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Plan Sponsor Basics Webinar Series

Issues for 401(k) Plan Sponsors with Employer Stock Investment Funds

Webinar 5 of 5

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Overview of Today's Topics

- Background on company stock in 401(k) plans
- Background on "stock drop" cases
- Supreme Court decision in *Fifth Third Bancorp v. Dudenhoeffer*
- Fourth Circuit decision in *Tatum v. RJR Pension Investment Committee*
- What's a fiduciary to do now?
- Effect of *Dudenhoeffer* on private company ESOPs

Background on Company Stock in 401(k) Plans

- 401(k) plans
  - Participants elect from a menu of investment options offered by the plan.
  - If structured appropriately, plan fiduciaries can be protected from liability from investment decisions made by participants.
  - At retirement, participants get the value of their accounts, so participants bear the investment risk of their accounts.
- Common investment options in 401(k) plans (one of these things is not like the others)
  - Mutual funds
  - Collective investment trusts
  - Separate accounts
  - Company stock fund

Background on Company Stock in 401(k) Plans

- Company stock is a common feature in 401(k) plans
  - Viewed as helping align interests of participants and employer
  - Some employers make contributions in company stock, including to help with cash flow constraints that could make cash contributions difficult
  - Can be a popular investment option because it presents the opportunity to invest in company stock with pretax dollars and tax-deferred growth

Background on Company Stock in 401(k) Plans

- ERISA explicitly allows for company stock in 401(k) plans and treats it differently than other investment options
  - 401(k) plans are exempt from "10% limit" that otherwise applies to investments in employer stock
  - Can have an "ESOP" within a 401(k) plan
  - ERISA explicitly exempts ESOPs from the fiduciary duty to diversify and the duty of prudence to the extent it requires diversification

Background on Stock Drop Cases

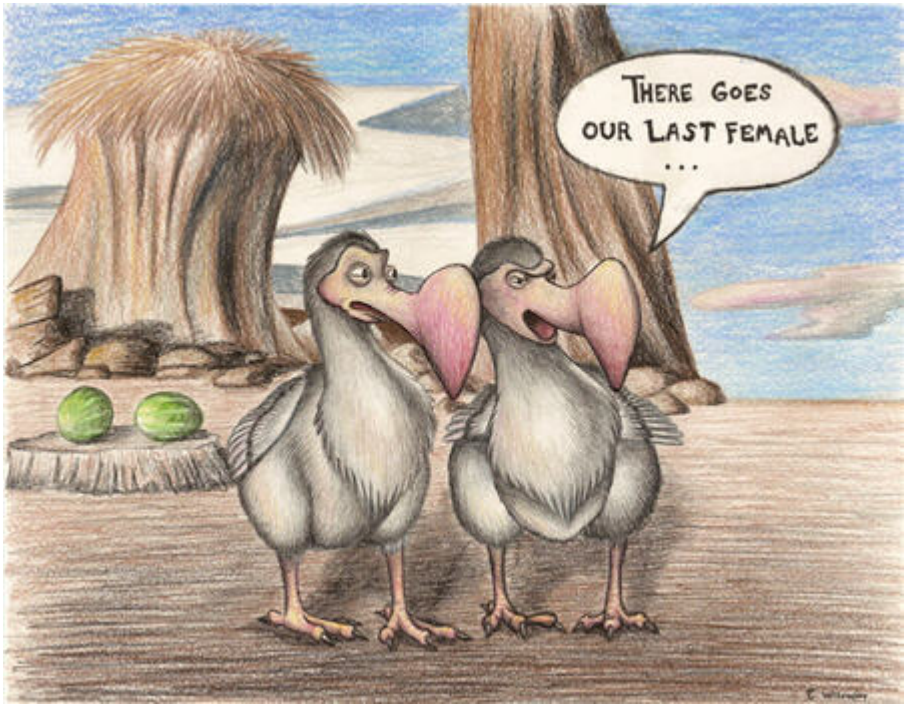
- Company stock funds have been the focus of litigation for some time in so-called “stock drop” cases
- The cases are generally brought after a significant drop in share prices (and thus losses to the plan participants invested in the company stock fund)
- These cases generally allege (among other things) that:
  - The fiduciaries breached their duties by imprudently investing in company stock
  - The stock price was artificially inflated because adverse information had been concealed from the market
  - The plan fiduciaries made misrepresentations to participants about the value of company stock

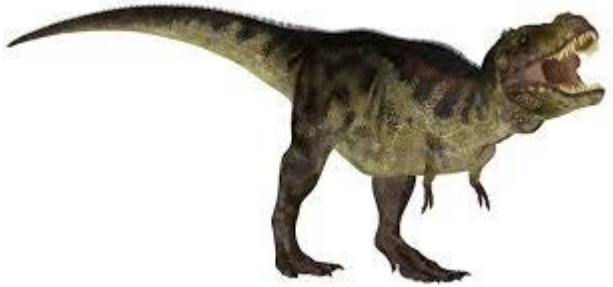
Background on Stock Drop Cases

- As of 2013, almost every Court of Appeals adopted a presumption of prudence
- This means that a court would presume the fiduciary had acted prudently in offering the company stock if:
  - the plan terms mandate the investment, i.e., “hard wired” or
  - the plan terms encourage the investment
- The presumption of prudence was very helpful to plan fiduciaries in situations where stock prices were falling and was the foundation of the plan fiduciary’s success in many stock drop lawsuits

Background on Stock Drop Cases

Here's the state of the presumption of prudence today, thanks to . . .





Fifth Third Bancorp v. Dudenhoeffer, 133 S. Ct. 1656 (June 25, 2014)

- Participants in Fifth Third 401(k) plan challenged prudence of Fifth Third stock as an investment option.
- Fifth Third stock declined in value during the market collapse in 2008/2009.
- The case made its way to the previous session of the Supreme Court and was decided this summer.
- The Court rejected the presumption of prudence as not grounded in ERISA, but did set forth certain parameters for stock drop claims going forward.

Fifth Third Bancorp v. Dudenhoeffer, 133 S. Ct. 1656 (June 25, 2014)

- What were the presumption's statutory bases?
  - Apparently, there were none.
    - *"In our view, the law does not create a special presumption favoring ESOP fiduciaries. Rather, the same standard of prudence applies to all ERISA fiduciaries, including ESOP fiduciaries, except that an ESOP fiduciary is under no duty to diversify the ESOP's holdings."*
- This was a 9-0 decision.
  - The policy-oriented members of the Court and the statutory text-oriented members of the Court were all able to agree. That doesn't happen every day.

Fifth Third Bancorp v. Dudenhoeffer, 133 S. Ct. 1656 (June 25, 2014)

- What about nonpecuniary goals of employee stock ownership?
  - Irrelevant to prudence analysis.
- But ERISA defines the duty of prudence in terms of what a reasonable person would do "in the conduct of an enterprise of a like character and with like aims."
  - This language refers only "to the sort of financial benefits (such as retirement income) that trustees who manage investments typically seek to secure for the trust's beneficiaries."

Fifth Third Bancorp v. Dudenhoeffer, 133 S. Ct. 1656 (June 25, 2014)

- "Congress, in seeking to permit and promote ESOPs, was pursuing purposes other than the financial security of plan participants."

- "But we are not convinced that Congress also sought to promote ESOPs by further relaxing the duty of prudence as applied to ESOPs with the sort of presumption proposed by petitioners."

Fifth Third Bancorp v. Dudenhoeffer, 133 S. Ct. 1656 (June 25, 2014)

- Duty of Prudence Trumps the Plan Terms
  - "[T]he duty of prudence trumps the instructions of a plan document, such as an instruction to invest exclusively in employer stock even if financial goals demand the contrary."
- Potential Broader Implications
  - Hard wiring
  - Other plan terms and decisions?

Fifth Third Bancorp v. Dudenhoeffer, 133 S. Ct. 1656 (June 25, 2014)

- But not necessarily a seal of approval for stock drop claims because not all claims are sufficient.
- The Court identified these three constraints on stock drop claims:
  - Fiduciaries are not required to second-guess the market valuation of publicly traded securities absent "special circumstances."
  - Fiduciaries are not required to act on inside information, thereby violating securities laws.
  - Fiduciaries can consider whether their actions—stopping purchases or publicly disclosing negative information—would do more harm than good by causing a likely drop in stock prices.

Fifth Third Bancorp v. Dudenhoeffer, 133 S. Ct. 1656 (June 25, 2014)

- Do fiduciaries need to second-guess the market price of securities that are traded in an efficient market?
  - If stock trades in an efficient market…probably cannot challenge the market price absent "special circumstances."
  - What does that mean?
  - Even if price is accurate, investment is not appropriate for a pension plan. Likely to see allegations related to:

Penny stocks?	Options and other derivatives?
Bankruptcy?	Long-term financial decline of the company?

  - But a careful financial professional will understand that these are really diversification issues.

Fifth Third Bancorp v. Dudenhoeffer, 133 S. Ct. 1656 (June 25, 2014)

- Do fiduciaries need to take action based on inside information that would violate securities laws?
  - No, but the Court invited the SEC to provide guidance on this point.
  - District courts "should consider the extent to which an ERISA-based obligation" to "refrain" or "disclose" may "conflict with the complex insider trading and corporate disclosure requirements imposed by the federal securities laws or with the objectives of those laws."
  - So still uncertainty on how to deal with inside information.

Fifth Third Bancorp v. Dudenhoeffer, 133 S. Ct. 1656 (June 25, 2014)

- Do fiduciaries have to divest of company stock even if it would hurt the plan?
  - No, not unless the complaint has "plausibly alleged that a prudent fiduciary in the defendant's position could not have concluded that stopping purchases—which the market might take as a sign that insider fiduciaries viewed the employer's stock as a bad investment—or publicly disclosing negative information would do more harm than good to the fund by causing a drop in the stock price and a concomitant drop in the value of the stock already held by the fund."
  - The Court provided no additional guidance on how to apply this standard, which is far from crystal clear.

Fifth Third Bancorp v. Dudenhoeffer, 133 S. Ct. 1656 (June 25, 2014)

- Allegation: "Starting on A date on continuing through B date, the stock was an imprudent investment":

Tatum v. RJR Pension Investment Committee, 2014 WL 3805677 (4th Cir. Aug. 4, 2014)

- Reverse stock drop case—fiduciaries decided to sell stock over the course of six months, and stock price subsequently *increased*.
- District court and Fourth Circuit held that fiduciaries breached their fiduciary duty by selling employer stock when:
  - it was required by the plan terms;
  - there was no documented evidence that the Committee properly evaluated the investment and determined that it was not prudent; and
  - there was no documented evidence that the fiduciaries reached the six-month timeline with due consideration for alternatives, etc.
- Fourth Circuit said that fiduciaries are liable unless they prove that a hypothetical prudent fiduciary *would have* made the same decision—shifting the burden to defendants.

Tatum v. RJR Pension Investment Committee, 2014 WL 3805677 (4th Cir. Aug. 4, 2014)

- Lessons learned:
  - Process is really important
  - Only thing more important is documentation of the process
  - Plan amendment issues

What's a Fiduciary to Do Now?

- Putting aside how we might defend a case in litigation, what is an *actual* fiduciary *actually* supposed to do?
  - "Run for the hills" is not the most well-received advice
- Primary takeaway—company stock funds need to be treated like other investment options. What does that mean?
  - Establish a process for monitoring—e.g., quarterly reports, evaluation criteria, etc.
  - Establish a benchmark (don't ask us what to use . . . we're lawyers)
  - Then document, document, document (lesson from *Tatum*)

What's a Fiduciary to Do Now?

- Consider the role of an independent fiduciary
  - A number of different roles possible
  - Fully outsource fiduciary responsibility for the company stock fund (have to be willing to have the independent fiduciary decide not to offer it)
  - Use the independent fiduciary to help conduct the evaluation process, but the ultimate decision still rests with plan fiduciaries
- Consider the composition of your fiduciary committee
  - Reconsider "C"-level officers on committees
  - Manage conflicts of interest

What's a Fiduciary to Do Now?

- Consider limits on investment in company stock funds or role of company stock
  - Limits such as no more than 20% of account balance in company stock
  - Consider whether to continue matching contributions in company stock
- Consider plan document language
  - We have long preached the gospel of hardwiring
  - Does it still make sense?
- At the end of the day, the question is: "how does a fiduciary justify a single stock investment option?"
  - For example, why Coke stock but not Pepsi?
  - Perhaps hardwiring can make a difference on that point

What's a Fiduciary to Do Now?

- If plan fiduciaries determine to eliminate the company stock fund, there are numerous considerations:
  - Participant communications and messaging
  - Timing of the elimination and phase out (lesson from *Tatum*: document the process for determining the phase out period)
  - Net unrealized appreciation (NUA) considerations
  - Securities law considerations in connection with selling the stock, registration statements of the 401(k) plan, etc.
  - Mapping balances in company stock fund
- There are also steps short of eliminating the company stock fund, such as "freezing" company stock funds and no longer accepting new contributions
  - Consider treatment of dividends—will dividends still be able to be invested in company stock?

Effect of *Dudenhoeffer* on Private Company ESOPs

- Fiduciaries of private company ESOPs are dealing with stock for which there is no readily available market.
- Upshot of *Dudenhoeffer* may be more emphasis on fiduciary process in evaluating ESOP stock purchases, second-stage transactions, etc.
- “Price” issues are much more complex.
- Should fiduciary have sold?
- Could fiduciary have sold?

Questions?

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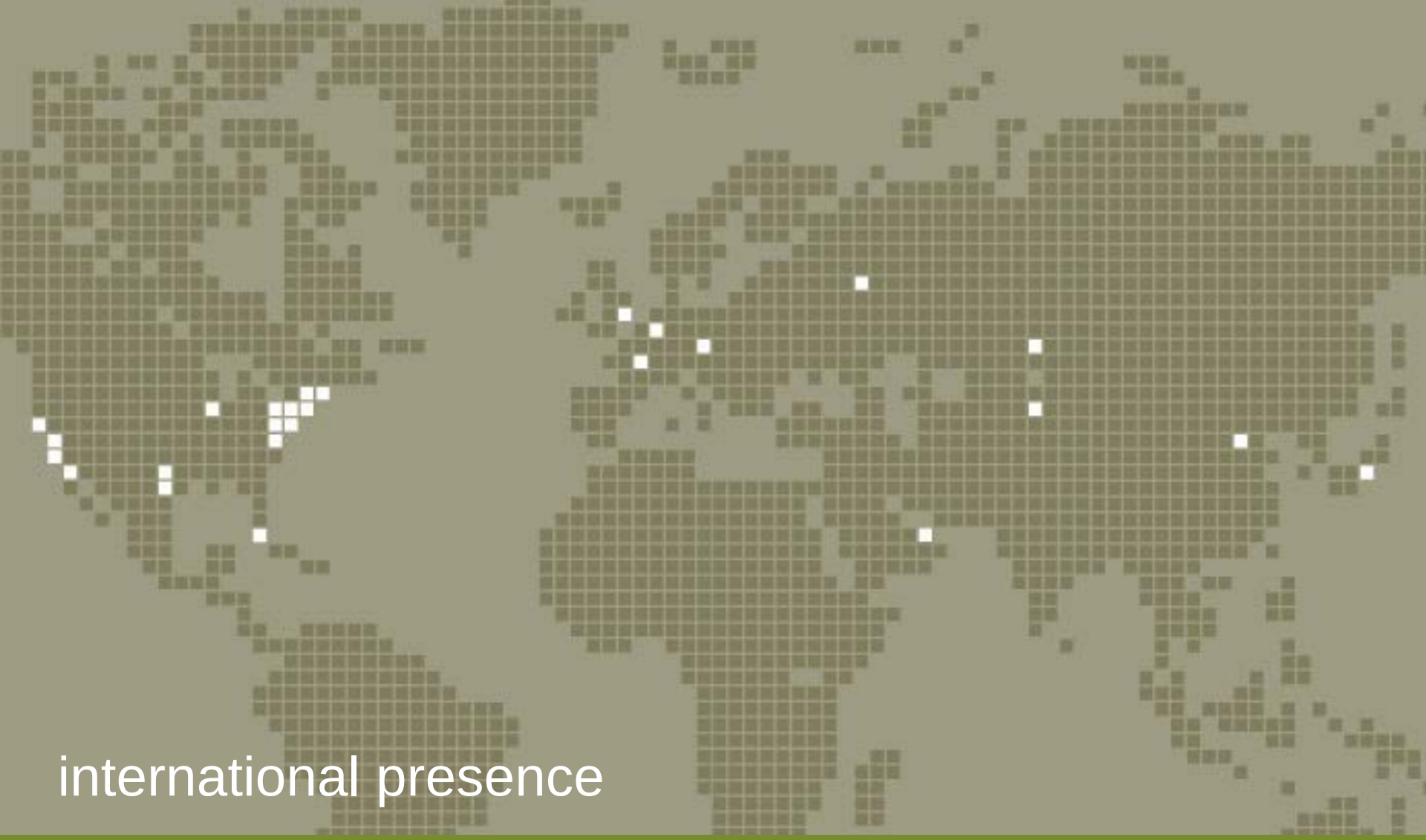

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