk-return characteristics be offered in order to involve Section 404(c)'s protections. 29 C.F.R. § 2550.404c-1(b)(3).

¹⁵⁹ 476 F.3d 299 (5th Cir. 2007).

¹⁶⁰ *Id.* at 309-13. *See also Hecker v. Deere*, 556 F.3d 575, 589-90 (7th Cir. 2009) (following *Langbecker* to conclude Section 404(c) can be a defense to selection of investment options when participant has sufficient options to control his risk of loss), *clarified at* 569 F.3d 708 (2009); *Rogers v. Baxter International Inc.*, -- F. Supp. 2d --, 2010 WL 1780349, at *5-*10 (N.D.Ill. May 3, 2010) (following *Hecker* and applying Section 404(c) defense to company stock prudent investment claim and granting summary judgment on same).

¹⁶¹ 444 F.3d 916, 923-24 (7th Cir. 2006).

¹⁶² The standard of materiality for ERISA investment decisions is the same as the one used under the federal securities laws, i.e., is there a substantial likelihood that a reasonable investor would have made a different investment decision had she or he had the information at issue. *Cf., e.g., In re Duke Energy ERISA Litig.*, 282 F. Supp. 2d 786, 791-92 (W.D.N.C. 2003) (round trip trades accounting for less than one-third of one percent of overall revenue are immaterial as a matter of law; claimed qualitative control problems and the alleged masking of lack of revenue growth not negate nonmateriality).

brought as class claims, which are discussed briefly in this Article in Section II(C); this section discusses some of the key issues that have arisen on the merits.

A. *Communications and Fiduciary Status*

SEC filings and statements made to the market regarding a company's business and financial information are generally made in a corporate, not a fiduciary, capacity.¹⁶³ Plaintiffs have attempted to “end run” this corporate-fiduciary distinction by arguing a “dissemination” theory – that the dissemination of these SEC filings to plan participants triggers ERISA fiduciary duties. The

¹⁶³ See, e.g., *Kirschbaum v. Reliant Energy Inc.*, 526 F.3d 243, 257 (5th Cir. 2008) (SEC filings, even those made as part of an ERISA plan, are made in corporate not fiduciary capacity); *In re Bank of America Securities, Derivative & ERISA Litig.*, 2010 WL 3448197, at *24 (S.D.N.Y. Aug. 27, 2010) (same); *In re Wachovia Corp. ERISA Litig.*, 2010 WL 3081359, at *16 (W.D.N.C. Aug. 6, 2010) (same); *Lanfear v. Home Depot, Inc.*, -- F. Supp. 2d --, 2010 WL 2427413, at *13 (N.D.Ga. June 7, 2010) (same); *Herrera v. Wyeth*, 2010 WL 1028163, at *7 (S.D.N.Y. Mar. 17, 2010) (same); *In re Bausch & Lomb, Inc.*, 2008 WL 5234281, at *7-8 (W.D.N.Y. Dec. 12, 2008) (same); *Shirk v. Fifth Third Bancorp.*, 2009 WL 692124, at *16-19 (S.D. Ohio Jan. 29, 2009) (same); *In re Harley Davidson*, 660 F. Supp. 2d 953, 967 (E.D.Wis. 2009) (same); *Sims v. First Horizon Nat'l Corp.*, 2009 WL 3241689, at *25-28 (W.D. Tenn. Sept. 30, 2009) (same); *In re Citigroup ERISA Litig.*, 2009 WL 2762708, at *20-25, *26 (S.D.N.Y. Aug. 31, 2009); *In re Avon Products, Inc. ERISA Litigation*, 2009 WL 884687, at *12-16 (S.D.N.Y. Mar. 30, 2009) (adopting Report and Recommendations of Mag. Judge Dolinger); 2009 WL 848083 (S.D.N.Y. Mar. 3, 2009) (Report and Recommendations of Mag. Judge Dolinger); *Crowley v. Corning, Inc.*, 234 F. Supp. 2d 222, 228 (W.D.N.Y. 2002), *aff'd on motion to amend*, 2004 WL 763873 (W.D.N.Y. Jan. 14, 2004) (holding as matter of law that these statements to the market are not made in a fiduciary capacity); *Hull v. Policy Management Systems Corp.*, 2001 WL 1836286, at *4 (D.S.C. Feb. 9, 2001) (same); *Stein v. Smith*, 270 F. Supp. 2d 157, 172-73 (D.Mass. 2003) (same); *In re Williams Cos. ERISA Litig.*, 271 F. Supp. 2d 1328, 1338 (N.D.Okla. 2003) (same); *In re WorldCom, Inc. ERISA Litig.*, 263 F. Supp. 2d 745, 760 (same). *But see In re Regions Morgan Keegan ERISA Litig.*, 692 F. Supp. 2d 944, 955-56 (W.D. Tenn. 2010) (at motion to dismiss stage, incorporation of SEC filings may implicate fiduciary duties where misrepresentations were made in information); *In re IKON Office Solutions Securities Litig.*, 86 F. Supp. 481 2d, 491-92 (E.D.Pa. 2000) (at motion to dismiss stage allowing further factual development on whether company acted in fiduciary role regarding communication of information related to its company stock); *In re Dell, Inc. ERISA Litig.*, 563 F. Supp. 2d 681, 695-96 (W.D.Tex. 2008) (denying dismissal of disclosure claim and holding a question a fact existed); *In re Computer Sciences Corp. ERISA Litig.*, 635 F.Supp.2d 1128, 1141 (C.D. Cal. July 13, 2009) (explaining, in Ninth Circuit, SEC filings can give rise to ERISA liability when the defendant intentionally incorporates them into plan documents, e.g., prospectuses); *In re Reliant Energy ERISA Litig.*, 336 F. Supp. 2d 646, 660-63, 670-71 (S.D.Tex. 2004) (filing Form S-8 may confer fiduciary status on the defendant to the extent that the defendant had discretion with regard to the information to include in the form, but the mere fact that the form incorporates by reference future SEC filings does not confer fiduciary status on the defendants).

securities laws require that plan participants be offered access to SEC filings that are provided to other potential purchasers or owners of the employer's stock.¹⁶⁴ Thus, these filings are disseminated in the company's corporate role as issuer of the stock. If the plan is a participant-directed plan intended to comply with Section 404(c) of ERISA, the DOL's Section 404(c) regulation also imposes these dissemination requirements. These requirements are typically met by incorporating by reference a company's SEC filings into the plan's prospectus/Summary Plan Description ("SPD").¹⁶⁵ This SPD is itself part of the prospectus required to be distributed by the federal securities laws.¹⁶⁶ Likewise,

¹⁶⁴ The federal securities laws mandate that when corporations choose to sponsor a 401(k) or like voluntary, contributory plan that offers an employer's securities, it must file a Form S-8 registration statement with the SEC. *See WorldCom, Inc.*, 263 F. Supp. 2d at 766. When securities are being offered pursuant to a registration statement on Form S-8, a prospectus meeting the requirements of § 10(a) of the Securities Exchange Act is required. 15 USC §77j; Securities Act, Rule 428; 17 CFR §230.428. The prospectus must be disseminated to all employees who are eligible to become plan participants. 15 USC §77j; Securities Act, Rule 428; 17 CFR §230.428(b)(1)(i). Part II, Item 3 of Form S-8 provides the list of documents incorporated by reference in the registration statement and in the § 10(a) prospectus. Among those documents incorporated by reference are reports filed pursuant to §§ 13(a) or 15(d) of the Act since the end of the fiscal year. Part II, Item 3, Form S-8. These documents include the 10K, 10Q, and 8K filings. *See* §13(a) of the Act. For a detailed discussion of the history and import of the plan prospectus requirements, see Susan J. Stabile, *I Believed My Employer and Didn't Sell My Stock: Is There an ERISA (or 34 Act) Remedy for Me?*, 36 CONN. L. REV. 385, 394-96 (Winter 2004).

¹⁶⁵ *Cf.*, e.g., *In re Tyco Int'l., Ltd.* MDL, No. 02-1335-PB, 2004 U.S. Dist LEXIS 24272, at *11 (D.N.H. Dec. 2, 2004) (committee members who sign SEC filings on behalf of plan committee are acting in a ministerial, not fiduciary role, in signing those filings).

¹⁶⁶ An SPD may be used to fulfill the plan information delivery requirements of the Section 10(a) prospectus provided that the SPD includes all material plan information required by Item 1 of Form S-8, or is supplemented with an additional document or documents containing the required information not included in the SPD; the required legend noting Securities Act registration is included in the forepart of the document; and the SPD is prepared early enough to ensure timely delivery of current plan information to participants under the federal securities laws. *See WorldCom, Inc.*, 263 F. Supp. 2d at 760. *See also Registration and Reporting Requirements for Employee Benefit Plans*, 46 S.E.C. 518, p.4, SEC Release No. 6867, 28094, 33-6867, 34-28094, 1990 WL 310688 (June 6, 1990); *Securities Law Considerations Affecting Employee Benefit Plans*, BNACPS No. 44-2 §IV (March 2003). Delivery of the prospectus has to precede or accompany offers and sales of the registrant's securities. *See* Form S-8(A); *see also Registration and Reporting Requirements for Employee Benefit Plans*, 46 S.E.C. 518, p. 4, SEC Release No. 6867, 28094, 33-6867, 34-28094, 1990 WL 310688 (June 6, 1990). Therefore, the SPD would have to be distributed prior to ERISA guidelines, as ERISA only requires plan administrators furnish the SPD either within 90 days *after* an employee becomes a plan participant or within 120 days of the plan becoming subject to ERISA. *See also Registration and Reporting Requirements for Employee Benefit Plans*, 46 S.E.C.

the DOL has taken the position in its Section 404(c) regulation and the preamble thereto that its regulation “is not intended to require a plan fiduciary to disclose information to the general public.”¹⁶⁷ Because the securities laws insider-trading rules prohibit selective disclosures for purposes of trading, this suggests that the DOL’s Section 404(c) regulation is not meant to require disclosures of a company’s material, *non-public* business or financial information. Through the preamble to its Section 404(c) regulation, the DOL further indicates that fiduciaries act in a “pass-through” role in the provision of these SEC filings.¹⁶⁸ As to the ERISA SPD requirements, the SPD is not required to include information concerning the relative merits of offered investments; moreover, ERISA does not require plan fiduciaries to offer participants investment advice.¹⁶⁹

Nonetheless, in the *WorldCom*¹⁷⁰ saga, the courts indicated that there may be an ERISA fiduciary duty triggered by this mandated dissemination of these SEC filings – although these cases may be limited to their unique facts of a fiduciary’s alleged knowing distribution of fraudulent SEC filings.¹⁷¹ In subsequent cases, however, some courts have allowed this dissemination theory to survive a motion to dismiss under the theory that anything incorporated into the prospectus/SPD may ultimately be deemed a fiduciary communication.¹⁷² In *In re*

518, p. 4, SEC Release No. 6867, 28094, 33-6867, 34-28094, 1990 WL 310688 (June 6, 1990).

¹⁶⁷ 57 Fed. Reg. 46,906, 46,923 (Oct. 13, 1992).

¹⁶⁸ See 57 Fed. Reg. at 46,912 (“with the exception of certain plan and participant specific information, the information required to be furnished and made available to participants . . . is information which is typically furnished by, or readily available from, investment managers, investments advisers, and issuers of securities.”); *id.* at 46928 (“Information provided to non-plan shareholders of employer securities . . . must be passed through to participants and beneficiaries invested in the [employer stock] fund.”).

¹⁶⁹ See *e.g.*, *Pennsylvania Fed’n.*, 2004 WL 228685, at *5 (noting same and concluding an SPD stating that the employer stock fund is undiversified and more volatile than a diversified investment is sufficient); *In re Unisys Sav. Plan Litig.*, 74 F.3d 441, 443 (3d Cir. 1996) (ERISA imposes no duty to provide investment advice).

¹⁷⁰ *In re WorldCom, Inc.*, ERISA Litig., 263 F. Supp. 2d 745 (S.D.N.Y. 2003).

¹⁷¹ See *Vivien v. WorldCom, Inc.*, 2002 WL 31640557, at *6-8 (N.D.Cal. July 22, 2002) (distinguishing *Hull v. Policy Mgmt. Sys. Corp.*, 2001 WL 1836286 (D.S.C. Feb. 9, 2001); incorporating SEC filings in SPD may trigger ERISA fiduciary duties because ERISA triggers duty to distribute SPD to Plan participants); *WorldCom, Inc.*, 263 F. Supp. 2d at 766 (same).

¹⁷² See *Rankin v. Rots (Kmart)*, 278 F. Supp. 2d 853, 875-77 (E.D.Mich. 2003) (quoting and applying *WorldCom, Inc. ERISA Litig.*); *In re Sears Roebuck & Co. ERISA Litig.*, 2004 WL 407007, at *6 (N.D.Ill. Mar. 3, 2004) (adopting *WorldCom, Inc. ERISA Litig.* analysis); *In re Sprint Corp. ERISA Litig.*, 2004 WL 1179371, at *13-15 (D.Kan. May

Tyco International Multidistrict Litigation,¹⁷³ however, the court gave effect to the fact that the challenged SEC filings were disseminated in a corporate capacity in dismissing fiduciary claims related to those filings:

[T]here is little evidence in the legislative history of either the Securities Act, which is the source of the disclosure requirements, or ERISA to support the view that an issuer of stock necessarily assumes fiduciary responsibilities in complying with its obligations under the securities laws if it chooses to allow its employees to invest in its stock as a part of an individual account plan. Although plaintiffs plainly had a right to expect that Tyco International would refrain from making material misstatements in its SEC filings, that expectation must be enforced under the securities laws rather than ERISA. Accordingly, I reject plaintiffs' argument that Tyco International was engaged in discretionary acts of plan administration when it disseminated the Form S-8s and Section 10(a) prospectuses.¹⁷⁴

In a variation on the *WorldCom*¹⁷⁵ "dissemination" theory, in *In re Dynegey Inc. ERISA Litigation*,¹⁷⁶ the court concluded that a statement in the prospectus/SPD encouraging employees to "carefully review" the company's SEC

27, 2004) (refusing to dismiss plaintiffs' disclosure claim because the alleged false filings were incorporated into the prospectus/SPDs); *Gee v. UnumProvident Corp.*, 2005 WL 534873, at *16 (E.D.Tenn. Jan. 13, 2005) (incorporating SEC filings in SPD may trigger ERISA fiduciary duties because ERISA triggers duty to distribute SPD to plan participants); *In re Beazer Homes USA, Inc. ERISA Litig.*, 2010 WL 1416150, at *8 (N.D.Ga. Apr. 2, 2010) (refusing to dismiss plaintiffs' disclosure claims because incorporation of SEC filings may trigger ERISA fiduciary duties). *See also In re Honeywell Int'l. ERISA Litig.*, 2004 WL 3245931, at *8-10 (D.N.J. June 14, 2004) (same for those responsible for distributing the SPDs). For an apt example of the district courts' confusion in this area, *see In re JDS Uniphase Corp. ERISA Litig.*, 2005 WL 1662131 (N.D.Cal. July 14, 2005) in which the district court first correctly noted that the preparation of reports required by government is a ministerial function, *id.* at *2, and also correctly noted that the plan prospectus is required to be disseminated by the corporation under the federal securities laws. *Id.* at *12. The court nonetheless then stated that "therefore" these are ERISA fiduciary communications. *Id.*

¹⁷³ 2004 U.S. Dist. LEXIS 24272, at *22-23 (D.N.H. Dec. 2, 2004).

¹⁷⁴ *Id.*

¹⁷⁵ *See In re WorldCom, Inc., ERISA Litig.*, 263 F. Supp. 2d 745 (S.D.N.Y. 2003).

¹⁷⁶ 309 F. Supp. 2d 861, 878-79 (S.D.Tex. 2004).

filings (which ultimately were determined to contain material misrepresentations that were subsequently restated) stated a claim for a fiduciary breach against the plan committee responsible as plan administrator for the SPD. The *Dynegy* court suggested that although simply following the DOL's Section 404(c) regulation to disseminate SEC filings may not have involved any fiduciary discretion, the statement in the prospectus/SPD "encouraging" a careful review was discretionary, and hence fiduciary: "In so doing the [committee members] were bound by fiduciary duties of loyalty and prudence not to communicate information that materially misrepresented Dynegy's financial condition."¹⁷⁷ The *Dynegy* court further reasoned that this stated a claim for a breach, although the court noted that the plaintiffs would ultimately have to prove that each of the committee members, by virtue of their company positions and access to contradictory information, either knew or should have known that the financial statements referred to in the SPD were materially misleading.¹⁷⁸ The court also reasoned that this claim was properly characterized as a breach of the duty to speak truthfully (i.e., a *Varity* claim), not as a failure to disclose claim,¹⁷⁹ for which the court agreed there is no general duty to disclose a company's business or financial information absent allegations that the fiduciary knew that they were false.¹⁸⁰

Subsequent to *WorldCom* and *Dynegy*, the Fifth Circuit in *Kirschbaum v. Reliant Energy, Inc.*,¹⁸¹ held that SEC filings incorporated by reference in the plan's Form S-8 registration statement and 10a prospectus are still made in a corporate, not fiduciary, capacity because they are required to be distributed by the federal securities laws.¹⁸² In so holding, the court distinguished *Dynegy* by stating in *Dynegy* plaintiff had alleged the 10a prospectus also constituted the ERISA SPD.¹⁸³

In the traditional ESOP context involving closely-held companies, certain additional facts may subject to fiduciary duties what would otherwise be thought of as corporate communications.¹⁸⁴ Finally, for purposes of deciding a motion to

¹⁷⁷ *Id.* at 879-80.

¹⁷⁸ *Id.* at 880-81.

¹⁷⁹ *Id.* at 883.

¹⁸⁰ *Id.* at 887-90.

¹⁸¹ *Kirschbaum v. Reliant Energy Inc.*, 526 F.3d 243, 257 (5th Cir. 2008).

¹⁸² *Id.*

¹⁸³ *Id.*

¹⁸⁴ *See* *Flake v. Hoskins*, 55 F. Supp. 2d 1196, 1221 (D.Kan. 1999) (communications that went only to ESOP participants soliciting their votes in sale of company may have been

dismiss, some courts have allowed plaintiffs to pursue their claim that CEO statements made to the employees about the company's financial health and business prospects may have been made in a fiduciary capacity.¹⁸⁵

B. Affirmative Disclosure Duties Regarding a Company's Business and Financial Information

If a fiduciary *knows* plan assets have been misappropriated or are at risk for self-dealing, the courts have generally imposed a "duty to alert,"¹⁸⁶ although courts generally have been careful not to extend this "duty to alert" to impose "Good Samaritan" liability on non-fiduciaries who may know of problems.¹⁸⁷ Plan fiduciaries can also undertake a duty to inform by promissory language in

made in a fiduciary capacity); *Nelson v. IPALCO Enters., Inc.*, 2003 WL 402253, *4-5. (S.D.Ind. Feb. 13, 2003) (refusing to dismiss allegation that defendant was fiduciary where statement made at shareholders meeting that merger was a good deal for employees was accompanied by statement that speaker was acting as fiduciary for employees and shareholders).

¹⁸⁵ See *Stein v. Smith*, 270 F. Supp. 2d 157, 173-74 (D.Mass. 2003); *In re Sprint Corp. ERISA Litig.*, 2004 WL 1179371, at *15-16 (D.Kan. May 27, 2004) (concluding statements made in a company newsletter regarding the company's prospects could qualify as material misrepresentations made by defendants in their capacity as fiduciaries).

¹⁸⁶ See *Barker v. American Mobil Power Corp.*, 64 F.3d 1397, 1402-04 (9th Cir. 1995) (company co-mingled profit-sharing plan funds; fiduciary on administrative committee had suspicion this was occurring but never investigated or told participants; instead he sent letter that funds were earning interest); *Glaziers and Glassworkers Union Local No. 252 Annuity Fund v. Newbridge Securities*, 93 F.3d 1171, 1775-82 (3d Cir. 1996) (fund advisor stole and wasted fund assets; securities firm failed to disclose it terminated advisor over concerns regarding advisor's integrity); *Ream v. Frey*, 107 F.3d 147, 153-56 (3d Cir. 1997) (bank resigned as trustee and turned money over to company president when knew company had financial difficulties and company president had not been complying with his fiduciary duties); *Vescom v. American Heartland Health Adm.*, 2003 WL 186882, at *5 (D.Me. Jan. 17, 2003) (plan administrator setting up "self-funded" plan with 100% reinsurance knew prior to renewal reinsurer was not paying claims timely and was in default). *Cf. Ershick v. United Missouri Bank*, 1990 WL 126929, at *5 (D.Kan. Aug. 28, 1990), *aff'd*, 948 F.2d 660 (10th Cir. 1991) (although ESOP directed-trustee bank was also the commercial lender to the company; Granted bank summary judgment on lack of knowledge, bank followed federal regulatory guidance by building "Chinese Wall" between commercial loan department and trust department).

¹⁸⁷ See *CSA 401(k) Plan v. Pension Prof'ls. Inc.*, 195 F.3d 1135, 1138-40 (9th Cir. 1999) (third party administrator discovered discrepancies between amounts withheld and amounts deposited and suspected embezzlement by a trustee).

plan documents or plan communications.¹⁸⁸ In contrast, there is no general duty to inform of contingent corporate events, regardless of their materiality.¹⁸⁹

The analysis becomes more complicated when the issue involves a claimed duty to disclose material, adverse, non-public information that may affect the value of the investments in the employer stock fund. The securities laws insider trading rules prohibit selective disclosures of this information to participants, and generally ERISA disclosure obligations do not attach to those who are not charged to communicate plan information. Another potential hurdle is ERISA § 514(d), 29 U.S.C. § 1114(d), which prohibits ERISA from being used “to alter, amend, modify, invalidate, impair, or supersede” any other federal laws, such as the securities laws, and thus by its terms ought to prohibit the use of ERISA fiduciary duties to impose disclosures obligations *beyond* those imposed by the securities laws.¹⁹⁰ Indeed, writing for the Seventh Circuit, Judge Easterbrook recently observed that there is “no reason” for ERISA to be construed to require disclosures beyond those required by corporate or securities laws.¹⁹¹ And in *Baker v. Kingsley*,¹⁹² the Seventh Circuit applied this principle to dismiss claims that fiduciaries misled them regarding the company’s financial problems. In *Baker*, the plaintiffs alleged that the defendants breached their fiduciary duties by misleading them as to whether there was a “significant risk” that the company would falter and, as a result, that the health plan would be terminated. The court

¹⁸⁸ See *Franklin v. First Union Corp.*, 84 F. Supp. 2d 720, 733-36 (E.D.Va. 2000) (court used SPD “will be notified” language to impose duty to inform of changes to investment funds).

¹⁸⁹ *Sweeney v. Kroger Co.*, 773 F. Supp. 1266, 1269 (E.D. Mo. 1991) (claim should have informed that a group had expressed interest in buying company; court held that “plan administrators are not required to inform all Plan participants and beneficiaries of every corporate event, especially contingent events, that might impact the value of the company’s common stock.”). See also *Ervast v. Flexible Products Co.*, 346 F.3d 1007, 1016-17 & 1015 at n. 8 (11th Cir. Sept. 24, 2003) (in preemption context suggesting same for pending merger of ESOP-owned company).

¹⁹⁰ The federal securities laws establish when one is – or is not – liable for disclosures in SEC filings and other statements to the market. Using ERISA fiduciary law to impose duties and liabilities when the securities laws would not for those same disclosures appears to be using ERISA to “alter, amend, modify, or supersede” this law. To date, the courts have only addressed this issue at the motion to dismiss stage in cases involving allegations of massive fraud, and have assumed at this preliminary stage that there is no tension or conflict because the securities laws would themselves have required the same disclosures. *E.g., In re WorldCom, Inc. ERISA Litig.*, 263 F. Supp. 2d 745, 767 (S.D.N.Y. 2003).

¹⁹¹ *Beach v. Commonwealth Edison Co.*, 382 F.3d 656, 660 (7th Cir. 2004).

¹⁹² 387 F.3d 649 (7th Cir. 2004).

rejected this argument, holding that “vague allegations of ‘assessments’ of the general economic well-being of an employer, especially in the absence of specific allegations of intent to deceive, are not sufficient to state a claim for breach of fiduciary duty under ERISA.”¹⁹³ The court observed that “the failure to disclose the likelihood of bankruptcy and plan termination may have been an innocent byproduct of the company’s efforts to keep from its creditors and competitors information that it had no duty to disclose,”¹⁹⁴ and that “if we were to create a new fiduciary duty, as plaintiffs request, we run the risk of disturbing the carefully delineated corporate disclosure laws.”¹⁹⁵

Despite (or perhaps because of) these and other significant hurdles to using ERISA fiduciary duties to create a supplemental disclosure regime regarding a company’s business and financial information, the courts are divided on this issue at the motion to dismiss stage. On one side are cases such as *Edgar v. Avaya, Inc.*,¹⁹⁶ which involved allegations that fiduciaries allegedly concealed

¹⁹³ *Id.* at 662.

¹⁹⁴ *Id.*

¹⁹⁵ *Id.*

¹⁹⁶ 503 F.3d 340, 350 (3d Cir. 2007). *See also* Pugh v. Tribune Co., 521 F.3d 686 (7th Cir. 2008); Fisher v. JP Morgan Chase & Co., 703 F. Supp. 2d 374, 386-87 (S.D.N.Y. 2010) (no affirmative duty to disclose nonpublic information); *In re* Bank of America Securities, Derivative & ERISA Litig., 2010 WL 3448197, at *23 (S.D.N.Y. Aug. 27, 2010) (same); Gearren v. McGraw-Hill Cos., Inc., 690 F. Supp. 2d 254, 271-72 (S.D.N.Y. 2010) (no affirmative duty to disclose financial information); *In re* Wachovia Corp. ERISA Litig., 2010 WL 3081359, at *16 (W.D.N.C. Aug. 6, 2010) (same); Fisher v. JP Morgan Chase & Co., 703 F. Supp. 2d 374, 386-87 (S.D.N.Y. 2010) (same); Harris v. Amgen, Inc., 2010 WL 744123, at *13 (C.D.Cal. Mar. 2, 2010) (same); Herrera v. Wyeth, 2010 WL 1028163, at *7 (S.D.N.Y. Mar. 17, 2010) (same); Patten v. Northern Trust Co., 703 F. Supp. 2d 799, 813-14 (N.D.Ill. 2010) (same); Brieger v. Tellabs, 629 F. Supp. 2d 848, 865-866 (N.D. Ill. June 1, 2009); Banks v. Healthways, Inc., 2009 WL 211137, at *3-4 (M.D. Tenn. Jan. 28, 2009); *In re* Harley Davidson, 660 F. Supp. 2d 953, 967-968 (E.D.Wis. 2009); Sims v. First Horizon Nat’l Corp., 2009 WL 3241689, at *25-28 (W.D. Tenn. Sept. 30, 2009); *In re* Avon Products, Inc. ERISA Litigation, 2009 WL 884687, at *12-*16 (S.D.N.Y. Mar. 30, 2009) (adopting Report and Recommendations of Mag. Judge Dolinger); 2009 WL 848083 (S.D.N.Y. Mar. 3, 2009) (Report and Recommendations of Mag. Judge Dolinger); Graden v. Conexant Systems, Inc., 574 F. Supp. 2d 456, 465 (D.N.J. 2008); *In re* Bausch & Lomb, Inc., 2008 WL 5234281, at *7-*8 (W.D.N.Y. Dec. 12, 2008); Urban v. Comcast Corp., 2008 WL 4739519, at *14-*15 (E.D.Pa. Oct. 28, 2008); *In re* McKesson HBOC, Inc. ERISA Litigation, 2002 WL 31431588, at *6 (N.D.Cal. Sept. 30, 2002); Hull v. Policy Mgmt. Sys. Corp., 2001 WL 1836286, at *9 (D.S.C. Feb. 9, 2001); Cokenour v. Household Int’l., Inc., 2004 WL 725973, at *7-8 (N.D.Ill. Mar. 31, 2004); *In re* Syncor ERISA Litig., 351 F. Supp. 2d 970, 987 (C.D.Cal. 2004); DiFelice v. U.S. Airways, 397 F. Supp. 2d 735, 767-68 (E.D. Va. 2005) (concluding that absent allegations that the fiduciary misled participants, complying with ERISA’s detailed reporting requirements is sufficient); *see also* DiFelice,

adverse information that ultimately led to an earnings warning and severe drop in stock price. The *Edgar* court rejected the notion that ERISA imposes any supplemental disclosure duty; it also concluded that disclosure obligations were satisfied by SPD statements warning that investing in the non-diversified employer stock fund was risky.¹⁹⁷ On the other side are the “bankruptcy implosion” cases of *WorldCom*, *Kmart*, and *Enron* and the decisions that have followed them.¹⁹⁸ In the middle are cases such as *In re Dynegy Inc. ERISA Litigation*,¹⁹⁹ which concluded that there is no general fiduciary duty to correct a company’s financial statements absent allegations that the plan fiduciaries knew they were false, but which also held that a prospectus/SPD statement that encouraged participants to review SEC filings triggered fiduciary duties regarding those SEC filings. As noted, *Pugh* suggests that, when “red flags” do arise, ERISA fiduciaries may be able to rely on the corporate investigation and reporting process unless they have some reason to believe it is broken.²⁰⁰

398 F. Supp. 2d 453 (E.D. Va. 2005) (applying same to independent fiduciary appointed to manage company stock fund); *In re Calpine Corp. ERISA Litig.*, 2005 WL 173200, at *7 (N.D.Cal. Mar. 31, 2005).

¹⁹⁷ 503 F.3d at 350.

¹⁹⁸ See *In re ADC Telecomms., Inc.*, ERISA Litig., 2004 WL 1683144, at *7 (D.Minn. July 26, 2004) (“Company officers who act as plan fiduciaries may be required to draw upon their ‘corporate’ knowledge to properly fulfill their obligations to protect and prioritize the interests of plan beneficiaries.”); *In re WorldCom, Inc. ERISA Litig.*, 263 F. Supp. 2d 745, 766 (S.D.N.Y. 2003) (incorporating SEC filings in SPD may trigger ERISA fiduciary duties to supplement or correct); *Rankin v. Rots (Kmart)*, 278 F. Supp. 2d 853, 875–77 (E.D.Mich. 2003) (adopting *WorldCom* analysis); *In re Enron Corp. Secs., Derivative & “ERISA” Litig. (Tittle v. Enron Corp.)*, 284 F. Supp. 2d 511, 555–67 (S.D.Tex. 2003) (special circumstances and extreme impact of Enron fraud may have triggered duties to disclose; no conflict with securities laws because of obligation to make public disclosure to correct fraud). See also *In re Sears Roebuck & Co. ERISA Litig.*, 2004 WL 406007, at *6 (N.D.Ill. Mar. 3, 2004) (adopting *WorldCom* analysis when financial statements were restated); *Hill v. Bellsouth Corp.*, 313 F. Supp. 2d 1361, 1368–69 (N.D.Ga. 2004) (asserting that plan fiduciaries have duty to disclose information about company in event of “special circumstance” that “trigger[s] those heightened obligations”); *In re Fremont General Corp.*, 564 F. Supp. 2d 1156, 1159 (C.D.Ca. 2008) (same); *In re Guidant Corp. ERISA Litig.*, 2008 WL 2498127, at *5 (S.D.Ind. June 19, 2008) (same); *In re Diebold ERISA Litig.*, 2008 WL 2225712, at *10-*11 (N.D. Ohio May 28, 2008) (same); *Balsley v. Delta Star Employee Stock Ownership*, 2009 WL 4823196 (N.D. Cal. Dec. 10, 2009); *Bacon v. Stiefel Labs. Inc.*, -- F. Supp. 2d --, 2010 WL 2164566, at *2 (S.D.Fla. May 27, 2010); *Page v. Impac Mortgage Holdings, Inc.*, 2009 WL 890722, at *5-*6 (C.D. Cal. Mar. 31, 2009); *In re Computer Sciences Corp. ERISA Litig.*, 635 F.Supp.2d 1128, 1141-42 (C.D. Cal. July 13, 2009).

¹⁹⁹ 309 F. Supp. 2d 861, 879–80 (S.D.Tex. 2004).

²⁰⁰ See *Pugh v. Tribune*, 521 F. 3d 686, 700 (7th Cir. 2008).

C. Section 404(c) of ERISA as a Defense to Disclosure Claims

One court has noted that a breach of the duty to disclose material information related to the plan investment *may* ultimately mean that the participant did not exercise the requisite “control” over those investments.²⁰¹ On remand, the district court found after trial, however, that Section 404(c) was a defense to the plaintiffs’ claims.²⁰² Because Section 404(c) can require fact-intensive inquiries into the “total mix of information” on which each participant relied in order to determine whether the participant exercised the requisite control over his investments, the Section 404(c) defense can also negate class status for participant-directed claims.²⁰³

²⁰¹ See *In re Unisys Savings Plan Litig.* (“Unisys Savings I”), 74 F.3d 420, 445 n. 22 & 447 (3d Cir. 1996).

²⁰² *In re Unisys Sav. Plan Litig.*, 1997 WL 732473, at *31 (E.D.Pa. Nov. 24, 1997), *aff’d*, 173 F.3d 145 (3d Cir. 1999). See also *In re Electronic Data Sys. Corp. ERISA Litig.*, 224 F.R.D. 613, 624-26 (E.D.Tex. Nov. 8, 2004) (noting that Section 404(c) defense applies to disclosure claims; refusing to certify class on that claim because of the individual issues raised by the defense), *reversed on other grounds*, *Langbecker v. Electronic Data Sys. Corp.*, 476 F.3d 299 (5th Cir. 2007); *Lingis v. Motorola, Inc.*, 649 F. Supp. 2d 861, 870-874 (N.D. Ill. 2009) (applying Section 404(c) and dismissing plaintiff’s disclosure claim). *But see* *Page v. Impac Mortgage Holdings, Inc.*, 2009 WL 890722, at **3-*4 (C.D. Cal. Mar. 31, 2009) (rejecting the application § 404(c) defense to plaintiffs’ disclosure claim).

²⁰³ See *Electronic Data Systems*, 224 F.R.D. at 624–26; *Wiseman v. First Citizens Bank & Trust Co.*, 212 F.R.D. 482, 487–88 (W.D.N.C. Jan. 8, 2003) (class commonality and typicality requirements not met for participant-directed investments in 401(k) plan); *In re First American Corp.*, 258 F.R.D. 610, 2009 WL 2430879 (C.D.Cal. July 27, 2009) (same); *Thomas v. Aris Corp.*, 219 F.R.D. 338, 340–43 (M.D. Pa. 2003) (detrimental reliance not presumed on ERISA disclosure claims and possibility of §404(c) defense renders each potential class member’s claim significantly different from and atypical of each other); *but see In re Schering-Plough Corp. ERISA Litig.*, 589 F.3d 585 (3d Cir. 2009) (holding that ERISA § 404(c) did not negate class certification under *Fed. R. Civ. P.* 23(b)(1), but leaving open for the district court to consider whether 404(c) may negate class certification under *Fed. R. Civ. P.* 23(b)(3)); *Stanford v. Foamex L.P.*, -- F.R.D. --, 2009 WL 3075390 (E.D.Pa. Sept. 24, 2009) (rejecting 404(c) as a basis for denying class certification); *In re First American Corp.*, 258 F.R.D. 610, 619, 2009 WL 2430879 (C.D.Cal. July 27, 2009) (same).

V. SPECIAL ISSUES IN ESOPs OF CLOSELY HELD COMPANIES

Both publicly and closely held companies can create ESOPs as a means for employees to acquire tax-favored ownership.²⁰⁴ Congress provided these tax subsidies because it believes that employee ownership is a social good:

The committee believes that through the employee stock ownership plan, many corporate employers will be introduced to a new technique of corporate finance that will enable the company to build its own investment capital while providing equity ownership for their employees, and in this way benefit society as a whole.²⁰⁵

Congress, however, couples these tax subsidies with complex rules that must be complied with to qualify for those subsidies. Moreover, ERISA's fiduciary duties (other than the duty to diversify) govern those charged with ESOP administration. Particularly for closely held companies wholly or majority owned by the ESOP, any major business decision can have a substantial impact on the value of the ESOP's investments in the company's stock. Not surprisingly, the interplay between ESOP administration and management of the company's business often gives rise to litigation in which the courts must disentangle when the company ends and the ESOP, and fiduciary duties, begin.

An ESOP may obtain a loan in order to invest in the employer's stock – a powerful technique of corporate finance that allows, for example, a company's founders to be “cashed out” while gradually transferring ownership of the company to its employees. In a leveraged ESOP, the loan is used to purchase stock, and the company's cash contributions to the ESOP are used to extinguish the loan. As the loan is paid off, shares are released from the ESOP's “suspense” account to be allocated to the individual accounts of the ESOP participants.²⁰⁶

²⁰⁴ See generally *Donovan v. Cunningham*, 716 F.2d 1455, 1458-59 (5th Cir. 1983) (discussing purposes and goals of ESOPs); L. KELSO & P. HETTER, *TWO FACTOR THEORY: THE ECONOMICS OF REALITY* (1967); L. KELSO & M. ADLER, *THE CAPITALIST MANIFESTO* (1958).

²⁰⁵ S. REP. NO. 94-36 (1975), *reprinted in* 1975 U.S.C.C.A.N. 54, 107, (emphasis added) (legislative history to the Tax Reduction Act of 1975, discussing new tax incentives for ESOP formation, eventually called Tax Credit Act Stock Ownership Plans or “TRASOPs”).

²⁰⁶ See ABA SECTION OF LABOR & EMPLOYMENT LAW, *EMPLOYEE BENEFITS LAW* ch. 6, at I.B. (BNA 2d ed. 2000); SUSAN SEROTA, *ERISA FIDUCIARY LAW*, ch. 9, at II.B. (BNA 1995 & 2003 Supp.); *Donovan*, 716 F.2d at 1459. In *Fox v. Herzog, Heine, Geduld, Inc.*, 2005 U.S. Dist. LEXIS 36414, 36 EB Cases (BNA) 2112 (D.N.J. Dec. 27, 2005), a district court addressed whether the shares held in the suspense account of a

Unlike an ESOP of a publicly traded company, the ESOP of a closely held company does not have a market to gauge the value of the company's stock. Consequently, the DOL and the Internal Revenue Service (IRS) have set forth guidelines governing the valuation of the stock held by the ESOP. In order for a closely held company offering an ESOP to obtain various tax benefits, the Internal Revenue Code (IRC) also requires that the ESOP provide participants the right to sell their shares back to the company for a fair price.²⁰⁷ A "put option" is the participant's right to redemption; the company's burden to repurchase those shares is called its "repurchase obligation." As a result, ESOPs of closely held companies must conduct at least annual redemption valuations in order to value those shares and to forecast adequately the companies' financial obligations for the coming year. The method and how often a company chooses to conduct those valuations are typically left up to the ESOP trustee.²⁰⁸

A closely held ESOP's acquisition or sale of stock must meet not only the general fiduciary "prudence" standards of § 404 of ERISA, but also the prohibited transaction rules of § 406 of ERISA, 29 U.S.C. § 1106.²⁰⁹ Section 406 prohibits an ESOP from transacting with the company, its officers and directors, and any

leveraged ESOP were vested benefits belonging to the ESOP's participants. After a tender offer was approved by the trustee, the acquiring company decided to merge the ESOP in which the plaintiff was a participant into the acquiring company's ESOP, thereby merging the suspense account shares with those in the acquiring company's account and diluting the number of shares in the suspense account to allocate among the participants of the former company's ESOP. Plaintiffs filed suit under ERISA §§ 502(a)(2) and 502(a)(3), seeking the monetary value of the shares held in the suspense account of the former ESOP. The district court granted the defendant's motion for summary judgment. The district court dismissed plaintiffs' ERISA § 502(a)(2) claims because plaintiffs could not demonstrate a loss to the plan as a whole "rather than to individual beneficiaries or a subclass of beneficiaries." *Id.* at *7. The court held that the plan sustained no loss resulting from the merger, especially since there were no allegations that the shares of the acquiring company, Merrill Lynch, held a lesser value. *Id.* The district court then dismissed plaintiffs' ERISA § 502(a)(3) claims, holding that plaintiffs had no vested right to the unallocated shares held in the suspense account because "those shares were not [accrued] benefits protected under ERISA." *Id.* Consequently, the district court held that since plaintiffs had no right to the unallocated shares they could not show that the defendants are in possession of something that belongs to them. *Id.*

²⁰⁷ 29 U.S.C. § 409(h)(1)(B).

²⁰⁸ See ABA SECTION OF LABOR & EMPLOYMENT LAW, EMPLOYEE BENEFITS LAW, Ch. 6 §I.B. (Steven J. Sacher et al., eds., BNA 2d ed. 2000); ERISA FIDUCIARY LAW, Ch. 9 §II.B. (Susan P. Serota, ed., BNA 1995 & 2003 Supp.); *Donovan v. Cunningham*, 716 F.2d 1455, 1459 (5th Cir. 1983).

²⁰⁹ See, e.g., *Donovan*, 716 F.2d at 1463-65.

significant shareholders unless the ESOP pays or receives “adequate consideration” for the stock.²¹⁰ For ESOPs of a closely held company, ERISA § 3(18)(B), 29 U.S.C. § 1002(18)(B), defines “adequate consideration” as “the fair market value of the asset as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary [of Labor].” Much litigation surrounding ESOPs of closely held companies relates to whether “adequate consideration” was received or paid for the company’s stock, in short, whether the stock was properly valued, including after the valuation process concludes and a successor trustee takes over.²¹¹

A. Valuing the Company’s Stock

Litigation arises at all stages of the valuation process,²¹² whether it is at the inception of the ESOP, so that a company can comply with its repurchase obligations, for merger purposes, or to terminate the ESOP.²¹³ The very nature of an ESOP for a non-publicly traded company thus entails the constant valuation, acquisition, redemption, and sale of the company’s stock.²¹⁴

In *Donovan v. Cunningham*,²¹⁵ the Fifth Circuit issued the first major decision addressing valuation of stock for closely held ESOPs. In *Cunningham*, a

²¹⁰ Specifically, ERISA § 406(a) prohibits a plan from entering into a transaction with a party in interest regarding the purchase or sale of property. However, given that the very nature of an ESOP of a closely held company is to purchase stock from the company or its few shareholders – often directors or executives of the company – ERISA § 408(e), 29 U.S.C. § 1108(e), provides an exemption to ERISA § 406 if the purchase or sale is for “adequate consideration.”

²¹¹ *Fernandez v. K-M Industries Holding Co., Inc.*, 585 F. Supp. 2d 1177 (N.D.Cal. 2008) (successor trustee may be liable for failing to sue prior trustee when prior trustee purchased stock at inflated price); *see also*, 646 F. Supp. 2d 1150, 48 EB (BNA) Cases 1301 (N.D.Cal. 2009) (denying cross claim for indemnification).

²¹² The plaintiff must, of course, have standing to bring the claim. *Cf. Crawford v. Lamantia*, 34 F.3d 28, 32-33 (1st Cir. 1994) (participant who cashed out his ESOP holdings no longer had standing; he was unable to show how alleged breach affected benefits he would have received).

²¹³ *See, generally*, N. Goldberg, *ESOP Valuation Issues*, in SUSAN SEROTA, ERISA FIDUCIARY LAW, Ch. 10 (BNA 1995 & 2003 Supp.).

²¹⁴ *Cf. Armstrong v. Amsted Indus., Inc.*, 2004 WL 1745774, *9-10 (N.D.Ill. July 30, 2004) (applying *Lockheed v. Spinks*, 517 U.S. 882 (1996), to conclude that Section 406 does not apply to valuing the repurchase of stock from participants because this is the payment of benefits, which is not a “transaction” within the ambit of ERISA § 406), *reversed and remanded on other grounds*, 446 F.3d 728 (7th Cir. 2006).

²¹⁵ 716 F.2d 1455, 1466 & n.22 (5th Cir. 1983).

closely held corporation created an ESOP to buy out the company's chairman, Cunningham. The ESOP purchased shares from Cunningham in two transactions that took place over the span of seven months and, in both transactions, the ESOP purchased the shares for \$200 a share. In the first transaction, the company self-funded it by contributing \$288,000 in cash to the ESOP; the second transaction was a leveraged one in which the ESOP borrowed \$1 million to fund the share purchase. Although the stated intent was for the ESOP to acquire 100 percent of the company, at the end of these two transactions the ESOP owned 34 percent of the company, while Cunningham held the balance of 66 percent.²¹⁶

Prior to formation of the ESOP, the company considered various financing options, including retaining an investment banking firm to explore those options and to conduct a valuation of the company's stock. The investment banking firm issued a report valuing the stock on June 30, 1975, at \$200 a share based on the presumption that the purchase would be for 100 percent of the company's stock and that the company's revenues would grow at a substantial rate for the indefinite future. The ESOP trustees used this valuation to justify the ESOP's acquisitions of a minority interest from Cunningham 13 and 20 months after the date of the report.²¹⁷ The DOL filed suit, alleging that the ESOP fiduciaries committed a prohibited transaction by purchasing stock on behalf of the ESOP for more than "adequate consideration" in violation of ERISA § 406, and that they breached their duties of prudence under ERISA § 404 by failing to prudently and independently conduct an investigation as to the fair market value of the shares prior to purchase.²¹⁸

The Fifth Circuit noted that the case was one of first impression that had to be decided without the benefit of any DOL regulation.²¹⁹ The *Cunningham* court framed the DOL's allegations as raising one central issue: whether the ESOP purchased the shares for fair market value.²²⁰ In evaluating whether the shares were purchased for fair market value, the court held that ERISA's statutory language and general fiduciary case law required the ESOP fiduciaries to "prove that adequate consideration was paid by showing that they arrived at their determination of fair market value by way of a prudent investigation in the circumstances then prevailing."²²¹ This prudent investigation would be evaluated

²¹⁶ *Id.* at 1459-60, 1472.

²¹⁷ *Id.* at 1468-69.

²¹⁸ *Id.* at 1460.

²¹⁹ *Id.* at 1466 & n.22.

²²⁰ *Id.* at 1465.

²²¹ *Id.* at 1467-68.

in light of the “prudent man” standards set forth in ERISA.²²² The court then held that relying on an investment banking report conducted for the purpose of selling the company that was created thirteen and twenty months prior to the ESOP’s purchases did not amount to a prudent investigation.²²³ Among other things, this valuation failed to take into account that subsequent revenue and income growth was substantially below projections, that the ESOP did not acquire control of the company, and that the ESOP transaction itself affected the value of the company by increasing compensation costs and by imposing a \$1 million obligation on the company to pay off the ESOP loan.²²⁴

Pursuant to the Fifth Circuit’s recommendation in *Cunningham*, the DOL promulgated a proposed regulation defining “adequate consideration.”²²⁵ The DOL stated that the purpose of the regulation was to “provide a framework within which fiduciaries can fulfill their statutory duties.”²²⁶ The proposed regulation requires fiduciaries to meet a two-part test for determining whether “adequate consideration” is met: (1) the “value assigned to an asset must reflect its fair market value as determined pursuant to proposed [part (b)(2)]”; and (2) the “value assigned to an asset must be the product of determination made by the fiduciary in good faith as defined in proposed [part (b)(3)].”²²⁷ The DOL then defined fair market value as: “[t]he price at which an asset would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, and both parties are able, as well as willing, to trade and are well-informed about the asset

²²² *Id.* at 1467.

²²³ *Id.* at 1469-73. The Fifth Circuit did note, however, that “[t]o use an independent appraisal properly, ERISA fiduciaries need not become experts in the valuation of closely-held stock – they are entitled to rely on the expertise of others. However, as the source of the information upon which expert opinions are based, the fiduciaries are responsible for ensuring that that information is complete and up-to-date.” *Id.* at 1474.

²²⁴ *Id.* at 1469-73. *Cf.* N. Goldberg, *ESOP Valuation Issues*, in SUSAN SEROTA, ERISA FIDUCIARY LAW, Ch. 10 (BNA 1995 & 2003 Supp.) (discussing rationales for valuing ESOP’s acquisition without taking into account impact of ESOP financing).

²²⁵ Prop. Reg. 29 C.F.R. § 2510.3-18(b), 53 Fed. Reg. 17,632 (May 17, 1988). Although never made final, the DOL’s proposed regulation has provided a framework for analyzing whether an ESOP’s stock was acquired or sold for “adequate consideration.” *Cf., e.g.,* *Montgomery v. Aetna Plywood, Inc.*, 39 F. Supp. 2d 915, 919 (N.D.Ill. 1998); N. Goldberg, *ESOP Valuation Issues*, in SUSAN SEROTA, ERISA FIDUCIARY LAW, Ch. 10 (BNA 1995 & 2003 Supp.) (discussing same and collecting cases).

²²⁶ 53 Fed. Reg. at 17,633.

²²⁷ *Id.*

and the market for that asset.”²²⁸ In determining this fair market value, the proposed regulation requires the valuation report to contain:

- (A) A summary of the qualifications to evaluate assets of the type being valued of the person or persons making the valuation;
- (B) A statement of the asset's value, a statement of the methods used in determining that value, and the reasons for the valuation in light of those methods;
- (C) A full description of the asset being valued;
- (D) The factors taken into account in making the valuation, including any restrictions, understandings, agreements or obligations limiting the use or disposition of the property;
- (E) The purpose for which the valuation was made;
- (F) The relevance or significance accorded to the valuation methodologies taken into account;
- (G) The effective date of the valuation; and
- (H) In cases where a valuation report has been prepared, the signature of the person making the valuation and the date the report was signed.²²⁹

When the valuation is of stock of a non-publicly traded company (such as in the closely held ESOP context), the valuation report must *also* contain:

- (A) The nature of the business and the history of the enterprise from its inception;
- (B) The economic outlook in general, and the condition and outlook of the specific industry in particular;
- (C) The book value of the securities and the financial condition of the business;

²²⁸ *Id.* at 17,634. The proposed regulation provided that whether a fiduciary is “well-informed” will be a factual determination based upon the facts and circumstances of a particular case, including any special knowledge the fiduciary has that could affect the value of the asset at issue. *Id.* at n.1.

²²⁹ *Id.* at 17,637-38.

- (D) The earning capacity of the company;
- (E) The dividend-paying capacity of the company;
- (F) Whether or not the enterprise has goodwill or other intangible value;
- (G) The market price of securities of corporations engaged in the same or a similar line of business, which are actively traded in a free and open market, either on an exchange or over-the-counter;
- (H) The marketability, or lack thereof, of the securities. Where the plan is the purchaser of securities that are subject to “put” rights and such rights are taken into account in reducing the discount for lack of marketability, such assessment shall include consideration of the extent to which such rights are enforceable, as well as the company’s ability to meet its obligations with respect to the “put” rights (taking into account the company’s financial strength and liquidity);
- (I) Whether or not the seller would be able to obtain a control premium from an unrelated third party with regard to the block of securities being valued, provided that in cases where a control premium is taken into account: (1) Actual control (both in form and in substance) is passed to the purchaser with the sale, or will be passed to the purchaser within a reasonable time pursuant to a binding agreement in effect at the time of the sale, and (2) It is reasonable to assume that the purchaser’s control will not be dissipated within a short period of time subsequent to acquisition.²³⁰

In discussing the second, “good faith” part of the test, the DOL’s proposed regulation provides that the good faith requirement should be evaluated under an objective standard of conduct.²³¹ In addition, the proposed regulation sets forth two criteria a fiduciary must satisfy to meet the good faith requirement: the fiduciary must (1) “apply sound business principles of evaluation and to conduct a prudent investigation of the circumstances prevailing at the time of the

²³⁰ *Id.* at 17638.

²³¹ *Id.* at 17,634.

evaluation,”²³² and (2) “be independent of all parties to the transaction (other than the plan) or...rely on the report of an appraiser who is independent of all the parties to the transaction (other than the plan).”²³³

The DOL’s proposed regulation and the often conflicted nature of ESOP transactions (which may entail the purchase of shares from fiduciaries or from those who control the fiduciaries) thus make the independent valuation report central to the ESOP transaction. However, the courts are clear that this “independent appraisal ‘is not a magic wand that fiduciaries may simply waive over a transaction to ensure that their responsibilities are fulfilled.”²³⁴ Rather, the Ninth Circuit, in *Howard v. Shay*, stated that to rely on such a report the fiduciary must: “(1) investigate the expert’s qualifications, (2) provide complete and accurate information, and (3) make certain the reliance on the expert’s advice is reasonably justified under the circumstances.”²³⁵ In *Howard*, the ESOP sold its stock to the chairman of the company, who was also an ESOP fiduciary. The ESOP trustees retained Arthur Young, Inc., to conduct the valuation. Arthur Young arrived at the sales price by taking the appraised value of the underlying real estate assets and discounting those values by 60 percent because the holding company had only partial ownership of one subsidiary company, another 40 percent to 50 percent because the ESOP only had minority ownership of the holding company, and another 50 percent for lack of liquidity of the ESOP’s shares. Thus, stock that had an asset value of \$83 was appraised for sale to the chairman at \$14.40 a share.²³⁶

The Ninth Circuit held that the ESOP trustees’ acceptance of this valuation constituted a breach of their fiduciary duties under ERISA § 404 and a prohibited transaction under ERISA § 406. The court criticized the ESOP trustees for accepting the valuation price without negotiation and without attempting to test it through a second review or by shopping the stock to third party buyers. The court also found that the discounts applied were greater than the norms, were unsupported by empirical evidence, and were not challenged or even questioned by the ESOP trustees. Among other things, the court noted that the buyer (the

²³² The DOL took this requirement and its wording straight from the Fifth Circuit’s language in *Donovan v. Cunningham*, 716 F.2d 1455, 1467 (5th Cir. 1983).

²³³ 53 Fed. Reg. at 17,634-35. Thereafter, the DOL set forth proposed guidelines for courts to evaluate the “independence” of either the fiduciary or the appraiser. *Id.* at 17,635, 17,637.

²³⁴ *Howard v. Shay*, 100 F.3d 1484, 1489-90 (9th Cir. 1996) (*quoting* *Donovan v. Cunningham*, 716 F.2d 1455, 1474 (5th Cir. 1983)).

²³⁵ *Howard*, 100 F.3d at 1489.

²³⁶ *Id.* at 1487.

company's chairman) was, under the minority discount assumption, capturing the full value of this minority discount through this purchase. Finally, the court criticized what appeared to be the triple counting of discounts based on the asserted overvaluation and volatility of the underlying assets, as this ground was used by Arthur Young to justify each of the three discounts.²³⁷

Since the DOL's proposed regulation was issued, a circuit split has developed on whether, in order to establish that the stock was purchased for no more than "adequate consideration," a defendant must satisfy *both* the (1) fair value and the (2) good faith investigation requirements. The majority view is stated by the Sixth Circuit's recent opinion in *Chao v. Hall Holding Co.*,²³⁸ which held that a fiduciary must meet both tests. In *Hall Holding Co.*, the company established a leveraged ESOP to acquire approximately 10 percent of a subsidiary holding company's stock from the parent company's sole director and owner, Goldman. The ESOP trustees engaged an appraiser to value the operating company's – not the holding company's – stock, and the appraiser repeatedly stated he was valuing 100 percent of that company, while his appraisal did not purport to value an ESOP's purchase of stock. To arrive at the value paid by the ESOP, the defendant human resource director simply took the mid-point of the appraiser's valuation range and multiplied it by the 9.9 percent of stock to be acquired by the ESOP.²³⁹ The Sixth Circuit had little trouble concluding the defendants breached their duties to conduct a good faith investigation into the fair value to be paid for the stock: (1) their reliance on the valuation report was flawed, as that report valued the wrong company and it did not purport to value the minority stake purchased in a leveraged transaction by the ESOP; and (2) the trustees were unaware of what was going on and did not negotiate the price to be paid for the stock.²⁴⁰

The defendants in *Hall Holding Co.* argued that, under the Eighth Circuit's ruling in *Herman v. Mercantile Bank*,²⁴¹ they nonetheless should be relieved of liability if they met only the "fair value" test – i.e., under *Mercantile Bank*, an ESOP fiduciary is insulated from liability for failure to conduct a good faith investigation if a hypothetical prudent fiduciary would have paid the same "fair value" price.²⁴² The Sixth Circuit rejected this argument, noting that the

²³⁷ *Id.* at 1489-90.

²³⁸ 285 F.3d 415 (6th Cir. 2002).

²³⁹ *Id.* at 420-22.

²⁴⁰ *Id.* at 430-34.

²⁴¹ 143 F.3d 419, 421 (8th Cir. 1998).

²⁴² *Id.* at 421.

Eighth Circuit was the only court to use this relaxed test and that it believed such a test was contrary to the statutory definition of “adequate consideration” and to the Fifth Circuit’s approach in *Donovan v. Cunningham*.²⁴³ The Sixth Circuit also concluded that such a test was inappropriate for a Section 406 “prohibited transaction” claim, because ERISA § 406 was meant to create per se rules and ERISA § 406, unlike a violation of ERISA § 404, does not require proof that the violation caused harm.²⁴⁴

The valuation issue thus remains a major area of contention in the formation, management, and dissolution of closely held ESOPs. *Cunningham*, *Howard*, and *Hall Holding Co.* are detailed above.²⁴⁵ Other significant cases include:²⁴⁶

No Breach Found:

- *Herman v. Mercantile Bank*:²⁴⁷ The company filed bankruptcy approximately five years after recapitalization. In the company’s recapitalization, the ESOP sold and bought back its shares the next day at the same price; the ESOP’s ownership went from 33 to 63 percent because recapitalization resulted in the company undertaking a large loan that was used in part to re-purchase non-ESOP shares. The majority concluded the price paid was within the range of what a hypothetical reasonable prudent fiduciary

²⁴³ *Hall Holding Co.*, 285 F.3d at 436-37; see also *Howard v. Shay*, 100 F.3d 1484, 1489 (9th Cir. 1996) (applying both fair value and good faith investigation tests to ESOP’s sale of stock to company chairman).

²⁴⁴ *Hall Holding Co.*, 285 F.3d at 439.

²⁴⁵ For some other examples of cases addressing valuations issues, see *Keach v. United States Trust Co.*, 419 F.3d 626 (7th Cir. 2005) (affirming defense verdict after trial – failure to identify legal risks that were not material at time of ESOP transaction did not render transaction imprudent or a prohibited transaction); *Roth v. Sawyer-Cleator Lumber Co.*, 16 F.3d 915 (8th Cir. 1994) (reversing summary judgment because question of fact remained whether ESOP trustees’ decision to secure put options with security interests in company stock was objectively reasonable and prudent).

²⁴⁶ For an example of some of the unusual contexts and arguments that can arise in valuing ESOP stock, see *Summers v. State Street Bank*, 104 F.3d 105, 107-08 (7th Cir. 1997) (as part of substantial wage concessions, ESOP was created giving union employees majority ownership of United Airlines, a public company. Plaintiffs’ claim ESOP trustee should have valued wage and benefit concessions in approving deal was roundly rejected – wage and benefits concessions were not plan assets, nor is a trustee to consider effects of deal on employees as employees).

²⁴⁷ 143 F.2d 419 (6th Cir. 1998).

would have paid; the dissent argued the substantial debt incurred was used primarily to benefit the non-ESOP seller and impaired the stock's value by placing the company at risk.

- *Foltz v. U.S. News & World Report*:²⁴⁸ The plaintiffs claimed that profit-sharing fiduciaries should not have used the minority valuation approach when valuing the exercise of their put options; the court held that usage of minority valuation was proper (1) under relevant IRS regulations and (2) because the amount of stock repurchased from retirees was, in fact, a very small amount.
- *Henry v. Champlain Enterprises, Inc.*:²⁴⁹ The company wanted to raise more capital and decided to create an ESOP to accomplish the goal. The Second Circuit vacated a district court's decision that the trustee breached its duty in valuing the stock because the trustee was unable to produce detailed notes, rather focusing on the substance to conclude whether a breach occurred will depend on whether the purchase of the stock was reasonable under the then prevailing circumstances.

Breach Found:

- *Eyler v. Commissioner of Internal Revenue*:²⁵⁰ The plaintiff, a majority shareholder and owner of the company, engaged in a prohibited transaction and was subject to excise taxes by the IRS for selling the ESOP his shares at an overvalued price; the valuation was based on a year-old analysis by an investment banking firm, which valued the stock with the idea that the company was going public and not in light of the company creating an ESOP.
- *Horn v. McQueen*:²⁵¹ The ESOP fiduciaries breached their fiduciary duties by allowing the ESOP to overpay for shares, because the ESOP fiduciaries only conducted one valuation, which they took at face value, and failed to negotiate on behalf of the ESOP over the price of the company stock.

²⁴⁸ 865 F.2d 364, 373-74 (D.C. Cir. 1989).

²⁴⁹ 445 F.3d 610 (2d Cir. 2006).

²⁵⁰ 88 F.3d 445 (7th Cir. 1996).

²⁵¹ 215 F. Supp. 2d 867 (W.D.Ky. 2002).

- *Reich v. Valley National Bank of Arizona*:²⁵² A trustee purchased company stock through a leveraged ESOP created to take the company private. The court held that the ESOP trustee breached duties of loyalty and prudence by failing to conduct a good faith independent investigation into whether it was prudent for the ESOP to purchase company stock when the decision to go private was related to the company's poor financial condition.
- *Montgomery v. Aetna Plywood, Inc.*:²⁵³ A director/trustee acquired control of a company through an ESOP's sale of stock. The court found a breach in the failure to pay the ESOP a control premium and the failure to factor in benefits to the purchaser of the acquiring stock.

B. Separating ESOP Administration From Company Management

Another major area of contention for ESOPs of closely held companies is where to draw the line between the administration of the ESOP and the management of the company. This section focuses on cases resolving those lines. For an in-depth discussion of cases addressing whether a fiduciary should sell an ESOP's holding in company stock because of company misfortunes, *see* Part III(B), above. It is well established that a fiduciary can wear two hats, and that ERISA fiduciary duties do not attach to the individual's non-fiduciary role with respect to the company.²⁵⁴ However, the line between these fiduciary and settlor/employer roles can often become blurred with respect to ESOPs, especially when the individuals involved are major owners of closely held companies.

The default rule that settlor functions encompass creating, amending, and terminating the ESOP generally applies, although the unique characteristics of ESOPs as techniques of corporate finance and as means to acquire the company from insiders can blur these lines.²⁵⁵ It is also fairly well settled that the normal

²⁵² 837 F. Supp. 1259 (S.D.N.Y. 1993).

²⁵³ 39 F. Supp. 2d 915 (N.D.Ill. 1998).

²⁵⁴ *See, e.g.,* Lockheed Corp. v. Spink, 517 U.S. 882 (1996); Akers v. Palmer, 71 F.3d 226, 230-31 (6th Cir. 1995); Husvar v. Rapoport, 337 F.3d 603 (6th Cir. 2003); Kuper v. Iovenko, 66 F.3d 1447, 1456 (6th Cir. 1995).

²⁵⁵ *See* Akers v. Palmer, 71 F.3d 226, 230-31 (6th Cir. 1995) (creation and funding of ESOP are settlor acts); Kuper v. Iovenko, 66 F.3d 1447, 1456 (6th Cir. 1995) (applying to trust-to-trust transfer of ESOP assets rule that "purely business decisions by an ERISA employer are not governed by section 1104's fiduciary standards."). *Cf.* Dairy Fresh Corp. v. Poole, 108 F. Supp. 2d 1344, 1359-60 (S.D.Ala. 2000) (company owned by ESOP sought reformation of ESOP formation that would have reduced ESOP's ownership from 88% to 44%, thereby transferring majority ownership to company's

operation of a business does not trigger ERISA's fiduciary duties.²⁵⁶ However, when the company suffers major setbacks, the lines often get blurred between whether a director or officer is acting in his corporate or his fiduciary role and what his duties are under each.

In *Husvar v. Rapoport*,²⁵⁷ the Sixth Circuit applied the default rule that management of a business does not constitute an ERISA fiduciary function. In *Husvar*, participants in an ESOP of a non-publicly traded company filed suit alleging breach of corporate fiduciary duties that resulted in a loss in value for the company's stock. Although the company was not doing well financially, the plaintiffs alleged that the corporate executives continued to grant themselves substantial compensation and bonuses. The defendants tried to remove the case, contending that the plaintiffs were alleging claims arising under ERISA because those claims implicated fiduciary duties due under ERISA.²⁵⁸ In ordering the case remanded, the court held that the plaintiffs were alleging essentially that the executives' decisions to award themselves salaries and bonuses were in breach of their *corporate* fiduciary duties. The court reasoned that although mismanagement of a business would affect the value of the ESOP's investments, such mismanagement does not implicate the protections afforded by ERISA. The court distinguished between allegations regarding mismanagement of the ESOP fund versus those claiming that the company was mismanaged, holding that only the former stated claims for breach of ERISA fiduciary duties.²⁵⁹

If only it were so easy. Despite the preemptive force of ERISA, the courts often effectively defer to plaintiffs' choices as "masters of their complaint," thereby allowing them to engage in artful pleading to choose the law and the forum under which they wish to bring their claims. Thus the *same* conduct and common nucleus of operative fact can expose the officer/fiduciary to two

directors; court held company as plan administration breached its fiduciary duties of loyalty and prudence by seeking this reformation); *Eaves v. Penn*, 587 F.2d 453, 457-59 (10th Cir. 1978) (in conversion of plan assets into an ESOP, court held that person who benefited from the ESOP conversion by using it to take over the company with no cash outlay and who was involved in recommending and designing the ESOP was a fiduciary; court held fiduciary status attached because he received "indirect" compensation for his investment advice regarding the disposition of the pre-existing plan assets through the ESOP conversion).

²⁵⁶ *E.g.*, *Martin v. Feilen*, 965 F.2d 660, 666 (8th Cir. 1992) (noting "virtually all of an employer's significant business decisions affect the *value* of its stock...ERISA fiduciary duties only attach when an individual invests the ESOP's assets or administers the plan).

²⁵⁷ 337 F.3d 603, 605 (6th Cir. 2003).

²⁵⁸ *Id.* at 605-06.

²⁵⁹ *Id.* at 608-09.

potential sources of duties and liabilities.²⁶⁰ For example, in *Eckelkamp v. Beste*,²⁶¹ the Eighth Circuit treated a claim regarding excessive compensation as an ERISA fiduciary claim, with the only principled distinction to *Husvar* being that the plaintiffs in *Eckelkamp* chose to plead their claims under ERISA, whereas those in *Husvar* chose to plead them under state law.

In *Eckelkamp*, participants in an extraordinarily successful ESOP sued the company's officers and owners for alleged excessive compensation. Participants in the ESOP with at least one year of service had an average ESOP account balance of \$350,000; they earned an average of 125 percent in cash compensation as compared to those in comparable industries; and the company itself was wildly successful, earning an average annual 20 percent rate of return on its ESOP stock between 1985 and 2000.²⁶² The plaintiffs nonetheless claimed that the company's founder and officers breached their fiduciary duties under ERISA by allegedly overcompensating themselves. The court concluded that it did not need to decide whether a claim regarding executive compensation stated a claim under ERISA,²⁶³ although it did agree that ERISA preempted the plaintiffs' same claim pled under state law.²⁶⁴ Instead, the Eighth Circuit agreed with the district court that the plaintiffs failed to establish the ERISA claim for breach of fiduciary duties because the compensation methodology of the plaintiffs' expert was fundamentally flawed, i.e., it failed to factor in that *all* employees at the company were paid above market and that much of the executives' compensation was tied to bonuses earned because of the company's substantial, sustained business growth and financial success.²⁶⁵

Not all ESOP cases pursuing corporate mismanagement claims under ERISA have happy endings for the defendants, however. In a case that now

²⁶⁰ For some other examples of this dynamic, compare *Ervast v. Flexible Products Co.*, 346 F.3d 1007, 1014-17 (11th Cir. 2003) (concluding no complete ERISA preemption applied to claim company should have disclosed impending merger before plaintiff tendered his ESOP shares); with, e.g., *Sweeney v. Kroger Co.*, 773 F. Supp. 1266, 1269 (E.D.Mo. 1991) (treating as ERISA fiduciary claim the contention should have informed participants who cashed out their plan stock that a group had expressed interest in buying company).

²⁶¹ 315 F.3d 863 (8th Cir. 2002).

²⁶² *Id.* at 866.

²⁶³ *Id.* at 869 n. 2.

²⁶⁴ *Id.* at 870-71 (state law claim arose out of same facts and implicated the relations among primary ERISA entities).

²⁶⁵ *Id.* at 868.

stands as a precursor for the *Enron* and *WorldCom* ERISA lawsuits,²⁶⁶ – *Canale v. Yeagen*²⁶⁷ – plaintiffs used a derivative suit/need-to-act theory to impose ERISA fiduciary duties on corporate officers regarding corporate fraud and mismanagement.²⁶⁸ In *Canale*, the plaintiffs sued the company’s principal officers, who were also trustees of the ESOP. The ESOP owned stock in a holding company, whose principal asset was an insurance company named, ironically enough, Integrity.²⁶⁹ Integrity collapsed into bankruptcy because of alleged financial fraud by the defendants, including the alleged hidden siphoning of Integrity’s assets into other companies controlled by the defendants. The district court agreed that the fraudulent conduct of the defendants did not itself give rise to a claim for ERISA fiduciary duties; however, the defendants’ knowledge of their own misconduct and of its deleterious effect on the ESOP’s holdings created duties to act as ERISA fiduciaries:

Defendants can be charged with knowledge of the allegedly fraudulent acts of Integrity, its officers and directors, because defendants are the very individuals alleged to have performed or ordered the fraud allegedly perpetrated by Integrity. However, the basis for this ERISA lawsuit is not the perpetration of the fraud on Integrity’s shareholders itself, but the fact that knowing the plan’s investment had been impaired by their own fraudulent acts, defendants, acting as fiduciaries, failed to take any steps to protect the plan’s assets from dissipation.²⁷⁰

The *Canale* court also concluded that the defendants’ knowledge of their fraud triggered a duty under ERISA to bring a derivative lawsuit on behalf of the ESOP as a shareholder, even if that lawsuit would have required them to sue

²⁶⁶ *In re Enron Corp. Secs., Derivative & “ERISA” Litig.* (Tittle v. Enron Corp.), 284 F. Supp. 2d 511 (S.D.Tex. 2003); *In re WorldCom, Inc. ERISA Litig.*, 263 F. Supp. 2d 745 (S.D.N.Y. 2003).

²⁶⁷ 782 F. Supp. 963 (D.N.J. 1992).

²⁶⁸ The theory that fiduciaries breach their ERISA fiduciary duties by not bringing lawsuits or by otherwise failing to act when they allegedly know of corporate fraud has been applied to 401(k) plan investments in publicly traded companies. See *In re Enron Corp. Secs., Derivative & “ERISA” Litig.* (Tittle v. Enron Corp.), 284 F. Supp. 2d 511, 565-67 (S.D.Tex. 2003) (applying same to allegations of massive fraud regarding Enron).

²⁶⁹ 782 F. Supp. at 965-66.

²⁷⁰ *Id.* at 968.

themselves in their corporate capacities.²⁷¹ Recently, in *Community Bancshares v. Patterson*,²⁷² a district court followed the rationale enunciated in *Canale* and held that an ESOP fiduciary breached his fiduciary duty by not informing other ESOP fiduciaries of his fraud while serving as an ESOP fiduciary and CEO of the company.²⁷³

The blurred line between corporate mismanagement and ESOP fiduciary duties is further illustrated by *Martin v. Feilen*.²⁷⁴ In *Feilen*, the DOL challenged an accountant and a director and owner's involvement in numerous complicated corporate transactions related to the Feilen Meat Company, which was partially owned by an ESOP. The DOL argued that the defendants' self-interest in the transactions itself constituted breaches of their fiduciary duties, and that any transaction that affected the value of the stock owned by the ESOP implicated fiduciary duties because of that impact.²⁷⁵ As to the notion that self-interest in a transaction made the fiduciary inherently in breach, the Eighth Circuit in *Feilen* concluded that Congress specifically permitted such: "Thus, the ESOP fiduciary is not prohibited from being on both sides of a transaction involving the ESOP's assets, but he must serve both masters (or at least the ESOP) with the utmost care and fairness."²⁷⁶ The court also rejected the DOL's arguments regarding the scope of ERISA fiduciary duties related to an ESOP, reasoning that "[v]irtually all of an employer's significant business decisions affect the *value* of its stock...However, ERISA's fiduciary duties under §[404] attach only to transactions that involve investing the ESOP's assets or administering the plan."²⁷⁷ The court then applied this test to conclude ERISA fiduciary duties applied and were breached (1) when the defendants manipulated the price of and issuance of dividends from the company's stock in relation to the ESOP's sale of the stock, and (2) when the fiduciaries failed to bring a derivative lawsuit on behalf of the ESOP challenging their misappropriation of a corporate opportunity.²⁷⁸

²⁷¹ *Id.* at 968 n.3.

²⁷² 547 F. Supp. 2d 1230 (N.D.Ala. 2008).

²⁷³ *Id.* *But see* Blankenship v. Chamberlain, 2009 WL 1421201, at *2-*3 (E.D.Mo. May 20, 2009) (dismissing plaintiffs' breach of fiduciary duty claims because plaintiffs failed to allege that Chamberlain was acting in a fiduciary capacity when he made the allegedly injurious decisions).

²⁷⁴ 965 F.2d 660 (8th Cir. 1992).

²⁷⁵ *Id.* at 665.

²⁷⁶ *Id.* at 670.

²⁷⁷ *Id.* at 666.

²⁷⁸ *Id.* at 666-67.

Another example of these blurred lines occurred in *Johnson v. Couturier*.²⁷⁹ In *Johnson* plaintiff participants in the Noll Manufacturing Corporation ESOP brought suit against the former president and two other directors for allegedly breaching their fiduciary duties under ERISA by awarding \$34.8 million (approximately two-thirds of the company's value) to the former president, Couturier, in a buyout compensation package.²⁸⁰ The defendants also served as ESOP trustees.²⁸¹ Under various indemnification agreements executed between 2001 and 2005, defendants sought advancement of their defense costs from the company, which had become wholly owned by the ESOP in 2001.²⁸² On August 10, 2007, the successor to Noll was purchased and after bank debt, executive compensation and other expenses were satisfied, about \$10.8 million remained in escrow, to be distributed to participants once remaining legal costs (potentially including defendants' claimed advances) were deducted.²⁸³

Plaintiffs challenged defendants request for payment of their defense costs out of these escrowed assets. On appeal, the Ninth Circuit first rejected defendants' contention that determining Couturier's compensation was a business decision not subject to ERISA.²⁸⁴ The court observed that while corporate pay decisions were typically not subject to ERISA scrutiny, where, as here an ESOP fiduciary also serves as a corporate director or officer, imposing ERISA fiduciary duties on business decisions involving self-dealing with ERISA fiduciaries was needed to protect the ESOP.²⁸⁵ As to the enjoinder of the payment of defense costs, the court stated that plaintiffs were likely to succeed in proving that defendants had breached their fiduciary duties by approving Couturier's buyout package of \$34.8 million (approximately 65% of the company's total assets as of June 2004).²⁸⁶ The court noted that the Department of Labor's regulation permits

²⁷⁹ 572 F.3d 1067, 47 EB (BNA) Cases 1449 (9th Cir. 2009).

²⁸⁰ *Id.* at 1072-1075.

²⁸¹ *Id.*

²⁸² *Id.*

²⁸³ *Id.*

²⁸⁴ *Id.* at 1076-1077.

²⁸⁵ *Id.*

²⁸⁶ *Id.* at 1078-82.

indemnification of fiduciaries by the company but not the plan,²⁸⁷ and held that since here the assets were being held in escrow to distribute to participants, payment of any defense costs from these assets would be “tantamount” to the plan paying these costs. Accordingly, the court held that ERISA preempted state contract law that would permit the advancement of these costs.²⁸⁸

Finally, *Armstrong v. LaSalle Bank National Ass’n*,²⁸⁹ illustrates how major corporate events, involving no allegations of fraud or self-dealing, can nonetheless create potential duties to act on the part of ESOP fiduciaries. In *Armstrong*, a large, closely held company owned by an ESOP acquired another large company. This takeover required Amsted Industries to incur \$1 billion in debt, which left it with approximately \$200 million in available credit after the takeover. During this same period, the rise in the value of the company’s stock resulted in substantial distribution requests, as employees cashed out their ESOP holdings by leaving the company in record numbers, e.g., for 2000 the company’s repurchase obligations under the ESOP were projected to reach \$240 million. The company thus amended the ESOP to lessen the company’s repurchase obligations by requiring those who did not meet certain criteria to wait five years before their ESOP stock was cashed out.²⁹⁰

The Seventh Circuit, in an opinion written by Judge Posner, began its analysis by opining that ESOPs were imprudent *per se* because of an ESOP’s lack of diversification.²⁹¹ Although the Seventh Circuit conceded that Congress explicitly exempted ESOP fiduciaries from the duty to diversify, it held that the exemption justified a heightened standard of prudence.²⁹² The court held that a trustee’s valuation of the ESOP stock is entitled to “abuse of discretion review,” when the trustee is balancing the interests of current ESOP participants against those participants who want to leave.²⁹³ The court chided the trustee for failing to take into account the potential liquidity problems that the company would face if there was a run in redemptions following the acquisition of another company.²⁹⁴

²⁸⁷ See 29 C.F.R. 2509.74-4 (Department of Labor regulation on fiduciary indemnification permitting employer, but not the plan, to satisfy any liability incurred by a fiduciary for a fiduciary breach).

²⁸⁸ *Id.* at 1078-82.

²⁸⁹ 446 F.3d 728 (7th Cir. 2006).

²⁹⁰ *Id.* at 730-31.

²⁹¹ *Id.* at 732.

²⁹² *Id.*

²⁹³ *Id.* at 733.

²⁹⁴ *Id.* at 733-34.

The court suggested that the trustee could have lessened the risk by lowering the redemption price, and held that no abuse of discretion review is permitted if the trustee in fact did not exercise discretion in considering these factors.²⁹⁵

C. Control of the Closely Held Company and of the ESOP

Closely held companies owned by ESOPs would rarely qualify as models of corporate governance in a post-Sabarnes-Oxley Act world. The typical structure is that the company's directors appoint the ESOP fiduciaries, who may be either themselves or the officers of the company, who then vote the ESOP's shares to re-appoint the directors. For all ESOPs, the fiduciaries are charged with fiduciary duties to vote the shares prudently, although this duty may be somewhat lessened by "mirror voting" provisions, which provide that the unallocated shares of the ESOP shall be voted in the same proportion as those voted by the holders of allocated shares.²⁹⁶ For closely held ESOPs, however, unless the ESOP plan provides otherwise or the ESOP shares were acquired through a loan qualifying for certain tax benefits, even those participants who have shares allocated to their account do *not* get to vote those shares in director elections or other routine corporate matters. Rather, they are limited to voting their allocated shares in "major corporate transactions," defined to include any corporate merger or

²⁹⁵ *Id.*

²⁹⁶ In *Herman v NationsBank Trust Co.*, 126 F.3d 1354 (11th Cir. 1997), the DOL sued Polaroid's ESOP trustee, alleging that the trustee breached its fiduciary duty of prudence by failing to exercise its independent judgment with respect to competing tender offers to purchase the ESOP's shares. Polaroid created the ESOP to defeat hostile takeovers. In creating the ESOP, the plan provided for pass-through voting and mirror voting, wherein the unallocated shares in the ESOP would be voted in proportion to the voting of those shares that are allocated. *Id.* at 1357-58. Between 1988 and 1989, two competing tender offers were made with respect to the purchase of Polaroid shares, one from Shamrock and one from Polaroid. As a result, the ESOP trustee mailed out a description of the offers, along with instructions as to voting the allocated shares held in the ESOP. *Id.* at 1358. In the end, the ESOP trustee tendered the ESOP shares in accordance with the plan documents and the instructions from the plan participants, the majority of whom elected to tender their shares to Polaroid. *Id.* at 1359.

The Eleventh Circuit held that the ESOP's mirror voting provisions were facially valid under ERISA, but that a question of fact remained as to whether or not the ESOP trustee acted prudently in following those plan terms. *Id.* at 1368-69. For a further discussion of the substantial litigation in the not too distant past that involved the use and voting of ESOP shares in hostile takeover contexts, *see* SUSAN SEROTA, ERISA FIDUCIARY LAW ch. 9, at IV. (BNA 1995), ch. 9, at III.B. & C. (BNA 2003 Supp.) (collecting and analyzing cases).

consolidation, recapitalization, liquidation, dissolution, and the sale of all or substantially all assets of the business.²⁹⁷

Thus, the corporate governance structure in the closely held ESOP context is often very insular, with the directors having ultimate control over both the company and, through their appointment power, arguably the ESOP. ESOP participants have tried to use ERISA fiduciary duties to upend who controls the ESOP and the company with, to date, limited success.²⁹⁸ The leading case is the Sixth Circuit's decision in *Grindstaff v. Green*.²⁹⁹ *Grindstaff* arose out of a long running dispute between the company and the union over control of the ESOP, and hence of the company. The union and participants ultimately sued the company's directors and ESOP trustees, claiming that they breached ERISA fiduciary duties by continually re-electing the directors and by failing to amend the ESOP to provide for "pass through" voting rights so that the ESOP participants could vote for the directors.³⁰⁰

The *Grindstaff* court concluded that these allegations failed to state a claim. Regarding the ESOP trustees reelection of incumbent directors, the court noted that management entrenchment is the norm in the ESOP context, a matter of which Congress was fully aware when it authorized ESOP trustees to be able to act as and be appointed by corporate management. The court held that the voting of the ESOP shares in normal board elections did not constitute the management of plan assets, and thus were not subject to ERISA fiduciary duties to act solely in the interest of the ESOP participants. The Sixth Circuit distinguished two district courts cases that suggested otherwise as involving special circumstances not present in the "normal, uncontested 'course of affairs' annual elections" of company directors.³⁰¹ The court also easily rejected the notion the fiduciaries had

²⁹⁷ See ABA SECTION OF LABOR & EMPLOYMENT LAW, EMPLOYEE BENEFITS LAW ch. 6, at I.A.3. (BNA 2d ed. 2000).

²⁹⁸ Litigants have also attempted to use ERISA's fiduciary duties and ERISA's reporting and disclosure provisions to attempt to gain access to information regarding the management of the ESOP and of the company, again with limited success. See *Brown v. American Life Holdings, Inc.*, 190 F.3d 856, 861-862 (8th Cir. 1999) (holding ESOP fiduciaries did not breach their duties by failing to provide to ESOP participants various documents relating to the committees, including documents concerning the removal and appointment of ESOP committee members); *Faircloth v. Lundy Packing Co.*, 91 F.3d 648, 655 (4th Cir. 1996) (ESOP fiduciaries did not breach their duties to provide participants with documents relating to appraisal reports valuing the ESOP stock and minutes of the ESOP committee meetings, but were entitled to the ESOP's funding and investment policies).

²⁹⁹ 133 F.3d 416 (6th Cir. 1998).

³⁰⁰ *Id.* at 418-20.

³⁰¹ *Id.* at 421-25.

any duty to amend the plan to provide for “pass-through” voting rights, noting that plan amendment is a settlor function and that this pass through voting issue was part of the give and take in collective bargaining, which does not implicate ERISA fiduciary duties.³⁰²

EPILOGUE OF SELECTED CASES

Following in alphabetical order are case descriptions of selected cases discussed in this article that focus on fiduciary breach claims related to 401(k), ESOP, or other eligible individual account plan investments in employer stock.

- *Akers v. Palmer*, 71 F.3d 226 (6th Cir. 1995) (ESOP case – affirmed summary judgment for defendants). Company executives purchased shares at substantial discount; then created and funded the ESOP with the shares valued at fair market value. Plaintiffs claimed fiduciary duties attached to this creation and initial ESOP funding.
- *Armstrong v. Amsted, Industries, Inc.*, 2004 WL 1745774 (N.D.Ill. July 30, 2004), *reversed and remanded*, *Armstrong v. LaSalle Bank National Ass’n.*, 446 F.3d 728 (7th Cir. 2006). (ESOP case – reversing summary judgment for defendants). Large closely held ESOP conducted hostile takeover. Plaintiffs claimed that the financial drain caused by this hostile takeover imperiled the company’s ability to meet its repurchase obligations.
- *In re Avon Products, Inc. ERISA Litigation*, 2009 WL 884687, 46 EB (BNA) Cases 1786 (S.D.N.Y. Mar. 30, 2009) (adopting Report and Recommendations of Mag. Judge Dolinger); 2009 WL 848083, 46 EB (BNA) Cases 1769 (S.D.N.Y. Mar. 3, 2009) (Report and Recommendations of Mag. Judge Dolinger) (401(k)/ESOP case – granting defendants’ motion to dismiss). Plaintiffs brought putative class action lawsuit alleging that defendants breached their duties by continuing to offer company stock when they allegedly knew, or should have known, that Avon would sustain losses from disclosures of several selling and recruitment practices overseas.
- *In re Bank of America Securities, Derivative & ERISA Litig.*, 2010 WL 3448197 (S.D.N.Y. Aug. 27, 2010) (401k case – motion to dismiss for defendants). Putative class action

³⁰² *Id.* at 425.

brought stemming from company's acquisition of Countrywide Financial Corp. and Merrill Lynch & Co. as well as the financial crisis and 83% decline of company's stock.

- *In re Beazer Homes USA, Inc. ERISA Litig.*, 2010 WL 1416150 (N.D.Ga. Apr. 2, 2010) (401k case – motion to dismiss granted in part). Plaintiffs sued company and various individual defendants over offering of company stock as in investment option. Claims stemmed from the collapse of the housing market.
- *Brieger v. Tellabs*, 629 F. Supp. 2d 848 (N.D. Ill. 2009) (401k case – bench trial, judgment for defendants). Plaintiffs sued Tellabs and various individual defendants over the offering of Tellabs common stock as an investment option. The claims stemmed from Tellabs, along with other companies in the telecommunications industry, experienced market downturn. During the proposed class period, Tellabs stock declined from \$63.19 per share to \$6.58 per share.
- *Brown v. Medtronic*, 619 F. Supp. 2d 646 (D. Minn. 2009) (401k case – granting defendants' motion to dismiss). Plaintiff brought a class action claiming that Medtronic's stock was an imprudent plan investment for the 401(k) plan because Medtronic had failed to disclose that: (i) a medical product was being withdrawn from the market; and (ii) Medtronic was allegedly illegally marketing another medical product, thereby allegedly inflating the price of Medtronic stock.
- *Bunch v. W.R. Grace & Co.*, 553 F.3d 1 (1st Cir. 2009) (401(k) case – granting summary judgment for defendants). Company filed for Chapter 11 bankruptcy. Plaintiffs sued defendants, including independent fiduciary, for selling company stock as company was undergoing Chapter 11 re-organization.
- *Canale v. Yegen*, 782 F. Supp. 963 (D. N.J. 1992) (ESOP case – district court granted in part and denied in part defendants' motion for summary judgment). Defendants allegedly engaged in fraud and self-dealing regarding an insurance subsidiary owned by the ESOP.
- *In re Citigroup ERISA Litig.*, 21009 WL 2762708 (S.D.N.Y. Aug. 31, 2009) (401(k) case – granting defendants' motion to dismiss). Plaintiffs brought putative class action lawsuit alleging that defendants breached their duties by continuing to

offer Citigroup stock when they allegedly knew, or should have known, that Citigroup would sustain heavy losses from subprime loans following the collapse of the housing market.

- *Community Bancshares v. Patterson*, 547 F. Supp. 2d 1230 (N.D.Ala. 2008) (ESOP case – granting in part plaintiffs’ summary judgment). Fiduciary plan committee filed suit against former company CEO and individual fiduciary to ESOP alleging breach of fiduciary duty against defendant for the loss in value to the ESOP as a result of defendant’s misconduct.
- *In re Computer Sciences Corp.*, 635 F. Supp. 2d 1128 (C.D.Cal. 2009) (401k case – summary judgment for defendants). Plaintiffs filed class action lawsuit against defendants for offering company stock when company was investigated related to the alleged backdating of stock options.
- *Crowley v. Corning, Inc.*, 234 F. Supp. 2d 222 (W.D. N.Y. 2002), *aff’d on motion to amend*, 2004 WL 763873 (W.D.N.Y. Jan. 14, 2004) (401(k) case -- granting motion to dismiss). Corning supplied various optical products to the telecommunications industry. Plaintiffs claimed SEC filings contained false and misleading statements concerning demand for products and expected earnings; that company had bought a highly risky company with only one customer who was struggling with a business downturn; and that company was amassing hundreds of millions in obsolete inventory. Stock went down 80% during the proposed class period.
- *DiFelice v. US Airways, Inc.*, 397 F. Supp. 2d 735 (E.D. Va. 2005) (401(k) case -- granting directed trustee’s motion to dismiss); 397 F. Supp. 2d 758 (E.D. Va. 2005) (denying company fiduciaries summary judgment); 398 F. Supp. 2d 453 (E.D. Va. 2005) (granting independent fiduciary’s motion to dismiss); 436 F. Supp. 2d 756 (E.D. Va. 2006) (entering judgment for defendants after trial on the merits); 497 F.3d 410 (4th Cir. 2007) (affirming judgment for defendants after trial on the merits). The company publicly and extensively commented on its increasing financial distress, including a failed merger with United Airlines in July 2001 and that bankruptcy may be inevitable absent major costs concessions and government loans following the September 11, 2001 terrorist attacks. US Airways eventually declared bankruptcy in August 2002. Prior to this, in June 2002, the company appointed an independent fiduciary, who prohibited further

purchases of company stock by the plan.

- *Donovan v. Cunningham*, 716 F.2d 1455 (5th Cir. 1983) (ESOP case – reversing trial judgment for defendants). ESOP acquired shares for its formation in two transactions, in which the ESOP purchased the shares from the chairman of company. DOL claimed ESOP trustees paid more than adequate consideration for this stock based on an out of date valuation report that failed to factor in subsequent adverse developments and the particulars of the ESOP's purchase of the stock.
- *In re Dynegy Inc. ERISA Litig.*, 309 F. Supp. 2d 861 (S.D. Tex. 2004) (401(k)/ESOP case – denying motions to dismiss). Company offered a 401(k) plan that included an employer stock fund. For part of the proposed class period, the fund only accepted employer matches that had to be invested in this fund; the plan was then changed to allow investment into or out of this fund of both employee contributions and employer matches. The company was engaged in energy trading and eventually had to restate its financial statements for 1999-2002. Plaintiffs also alleged that certain high level corporate officers sold off large blocks of their company stock during the proposed class period.
- *Eckelkamp v. Beste*, 315 F.3d 863 (8th Cir. 2002) (ESOP case – affirming motion for summary judgment for defendants). Closely held company owned by ESOP provided outstanding returns. Plaintiffs nonetheless claimed company's executives paid themselves excessive compensation.
- *Edgar v. Avaya, Inc.*, 503 F.3d 340 (3d Cir. 2007) (401(k) case – affirming motion to dismiss). Plaintiff filed class action suit after the price of the stock declined from \$10.69 to \$8.01 per share, following Avaya's announcement that it would not meet its previously forecasted earnings goals for the 2005 fiscal year.
- *In re Electronic Data Sys. ERISA Litig.*, 305 F. Supp. 2d 658 (E.D. Tex. 2004) (401(k)/ESOP case – denying motions to dismiss). Company offered a 401(k) plan in which the employer stock fund was an ESOP. Company issued an earnings warning in September 2002 that resulted in a one-day drop in its stock price of approximately 50%. *See also In re Electronic Data Sys. ERISA Litig.*, 224 F.R.D. 613 (E.D. Tex. Nov. 8, 2004) (class ruling - certifying prudence claims while declining to certify disclosure claims), *rev'd Langbecker v.*

Electron Data Systems Corp., 476 F.3d 299 (5th Cir. 2007)
 (overturning certification of prudence claims).

- *In re Enron Corp. Securities, Derivative & ERISA Litig. (Tittle v. Enron Corp.)*, 284 F. Supp. 2d 511 (S.D. Tex. 2003) (401(k)/ESOP case – denying motions to dismiss ERISA claims). Company offered a 401(k) plan, an ESOP, and a defined benefit cash balance plan. In late 2001 the company rapidly imploded into bankruptcy amid a wave of accounting scandals. There was also a blackout for a change in the record keepers during the period when the adverse disclosures started to hit the market.
- *Fisher v. JP Morgan Chase & Co.*, 703 F. Supp. 2d 374 (S.D.N.Y. 2010) (401k case – motion for summary judgment for defendants). Company offered company stock fund. Company suffered 51% decline in stock price due to global financial crisis.
- *Gearren v. McGraw-Hill Cos., Inc.*, 690 F. Supp. 2d 254 (S.D.N.Y. 2010) (401k case – motion to dismiss for defendants). Plaintiffs filed putative class action alleging breaches of fiduciary duties stemming from the offering of company stock fund stemming from credit ratings provided to complex financial instruments during financial crisis.
- *Great Neck Capital Appreciation Investment Partnership v. Pricewaterhouse Coopers (In re Harnischfeger Industries, Inc. Securities Litig.)*, 212 F.R.D. 400, 414 (E.D. Wis. 2002) (granting ERISA objectors motion for fees). Securities class action. Company had to restate its financial statements by \$150MM because it failed to properly record costs related to problem overseas contracts. Company entered and finally emerged from bankruptcy. After the court granted and denied in part the securities defendants motion to dismiss, the securities case was settling for \$10MM. An ERISA plaintiff objected to the proposed securities settlement as unfair, as it was releasing ERISA claims that were being pursued in a separate ERISA action.
- *In re Harley Davidson, Inc., Sec. Litig.*, 660 F. Supp. 2d 953 (E.D. Wis. 2009) (401k case – granting defendants’ motion to dismiss). Plaintiffs filed suit alleging various breaches of fiduciary duty relating to the offering of company stock, stemming from the company losing market share and an

increasing gap between shipments to dealers and actual sales.

- *Harris v. Amgen, Inc.*, 2010 WL 744123 (C.D.Cal Mar. 2, 2010) (401k case – motion to dismiss for defendants). Plaintiffs filed suit over offering of company stock fund when stock declined in price in light of failed performance of company product.
- *Hastings v. Wilson*, 516 F.3d 1055 (8th Cir. 2008) (401k/ESOP – motion to dismiss for defendants). Plans at issue negotiated under the Railway Labor Act. Plaintiffs brought a putative class action arising out of the loss in value of stock in Northwest Airline precipitated by the airline’s voluntary filing for Chapter 11 in September 2005.
- *Henry v. Champlain Enterprises, Inc.*, 445 F.3d 610 (2d Cir. 2006). (ESOP case – reversing judgment against defendant). Company wanted to raise more capital and decided to create an ESOP to accomplish the goal. Outside financial adviser was hired to value company stock for trustee. Report was presented to the company and to the trustee and the trustee ultimately approved the ESOP transaction. IRS and company were later engaged in tax dispute, which resulted in lowering the price of the company shares for the ESOP transaction for tax purposes in order to settle the tax dispute.
- *Herman v. Mercantile Bank, N.A.*, 143 F.3d 419 (8th Cir. 1998) (ESOP case – affirming trial decision for defendant). Closely held ESOP in which company was recapitalized, cashing out non-ESOP shareholders. As part of recapitalization, the ESOP trustee re-purchased the stock at the same price but with greater ownership, and five years later the company went into bankruptcy.
- *Herrera v. Wyeth*, 2010 WL 1028163 (S.D.N.Y. Mar. 17, 2010), 2010 WL 3469681 (S.D.N.Y. Aug. 23, 2010) (401k case – motion to dismiss for defendants). Suit filed over offering of company stock fund. Plaintiffs alleged decline was tied to certain officers’ divestiture of stock options and allegations of insider trading.
- *In re Huntington Bancshares Inc. ERISA Litig.*, 620 F. Supp. 2d 842 (S.D.Oh. 2009) (401k case – granting defendants’ motion to dismiss). Plaintiffs brought putative class action lawsuit alleging that defendants breached various ERISA fiduciary duties by offering participants in a 401(k)

plan the option of investing in Huntington's stock. Huntington's stock declined from \$22 to \$7 per share during the putative class period, during which time the company allegedly suffered \$1.5 billion in losses as a result of a merger that exposed Huntington to the subprime market.

- *Husvar v. Rapoport*, 337 F.3d 603 (6th Cir. 2003) (ESOP case – reversed district court and ordered case remanded to state court). Participants in ESOP of closely held company filed suit alleging breach of corporate fiduciary duties because, although company was not doing well financially, the corporate executives continued to pay themselves substantial compensation and bonuses. Defendants tried to remove the case, alleging plaintiffs were bringing claims that arose under ERISA.
- *In re IKON Office Solutions, Inc. Securities Litig. (Whetman)*, 209 F.R.D. 94 (E.D. Pa. 2002) (401(k) case – approving non-cash settlement of ERISA claims). Plaintiffs claimed they were misled and that investments in company stock were imprudent. Court approved non-cash settlement based on numerous factors including: (i) the merits and complexity of the various defenses, including whether the case could proceed at all under § 502(a)(2); (ii) the value of the \$111 million securities settlement, of which the plan was a part; (iii) the bankruptcy of the insurer (although the company retained an ability to pay); (iv) the rebound in IKON's stock price, thus lessening damages; and (v) the substantial value attributed to IKON's structural changes to the plan –i.e., over \$50 million attributed to IKON's unlocking the employer match after two years of service in place of the prior bar requiring employees hold match in employer stock until age 55. *See also In re IKON Office Solutions, Inc. Securities Litigation (Whetman)*, 86 F. Supp. 2d 481 (E.D. Pa. 2000) (denying motion to dismiss on issue of breach of fiduciary duty under ERISA); *In re IKON Office Solutions, Inc. Securities Litigation (Whetman)*, 191 F.R.D. 457 (E.D. Pa. 2000) (class certification).
- *Johnson v. Couturier*, 572 F.3d 1067 (9th Cir. 2009) (ESOP case – denying defendants' appeal). Plaintiff participants in the Noll Manufacturing Corporation ESOP brought suit against the former president and two other directors for allegedly breaching their fiduciary duties under ERISA by awarding \$34.8 million (approximately two-thirds of the company's value) to the former president, Couturier, in a buyout compensation package.

- *Keach v US Trust Co.*, 419 F.3d 626 (7th Cir. 2005) (ESOP case – judgment for defendants after trial). Sweepstakes marketing company in which ESOP made a substantial purchase in 1995. Three years later adverse publicity and regulatory environment changed for the worse, and company went bankrupt in 2001. Plaintiffs claimed ESOP trustee should have foreseen the regulatory problems, and that company fiduciaries failed to fully disclose the regulatory issues at the time of the ESOP purchase.
- *Kirschbaum v. Reliant Energy, Inc.*, 526 F.3d 243 (5th Cir. 2008) (401(k) case – affirming summary judgment for defendants). Plaintiffs’ allegations arose out of the energy trading scandals occurring between 1999 and 2001. During this period certain employees of Reliant Energy had engaged in round trip trades, i.e., trades with no economic substance that were designed to inflate revenue. In May 2002, Reliant disclosed to the market that these trades had inflated revenue by about 10% over this period, and that the senior executives implicated in this trading had resigned. Reliant stock dropped 40% after these disclosures. Reliant’s 401(k) plan mandated the offering of Reliant stock as a plan investment option.
- *Kuper v. Quantum Chemical Corp.*, 838 F. Supp. 342 (S.D. Ohio 1993), *aff’d*, 66 F.3d 1447 (6th Cir. 1995) (ESOP plan transfer case – summary judgment for fiduciaries). Company had a 401(k) and ESOP plan. Spun off division in an asset sale; sale included a trust-to-trust transfer of all securities for employees transferred to new company. Trust assets frozen for 18 months to finalize sale and transfer, from March 31, 1989 to November 1, 1990. During this period company stock declined almost 80%, from \$49 to \$10. Plaintiffs claimed breached fiduciary duties by not divesting during the transfer period.
- *LaLonde v. Textron, Inc.*, 270 F. Supp. 2d 272, 274-76 (D. R.I. 2003) (401(k)/ESOP case – granting motion to dismiss), *aff’d in part, rev’d in part*, 369 F.3d 1 (1st Cir. 2004); 418 F. Supp. 2d 16 (D. R.I. 2006) (denying motion for class certification). Plan provided several investment options, one of which was an ESOP. Employer matched one-half of amount contributed by an employee; the employer match and 50% of the employee’s contributions were required to be invested in the ESOP. During 2000-2001 the employer stock lost approximately 43% of its value; some of the plan’s other investment funds lost between 9% to 22% of their value. Plaintiffs claimed breached

fiduciary duties by encouraging investment in the ESOP and that it was an imprudent investment because company was undergoing a restructuring and laying off thousands of employees.

- *Landgraff v. Columbia/HCA Healthcare Corp.*, 2000 WL 33726564 (M.D.Tenn. May 24, 2000) (prudent investment case – granting defendants judgment after trial), *aff'd*, 30 Fed. App. 366 (6th Cir. 2002) (Table). Company had stock bonus plan in which made match in company stock. Although not an ESOP, plan was designed to invest primarily in company stock. Defendants were the company and the members of its retirement committee, who made the investment decisions for the stock bonus plan. The members were the general counsel, the VP of finance, VP of human resources, and VP of benefits. Plaintiffs claimed individual defendants should have diversified out of company stock, and that company breached duties by not monitoring committee decisions and removing members who were not meeting their fiduciary duties. Plaintiffs claimed should have diversified because government investigations of company during 1997-98 negatively impacted its stock (which price dropped by about half) and financial performance.
- *Lanfear v. Home Depot, Inc.*, -- F. Supp. 2d --, 2010 WL 2427413 (N.D.Ga. June 7, 2010) (401k case – motion to dismiss for defendants). Plaintiff filed suit stemming from decline in stock relating to alleged backdating of stock options.
- *In re Lehman Bros. Securities & ERISA Litig.*, 683 F. Supp. 2d 294 (S.D.N.Y. 2010) (401k case – motion to dismiss for defendants). Plaintiffs filed suite against defendants stemming from the bankruptcy filing of Lehman Brothers Holdings, Inc. during the financial crisis.
- *Lingis v. Motorola, Inc.*, 649 F. Supp. 2d 861 (N.D. Ill. 2009) (401k case – summary judgment for defendants). Plaintiffs filed suit against defendants relating to certain loan agreements from 1990s-2001.
- *Martin v. Feilen*, 965 F.2d 660 (8th Cir. 1992) (ESOP case – affirmed in part and reversed in part district court's ruling on defendants' motions for summary judgment). Plaintiffs challenged numerous corporate transactions involving the company of a closely held ESOP. Court agreed that ESOP trustees' misappropriation of a corporate opportunity and

manipulation of shares prices and dividends in relation to the purchase and sale of the ESOP's shares breached fiduciary duties under ERISA.

- *In re McKesson HBOC Inc. ERISA Litig.*, 29 EB Cas. 1229, 2002 WL 31431588 (N.D.Cal. Sept. 30, 2002) & 391 F. Supp. 2d 812 (N.D. Cal. 2005). (401(k) case – granting in part motion to dismiss). The McKesson Corporation merged with HBOC in January 1999. After the merger, McKesson HBOC publicly announced that its merger partner, HBOC, had engaged in illegal accounting practices, had materially misstated the financial condition of the company, and that financial results would be restated downward. The merged company's stock price dropped sharply, with an alleged loss of \$800 million to the McKesson plan.
- *Moench v. Robertson*, 62 F.3d 553 (3d Cir. 1995) (ESOP case – reversing summary judgment for fiduciaries on prudent investment claim). Bank set up ESOP; eventually bank was taken over by regulatory agency. Plan committee members were also the directors for the bank. During final two-year period, bank's directors knew regulatory agencies were concerned over soundness of bank and trustee in fact eventually stopped investing in employer stock. Plaintiffs claimed breached fiduciary duties by continuing to invest when knew stock was an imprudent investment.
- *Morrison v. MoneyGram International, Inc.*, 607 F. Supp. 2d 1003 (D. Minn. 2009) (401k case – granting in part and denying in part defendants' motion to dismiss). Plaintiff filed suit alleging various breaches of fiduciary duty relating to the offering of company stock during the mortgage backed securities fallout.
- *Nelson v. IPALCO Enterprises, Inc.*, 512 F.3d 347 (7th Cir. 2008) (401(k) case – affirming judgment for defendants after trial as to whether breach of fiduciary duty to disclose claim). Plaintiffs appealed only one claim after judgment after trial on the merits for defendants. Plaintiffs alleged defendants breached their fiduciary duty to disclose by failing to inform participants that the defendants were selling most of their own stock – both acquired in the plan and by exercising vested options that they had received in their roles as managers or directors of Indianapolis Power & Light.
- *Noa v. Keyser*, 519 F. Supp. 2d 481 (D.N.J. 2007) (401(k) case

- granting motion to dismiss). Claim that it was a breach of fiduciary duties to *sell* employer stock.
- *Page v. Impac Mortgage Holdings, Inc.*, 2009 WL 890722 (C.D. Cal. Mar. 31, 2009) (401k case – denying in part and granting in part defendants’ motion to dismiss). Plaintiffs filed class action suit against defendants alleging various breaches of fiduciary duty stemming from the decrease in price of company stock related to the company’s losses from the subprime mortgage collapse.
- *In re Pfizer, Inc. ERISA Litig.*, Civ. Action No. 1:04 CV 10071 (S.D.N.Y. Mar.20, 2009) (401(k) case – denying in part and granting part defendants’ motion to dismiss). Plaintiffs brought putative class action alleging defendants breached their fiduciary duties by offering company stock when price fell after announcements related to two Pfizer drugs.
- *In re Polaroid ERISA Litig.*, 362 F. Supp. 2d 461 (S.D. N.Y. 2005) (401(k) case – motion to dismiss granted in part and denied in part). Polaroid’s corner of the camera market declined with the introduction of digital cameras and one hour film processing, and Polaroid eventually filed for Chapter 11 bankruptcy. Bankruptcy examiner claimed Polaroid may have had “going concern” qualifications in year before bankruptcy that were hidden by aggressive accounting at the end of 2000 concerning treatment of deferred tax assets, timing of reversal of restructuring reserve charges, and reclassification of various company debt.
- *Pugh v. Tribune Co.*, 521 F.3d 686 (7th Cir. 2008) (401(k) case – affirming motion to dismiss). Suit arose from company’s announcements that investigations revealed that two newspapers had inflated their circulation numbers for a couple of years.
- *Rankin v. Rots (Kmart)*, 278 F. Supp. 2d 853 (E.D. Mich. 2003) (401k/ESOP case – denying motions to dismiss). Suit arose out of the Kmart bankruptcy. Plaintiffs sued certain directors and officers and various plan committee members, claiming they breached various fiduciary duties regarding the plan investments in employer stock. *See also Rankin v. Rots (Kmart)*, 220 F.R.D. 511 (E.D. Mich. 2004) (certifying class).
- *Rogers v. Baxter Int’l., Inc.*, 521 F.3d 702 (7th Cir. 2008) (401(k) case – certification of issue as to whether claim can

proceed under ERISA § 502(a)(2)). Plaintiffs filed suit relating to two corporate events: the company falling short of its projections in 2002, and the 2004 announcement that the company would restate its financials to correct fraud at its Brazilian subsidiary.

- *In re Schering-Plough Corp ERISA Litig.*, 420 F.3d 231 (3d Cir. 2005) (401k case – finding standing to bring claim on behalf of the plan); 589 F.3d 585 (3d Cir. 2009) (401k case – reversing class certification). 401k plan offered employer stock fund as an investment option. Claim that stock which dropped was unlawfully inflated and an imprudent investment.
- *Shirk v. Fifth Third Bancorp.*, 2009 WL 692124 (S.D. Ohio Jan. 29, 2009) (401k case – granted defendants’ summary judgment). Plaintiffs alleged that offering company stock was imprudent because Fifth Third allegedly had a breakdown in internal controls that ultimately resulted in an \$81 million pre-tax charge.
- *Smith v Delta Air Lines, Inc.*, 422 F. Supp. 2d 1310 (N.D. Ga. 2006). (401(k) case – granting defendants’ motion to dismiss in part and denying in part). Airline company suffered financial distress in a post-9/11 time frame. The value of Delta’s stock declined by 92%, and Delta sustained losses in thirteen out of fourteen quarters, suffering a 6 billion dollar loss. Defendants filed a motion to dismiss. The plan was a savings plan with an ESOP component.
- *Steinman v. Hicks*, 252 F. Supp 2d 746 (C.D. Ill. 2003), *aff’d*, 352 F. 3d 1101 (7th Cir. 2003) (ESOP plan transfer – affirming summary judgment for fiduciaries). Company (Archer Daniels Midland) acquired subsidiary in a stock for stock transfer. Approximately 65% of the profit sharing portion of the subsidiaries plan assets was converted to ADM stock. The subsidiary’s plan was terminated and the distribution was made a year and one-half later; during this period ADM stock went from \$21.20 to \$15.50 a share. Plaintiffs claimed the plan fiduciaries should have diversified out of ADM stock because of the short-term investment horizon between termination and distribution.
- *Summers v. State Street Bank & Trust Co.*, 453 F.3d 404 (7th Cir. 2006) (401(k) case – motion for summary judgment for defendant). Plaintiffs, employee-participants, were unable to direct their investments, and instead were required to have their

ESOP money invested in United Airlines stock. Plaintiffs claimed that a letter from United's CEO stating that, absent a major change in its business after the terrorist attack of 9/11, the airline may go bankrupt, triggered a fiduciary duty of prudence to sell off United Airlines' stock because bankruptcy was allegedly inevitable at this point.

- *In re Syncor ERISA Litig.*, 351 F. Supp. 2d 970 (C.D. Cal. 2004) (401(k) case – motion to dismiss granted in part and denied in part); 516 F.3d 1095 (9th Cir. 2008) (reversing summary judgment for defendants). Plaintiffs filed suit arising out of claim the company engaged in an international bribery scheme.
- *Tatum v. R.J. Reynolds Tobacco Co.*, 392 F.3d 636 (4th Cir. 2004) (motion to dismiss denied). Claim that it was a breach of fiduciary duties to *sell* employer stock of spun off subsidiary that had declined substantially before the sale.
- *Thompson v. Avondale*, 29 EB Cas. 2865, 2003 WL 359932 (E.D.La. Feb.14, 2003) (ESOP divestment case; judgment for defendants after trial). Company was a large independent shipyard. Plaintiffs' claimed ESOP trustees lowered investment in company to eliminate potential union influence over the company. In February 1996 the trustees sold three and one-half million shares at \$15.75 a share, thus lowering ownership percentage from 47.2% to 22%; in June 1998 the trustees sold another one million shares at \$28.75 a share, reducing ownership to 13.4%. Avondale merged with Litton in August 1999 at \$39.50 a share.
- *In re Wachovia Corp. ERISA Litig.*, 2010 WL 3081359 (W.D.N.C. Aug. 6, 2010) (401k case – motion to dismiss granted). Plaintiffs brought putative class action alleging it was imprudent to continue to offer company stock in light of financial crisis and company's performance during that time.
- *In re Williams Companies ERISA Litig.*, 271 F. Supp. 2d 1328 (N.D. Okla. 2003) & 31 EB Cas. 1870, 2003 WL 22794417 (N.D. Okl. Oct. 27, 2003) (401(k) case – granting in part and denying in part motions to dismiss). Plaintiffs claimed fiduciaries failed to disclose information related to a spin-off of a telecommunications subsidiary and to risks in the energy trading part of the business. Plaintiffs also claimed the stock fund was not a prudent investment because the stock price was inflated through securities fraud.

- *Woods v. Southern Co.*, 396 F. Supp. 2d 1351 (N.D. Ga. 2005) (401(k) case – granting in part and denying in part motion to dismiss). Company spun off Mirant, a former subsidiary engaged in energy trading. Plan acquired stock through the spin off, adding the Mirant Stock Fund as an investment alternative, but prohibiting further investment in this fund. Mirant was subsequently accused of unlawful trading and accounting activities, and filed for bankruptcy around two years after the spin off.
- *In re WorldCom Inc. ERISA Litig.*, 263 F. Supp. 2d 745 (S.D. N.Y. 2003). (401(k) case — granting in part and denying in part motions to dismiss); 354 F. Supp. 2d 423 (S.D. N.Y. 2005) (401(k) case – granting summary judgment for directed trustee). In June 2002 WorldCom admitted it had improperly capitalized \$3.8B in expenses and would have to restate its 2001 and 2002 financial statements; later WorldCom admitted it had overstated earnings another \$3.3B for 1999 through 2002 and that it would likely have to write off \$50B in goodwill. In July 2002 WorldCom filed for bankruptcy and various WorldCom executives pled guilty to securities fraud. WorldCom had a 401k plan that offered company stock as an investment option. The plan named WorldCom as the plan administrator and the Investment Fiduciary; although it could do so, WorldCom never allocated these duties to others. Plaintiffs named a class period of 1998 to 2002 and sued, among others, the directors, the former CEO Ebbers, the former CFO Sullivan, and various WorldCom employees involved in day-to-day plan administration. 263 F.Supp.2d at 752-57. *See also In re WorldCom Inc. ERISA Litig.*, 2004 WL 2292362 (S.D.N.Y. Oct. 13, 2004) (concluding settlement bar order can factor in co-defendants' ability to pay) & 2004 WL 2338151 (S.D.N.Y. Oct. 18, 2004) (approving partial settlement).
- *Wright v. Medtronic, Inc.*, 2010 WL 1027808 (D.Minn. Mar. 17, 2010) (401k case – motion to dismiss for defendants). Company was engaged in series of litigations. Company disclosed certain litigation related charges in SEC filings. Plaintiffs filed suit that litigation charges rendered stock imprudent.
- *Wright v. Oregon Metallurgical Corp.*, 222 F. Supp. 2d 1224 (D. Oregon 2002), *aff'd*, 360 F. 3d 1090 (9th Cir. 2004) (prudent investment claim -- granting motions to dismiss).

Stock bonus plan provided as part of collectively bargained for benefits. Stock traded over the counter and went up rapidly; to avoid losing too many participants plan allowed for some divestment. Union rejected any further divestment. Company merged and plaintiffs sought to diversify the remaining holdings to capture the merger premium. Plaintiffs claimed fiduciaries should have diversified out of merged company's stock because of decline in that company's business and stock.