

ERISA “Stock-Drop” Litigation:

Preparing Your Organization For A Surge In Claims

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PRINT ALL. If you do not, your printer will only print the current slide.

How far do ERISA's fiduciary duty provisions reach?

- Predicting the types of conduct that will be deemed fiduciary conduct is sometimes informed guesswork – at best
- Add in an increasingly sophisticated plaintiffs' bar, and you never know where an ERISA claim might turn up
- Answer: To places and types of disputes you have probably never envisioned

Consider this scenario

- A major gas company overstates its gas and oil reserves by 20%. The gas company does the right thing and corrects the overstatement. You can't get an ERISA problem from this, you say.

Wrong...

- When the correction is announced, Shell Oil Company's stock drops nearly eight percent.
- What else do you get? Four ERISA class-action cases (later consolidated) by participants in Shell's 401(k) and other retirement plans that invested in Company stock between December 3, 1999 and April 29, 2004.

Here's another scenario

- A major drug store chain removes from store shelves merchandise that was scheduled to be marked down, delays accounting for the expense and treats the merchandise as if it has full value in its earnings reports.
- The chain also delays disclosing that it plans to close 200 underperforming stores, and its CEO allegedly sells \$5 million worth of his own stock but waits months to disclose that earnings would not meet projections. When disclosures are made, the chain's stock drops 17 percent.
- What does this have to do with ERISA?

Answer

The Moral

- An ERISA breach of fiduciary duty class-action suit by CVS 401(k) plan participants whose plan accounts held CVS stock between December 1, 2000 and October 30, 2001

ERISA is
EVERYWHERE

Understanding what makes these lawsuits attractive to the plaintiffs' bar is critical for:

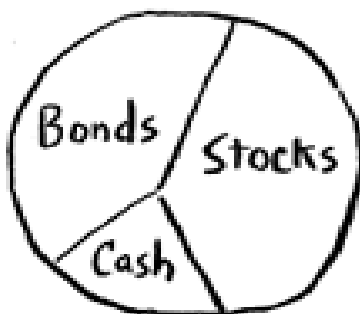
1. Understanding which cases should be litigated to a conclusion or positioned for settlement; and
2. Having an intelligent basis for evaluating plan-related documents and fiduciary conduct regarding 401(k) plans that offer company stock as an investment, employee stock ownership plans (ESOPs), or combinations of both.

Stock-Drop Litigation

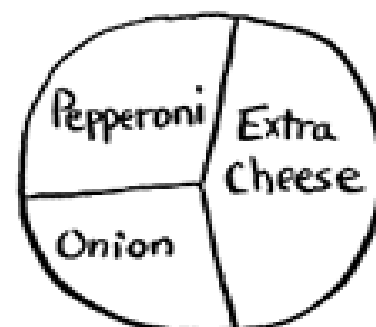
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YOUR PORTFOLIO

1999



2003



SIPRESS

Stock-Drop Litigation – A Sobering Perspective

A prominent consulting firm recently reported that it had researched the federal court dockets looking for ERISA “stock-drop” litigation and found 76 cases.

- 14 cases had settled
- 11 cases were dismissed by the courts
- 51 cases were active
- Of those 14 cases that settled, the average settlement was **\$33 million**
- Only five cases settled for under \$10 million

So...

- **What exactly is this creature known as “stock-drop” litigation?**
- **Why is “stock-drop” litigation generating big-dollar settlements?**
- **Why is the plaintiffs’ class-action bar flocking to these cases?**
- **Why are fiduciary insurance carriers paying a whole lot of attention to the underwriting of individual account plans that include company stock as investments?**

QUIZ #1 (and this is an easy one):

What case put “stock-drop” litigation on the map?

Answer: Enron, of course

- You all probably know a lot about that case
- 11,000 of Enron's workers participated in the Enron 401(k) plan
- The Enron 401(k) plan allowed employees to invest their individual accounts in Enron shares
- The company matched employees' contributions with contributions to the company stock fund

Enron stock reached a high of \$90 in August 2000

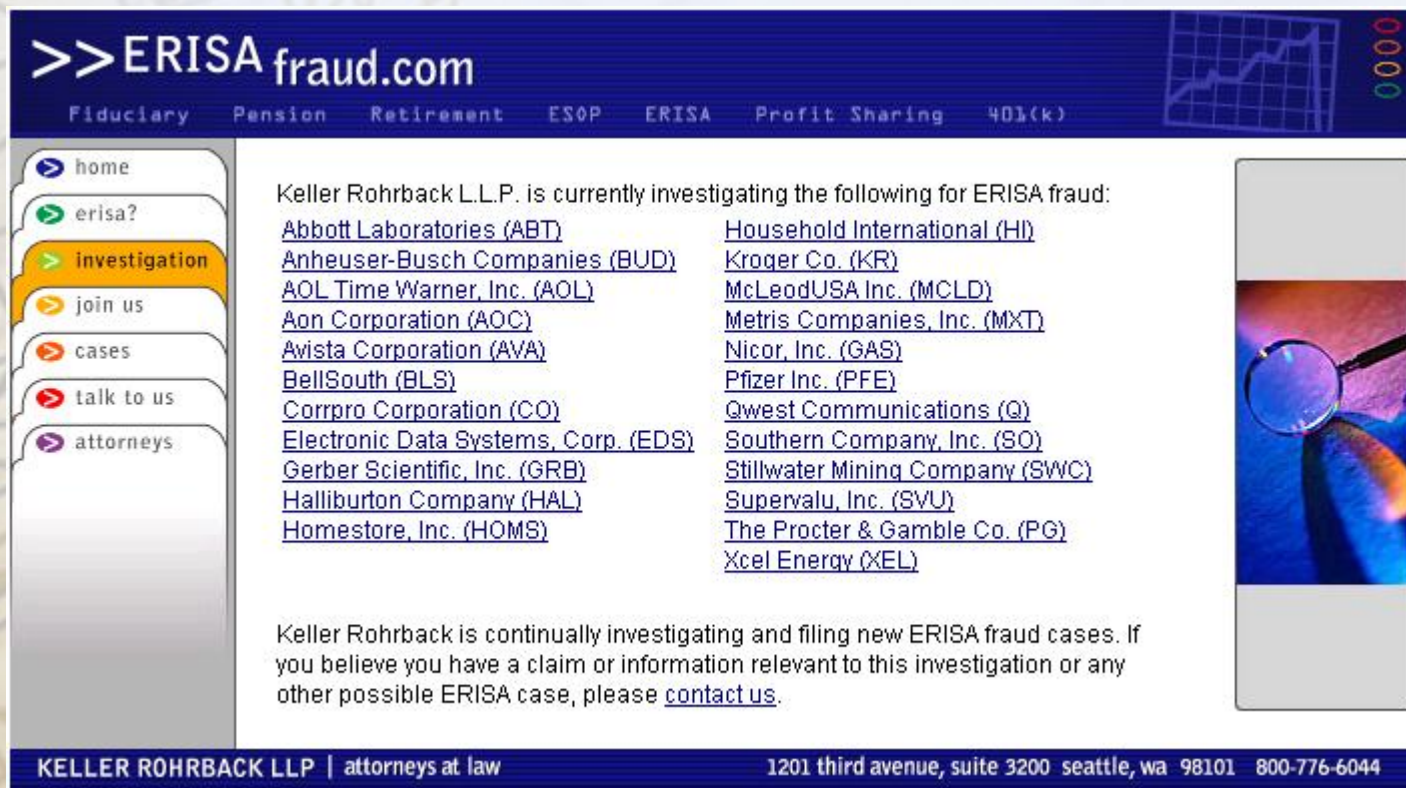
- By January 2001, Enron participants had about 62% of their retirement savings – or about \$1.3 billion – invested in Enron stock
- Then came the implosion:
 - Allegations that Enron misled investors by concealing debt in offshore partnerships
 - Enron's decision to restate its earnings and report a large third quarter 2001 loss
 - The subsequent collapse of Enron's stock price, which wiped out approximately \$1 billion in retirement savings

What came next?

- The lawsuits, of course
- Shareholder suits alleging stock fraud
- And follow-on ERISA suits alleging that the 401(k) plan fiduciaries misbehaved by allowing the massive losses in the company stock fund
- The Enron ERISA complaint survived a motion to dismiss and a number of the fiduciary defendants agreed to settle for \$85 million, which reportedly was the fiduciary insurance policy limit

How do these suits get started?

Mining for Plaintiffs



The screenshot shows the website ERISA fraud.com. The navigation menu includes: home, erisa?, investigation (highlighted), join us, cases, talk to us, and attorneys. The main content area lists companies being investigated for ERISA fraud, organized in two columns. A magnifying glass icon is visible on the right side of the page.

>> ERISA fraud.com

Fiduciary Pension Retirement ESOP ERISA Profit Sharing 401(k)

home
erisa?
investigation
join us
cases
talk to us
attorneys

Keller Rohrback L.L.P. is currently investigating the following for ERISA fraud:

| | |
|--|---|
| Abbott Laboratories (ABT) | Household International (HI) |
| Anheuser-Busch Companies (BUD) | Kroger Co. (KR) |
| AOL Time Warner, Inc. (AOL) | McLeodUSA Inc. (MCLD) |
| Aon Corporation (AOC) | Metris Companies, Inc. (MXT) |
| Avista Corporation (AVA) | Nicor, Inc. (GAS) |
| BellSouth (BLS) | Pfizer Inc. (PFE) |
| Corpro Corporation (CO) | Qwest Communications (Q) |
| Electronic Data Systems, Corp. (EDS) | Southern Company, Inc. (SO) |
| Gerber Scientific, Inc. (GRB) | Stillwater Mining Company (SWC) |
| Halliburton Company (HAL) | Supervalu, Inc. (SVU) |
| Homestore, Inc. (HOMS) | The Procter & Gamble Co. (PG) |
| | Xcel Energy (XEL) |

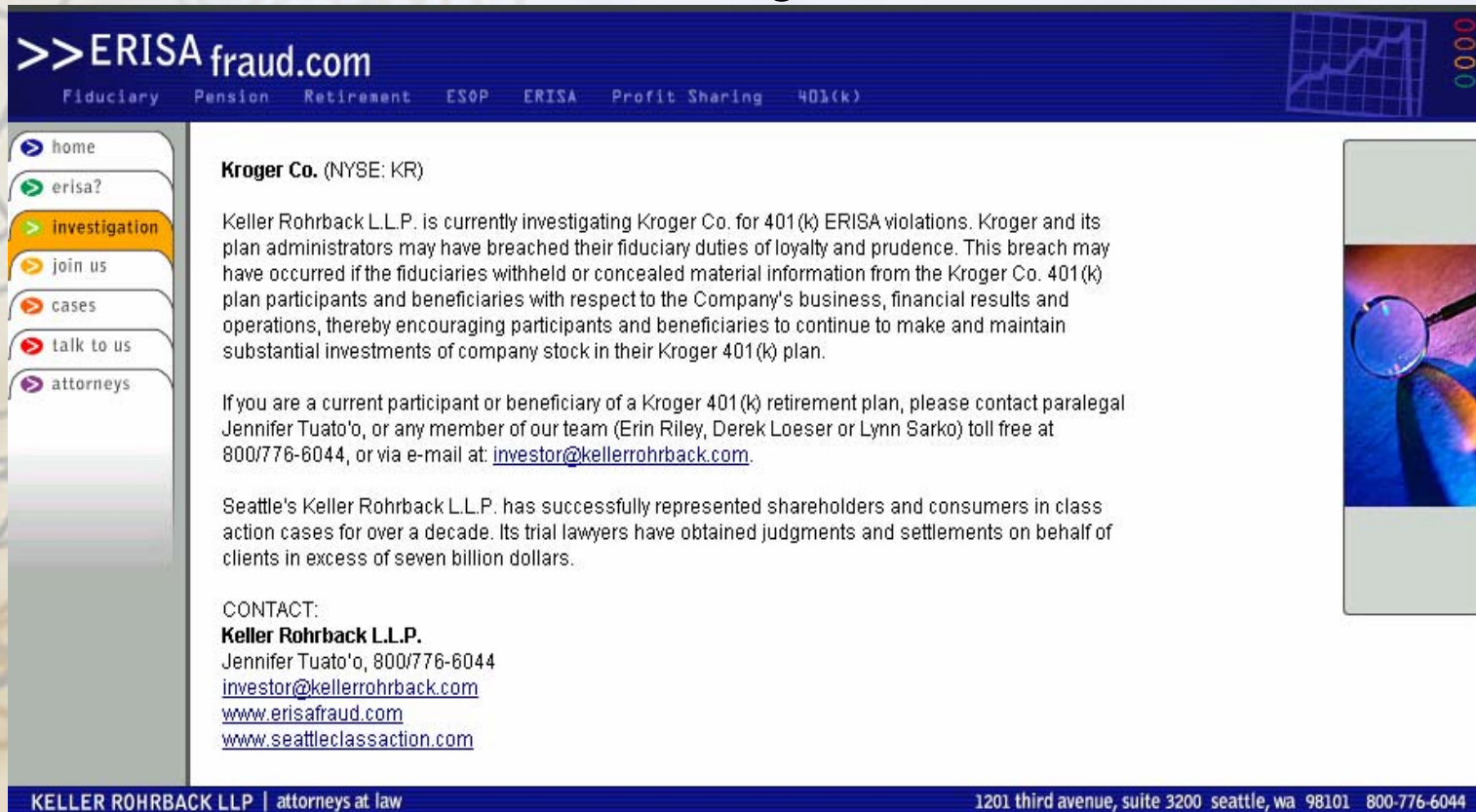
Keller Rohrback is continually investigating and filing new ERISA fraud cases. If you believe you have a claim or information relevant to this investigation or any other possible ERISA case, please [contact us](#).

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How do these suits get started? (cont'd)

“Investigations”



>> ERISA fraud.com
Fiduciary Pension Retirement ESOP ERISA Profit Sharing 401(k)

- home
- erisa?
- Investigation**
- join us
- cases
- talk to us
- attorneys

Kroger Co. (NYSE: KR)

Keller Rohrback L.L.P. is currently investigating Kroger Co. for 401(k) ERISA violations. Kroger and its plan administrators may have breached their fiduciary duties of loyalty and prudence. This breach may have occurred if the fiduciaries withheld or concealed material information from the Kroger Co. 401(k) plan participants and beneficiaries with respect to the Company's business, financial results and operations, thereby encouraging participants and beneficiaries to continue to make and maintain substantial investments of company stock in their Kroger 401(k) plan.


If you are a current participant or beneficiary of a Kroger 401(k) retirement plan, please contact paralegal Jennifer Tuato'o, or any member of our team (Erin Riley, Derek Loeser or Lynn Sarko) toll free at 800/776-6044, or via e-mail at: investor@kellerrohrback.com.

Seattle's Keller Rohrback L.L.P. has successfully represented shareholders and consumers in class action cases for over a decade. Its trial lawyers have obtained judgments and settlements on behalf of clients in excess of seven billion dollars.

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What do all of these “stock-drop” suits have in common?

- Some business event that causes the company’s stock price to drop, such as:
 - Corporate fraud
 - Restatement of corporate earnings
 - Failure of a business plan
 - Downturn in an industry sector
 - Bankruptcy

Who gets sued?

- **Named fiduciaries, including plan sponsors and plan administrators**
- **Fiduciary committees and their members**
- **Appointing fiduciaries – board members and committees**
- **The not-so-innocent bystander as de facto fiduciary – Ken Lay touting the stock in the Enron cafeteria while quietly dumping his own shares**
- **The recordkeeper and/or trustee (Fidelity, Schwab, etc.)**
- **Other service providers (accountants, consultants)**

The meat and potatoes

- What exactly do the “stock-drop” complaints allege and what proof is required to prevail on the claims?

Two basic claims

1. Prudence – The company stock fund became an imprudent investment alternative because of circumstances adversely affecting the company, and the plan fiduciaries breached their fiduciary duty by continuing to allow investments in the fund. (“Enron lite”)
2. Misrepresentation/Omission – The plan fiduciaries knew or should have known about the circumstances adversely affecting the company, and they breached their fiduciary duty by affirmatively misleading or failing to warn participants of the risks. (“Enron”)

Defense of Prudence Claims

Congress decided to treat company stock in eligible individual account plans differently from other investments

- Eligible individual account plans (EIAPs) = ESOPs, 401(k) savings plans, stock bonus plans, profit-sharing plans
- Congress wanted to encourage ownership by employees of the companies for which they work
- To do that, it had to remove barriers that restricted a fiduciary's ability to invest in company stock

Congress specifically removed certain ERISA barriers to investment in company stock

- First, it excused EIAP investments in company stock from the 10% limitation that applies to other ERISA pension plans
- Second, it excused EIAP fiduciaries of the duty to act prudently with respect to investments in company stock, to the extent prudence requires diversification (404(a)(2))

In some courts, removal of these barriers means that company stock is a “presumptively prudent” investment

- *Moench* (3d Cir.), *Kuper* (6th Cir.), *Wright* (9th Cir.) – agreed that ESOP and EIAP investments in company stock are “presumptively prudent” (though not settled as to EIAPs)
- What does this mean for fiduciary defendants who get sued when the price of company stock drops?
- Plaintiffs have to first allege and then prove facts that will rebut the presumption of prudence
- Other courts disagree as to EIAPs (vs. ESOPs) – *Shering-Plough* (3d Cir.)

Rebutting the presumption of prudence

- **What does a plaintiff have to show?**
 - The present circumstances facing the company were known or anticipated at the time the plan was created;
 - and
 - Allowing the company stock investment to continue now, in the context of those circumstances, would defeat the purpose of the plan

In *Moench*, the court said the presumption was rebutted by:

- Precipitous drop in stock price
- Company filing for bankruptcy
- Conflict of interest

The presumption-of-prudence defense may be rebutted on a motion to dismiss

- Stock price drops off the chart (99% drop in Enron; 99% drop in Global Crossing; 98% drop in WorldCom)
- Company is in bankruptcy – not viable as an ongoing concern
- Second test – whether company is on brink of collapse – creates factual issues almost by definition

But on the merits . . . plaintiffs must still prove imprudence

- When is investment in a publicly traded security “imprudent”?
Defense argument: When its price does not reflect its true worth
- If there are any stock analysts who counseled shareholders to hold on to the stock even in the face of the company’s public difficulties, fiduciaries can argue that a “hypothetical prudent fiduciary” would have done the same thing as the plan fiduciary
- “Prudence” in context of entire 401(k) portfolio

...and causation

- Causation under ERISA 409: fiduciary liable for “losses to the plan *resulting from*” the fiduciary’s breach
- Plaintiff must show a causal link between a fiduciary’s failure to investigate the continued prudence of the investment and the harm suffered by the plan
- *Dura Pharmaceuticals* (S. Ct. 2005) – Causation cannot be presumed; securities laws are not insurance against bad investment decisions

Other Defenses

- **Some individual defendants not fiduciaries**
- **Company not a fiduciary**
- **“Two hats” doctrine precludes breach of duty of loyalty claims/conflict of interest claims**
- **Obligation to follow terms of the plan precludes breach of duty of loyalty claims/conflict of interest claims**
- **Co-fiduciary liability claim automatically fails if primary breach claim is dismissed**

Fiduciary Misrepresentations and Omissions



Fiduciary Misrepresentations and Omissions

- **Second broad category of fiduciary breach claims in stock-drop cases**
- **Broadly stated, fiduciaries have an affirmative duty to warn plan participants of material adverse information about their investments in the employer stock and/or to tell them the stock is a risky investment**

Problems with the theory

- **Tension with the insider-trading prohibitions of the federal securities laws**
 - Can ERISA be construed to require disclosure of material inside information only to plan participants (so they can transfer their money in advance of the market and avoid losses)?
 - DOL very active in this area; Enron amicus brief: (i) could have disclosed information to the market (“look out below!”); (ii) eliminate employer stock as an investment option (“look out below!”); (iii) alert the DOL and/or the SEC (“look out below!”)

Causation, causation, causation

- Individual participant must prove detrimental reliance on *both* the alleged misrepresentation and any omission
- Plaintiffs may tie themselves in knots
 - Complaint alleges that many participants knew of wrongdoing and many were predisposed to invest in their employer's stock
- No court has ever held that reliance can be presumed, quite unlike Rule 10b-5 cases

Damages

- Plaintiffs' preferred damages model: best performing alternative investment
- Alternative models:
 - Closest available alternative investment
 - Hypothetical representative portfolio
 - *Donovan v. Bierwirth* (2d Cir.) – dated model, see *Dura Pharmaceuticals*
 - Market price without misrepresentation
 - Investment performance if funds had been available for other plan purposes

Damages (cont'd)

- *Dura Pharmaceuticals*: Courts should look critically at pat damages claims
- Timing of the calculation

ANOTHER QUIZ:

What obscure section of ERISA allows fiduciaries to avoid liability for participants' bad investment decisions?

- a) 502(a)(2)
- b) 10b-5
- c) 404(c)

And the answer (we hope) is . . .

404(c): “In the case of a pension plan which provides for individual accounts and permits a participant or beneficiary to exercise control over the assets in his account:

. . .

no person who is otherwise a fiduciary shall be liable under this part for any loss, or by reason of any breach, which results from such participant’s or beneficiary’s exercise of control.”

ERISA § 404(c)(1)(B), 29 U.S.C. § 1104(c)(1)(B).

Why does 404(c) matter?

- The 404(c) defense, if applied, relieves the plan fiduciaries – company, trustee, officers and directors – of liability if employees lose money in their 401(k) accounts because of their own poor investment decisions
- Especially helpful in employer stock cases

How broad is the 404(c) defense?

- By its terms, the 404(c) defense protects the fiduciary from “any loss” or “any breach” resulting from a participant’s exercise of control over assets in an individual account plan
- The legislative history indicates that the 404(c) defense applies where the participant instructs the plan to invest “the full balance of his account in, e.g., a single stock”

Unresolved issue

Does the 404(c) defense apply to the selection and evaluation of funds in a defined contribution plan?

Department of Labor says no, but they made it up.

Unisys Savings Plan Litigation says yes.

Issue resolved adversely to plans in *DiFelice v. U.S. Airways*

Overview of 404(c) requirements

- **Plan structure**
- **Disclosure**
- **Employer stock**

How can you make sure your plan is in compliance?

- **First thing to check: Does the plan document or SPD say it is intended to be a 404(c) plan and that fiduciaries are relieved of liability for participant investment choices?**
- **Equally important, but much harder to determine: Is the plan actually operated in compliance with 404(c)?**

“Preventive Medicine” for 401(k) Plans That Hold Employer Stock

- We hold this truth to be self-evident: If your company has a 401(k) plan that provides for investment in employer stock, it’s a bulls-eye for an ERISA breach-of-fiduciary-duty lawsuit, likely a class-action lawsuit.
- So: How do you improve your odds of prevailing – particularly at the motion to dismiss stage – when the lawsuit is filed?



Preventive Medicine: Radical Surgery

- Eliminate employer stock as an investment option
 - Unpalatable for most companies; employee, shareholder relations issues, as well as depriving employees of what may be an excellent investment option
 - Counter: Can give employees access to stock on a tax-favored basis through an employee stock purchase plan (ESPP), without ERISA exposure (but with potential adverse accounting)
- Must be done carefully to avoid liability
 - Phase-in; allow period (1-2 years) to diversify out of stock (with drop-dead date at end – no 404(c) protection for default fund)
 - Need well-planned employee, public communications program

Preventive Medicine: Minor Surgery

- Limit stock as an investment option
 - Limit allocation to, e.g., 20% of payroll contributions (generally not a recordkeeping issue)
 - Limit transfers into stock fund from other funds (may present significant recordkeeping problems)
 - Potential impact of limitations on availability of 404(c) protection is unclear
 - If you pick 20% as the limit, are you suggesting that having up to 20% of retirement funds in a single stock is advisable?
 - Must be combined with effective investment education.

Preventive Medicine: Minor Surgery (continued)

- Allow free diversification out of company stock, even for matching contributions
 - Requires a philosophical shift for many employers
 - All matching (i.e., match in cash) vs. vested matching (i.e., match in stock; keep as stock until vested)
 - Issues re implementing new diversification right: Need to be prepared for spike in stock sales (cash demands within plan; impact on share price) (in practice, rarely becomes a real problem)

Preventive Medicine: Cosmetic Surgery

- Make sure that employer stock (in fact, all investment funds) are “baked” into the plan document (settlor choice) instead of being selected by the plan’s investment committee (fiduciary choice)
- Consider converting the employer stock fund into an ESOP
 - May permit higher (“clearly imprudent”) Moench standard for prudence claim related to employer stock
 - Requires relatively small changes in most public company plans that already offer employer stock as an option and permit free diversification (e.g., voting pass-through; right to receive distribution in kind)
 - May permit dividends on stock in plan to be deducted

Preventive Medicine: Cosmetic Surgery (continued)

- Review carefully plan's fiduciary structure; consider ways to limit or avoid "imprudent monitoring/failure to disclose" claims
 - Leave board members and top-tier officers (those most likely to be exposed to material non-public information) off the committee
 - Consider "baking" the committee membership into the plan (e.g., by title or position) to avoid "appointment/monitoring" claims
 - Consider retaining an outside fiduciary, especially when rough waters may be ahead (but be careful; may be used against you; see US Airways decision)

Preventive Medicine: “Wellness” Programs

- Review content and effectiveness of education program
 - Are employees “getting it”? Is your approach working, particularly for the rank-and-file?
- Consider investment advice or investment management alternatives
 - Problem is that law is still developing re: fiduciary, prohibited transaction issues
 - Pending legislation may provide relief

Preventive Medicine: “Wellness” Programs (continued)

- Review plan for 404(c) compliance
- Review plan fiduciary practices (committee charters, minutes, how often committee meets, use of outside advisors where appropriate)
- Review ERISA fiduciary insurance

Special Issues in Private Company ESOPs – Matters Likely to Trigger Litigation

- Purchase of employer securities
- Sale of company
- High levels of executive compensation
- Related-party transactions

ERISA “Stock-Drop” Litigation:

Preparing Your Organization for a Surge in Claims

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