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THE PRO-FIDUCIARY TRIAL RULING IN *DIFELICE v. US AIRWAYS*, AND WHAT IT MEANS FOR ERISA STOCK LITIGATION

By Charles C. Jackson and Christopher A. Weals

Charles C. Jackson is a partner in Morgan Lewis' Labor and Employment Law Practice in Chicago. He can be reached at 312-324-1156 or charles.jackson@morganlewis.com. Christopher A. Weals is a partner in Morgan Lewis' Labor and Employment Practice in the Washington, D.C. office. He can be reached at 202.739.5350 or cweals@morganlewis.com

In the first post-*Enron* "stock drop" case to go to trial, *DiFelice v. US Airways, Inc.*, Case No. 1:04cv889 (E.D. Va. June 26, 2006), the district court ruled against a class of 401(k) plan participants, holding that US Airways did not breach its fiduciary duties under ERISA by continuing to permit voluntary investment in the stock of its parent corporation, US Airways Group, Inc., during the months leading up to the first US Airways bankruptcy in 2002.

ERISA practitioners are already debating the significance and correctness of the court's legal rulings and the plaintiff class has appealed. Regardless of the case's ultimate place in ERISA jurisprudence, this was a major victory for US Airways and its fiduciaries. What's more, we believe the greatest impact of the decision will be how it alters the practical landscape for both litigating and settling ERISA stock drop cases.

Until now, the price of voluntary resolution has largely depended on the perceived strength of certain technical legal arguments, from the theory that employer stock is an "imprudent" investment to damages models built largely on hypothetical and untested constructs such as an "orderly sale." Because these arguments were largely untested at trial, lawyers, insureds and claims examiners had to make judgments about the perceived strengths or deficiencies of claims based on hypotheses of what exposure *might* be *if* the case *were* to go to trial. In other words, the settlement equation has been principally informed by Rule 12(b)(6) jurisprudence and an occasional summary judgment motion. In addition, though there is no discernible pro-plaintiff bias in the case law, litigants sense an unspoken rule that courts will give special scrutiny to stock drop cases because the assets of retirees have been completely lost or seriously diminished. Unfortunately, such soft case-evaluation criteria have had adverse consequences for insureds and insurers alike.

These forces and a slew of generous settlements have conditioned the plaintiffs' bar to demand settlements that are at or above policy limits, even though such figures are hard to justify on a litigation risk basis. Juxtaposed against the insurer's risk-based analysis are the legitimate concerns of insureds, who rightly view insurance against these claims as, well, insurance. The insureds desire finality, and the elimination of risk and exposure. If there is some issue about corporate indemnity over and above available insurance, these concerns are amplified even more. While not all settlements are disproportionate, motion-based legal arguments and settlement contentions have the inevitable effect of increasing settlement values and jeopardizing insureds who, in the end, simply want protection.

Trials change everything. Though many lawyers practicing in this area have tried cases, most lawyers on both the defense and plaintiffs' side are not trial lawyers. A well-tried case can directly and convincingly disprove claims of "imprudence" that have been kept alive by the forgiving standards of Rule 12(b)(6). Importantly, a trial addresses the very real need of a federal judge to determine that the company's fiduciaries have in fact fulfilled their duties to retirees and other plan participants. Equally important, a plaintiff's knowledge that an insured and insurer are willing to go through a trial if necessary should have the effect of driving down settlements to more properly correspond to the merits of the particular claims, rather than simply fixing a price based on perceived trends, the limits of the insurance policies, and a mushy "what if" risk analysis based on Rule 12(b)(6) rules.

In Section A, we review the *DiFelice* decision, explaining the facts that drove the court's findings and the legal principles on which the court relied. In Section B, we examine some of the trial practicalities that shaped the evidence, including the role of plaintiff's experts and defense experts. Though its financial circumstances were difficult, US Airways had a strong story to tell. Plaintiffs in the end simply could not deal with the strength of this evidence, and the experts called by plaintiffs inadvertently showed the weaknesses in plaintiff's legal theories. In Section C, we outline considerations for insurer and insured alike for dealing with ERISA stock claims under fiduciary liability policies in the aftermath of *DiFelice*.

Adverse Business Circumstances, and Eventual Bankruptcy, Do Not Necessarily Require a Finding that Fiduciaries Violated Their Duties by Permitting Continued Voluntary Investment in Company Stock

In addition to the Company Stock Fund, the US Airways 401(k) Plan offered 12 additional investment options with varying levels of risk and return. The court found that the Plan's investment options were sufficiently diverse that participants could select a portfolio mix that achieved their individually-desired level of risk and return. During the period covered by the lawsuit, approximately 5% of the Plan's assets were invested in the Company Stock Fund.

Under the Plan, US Airways was the fiduciary with discretionary authority to select or remove investment options. US Airways delegated its authority to a Pension Investment Committee made up of three senior executives. Neither the Plan nor the trust agreement mandated the offering of the Company Stock Fund as an investment alternative, and US Airways had discretion to terminate the Company Stock Fund at any time. The Pension Committee met on a regular basis to review the performance of investment options provided in the Plan, and to consult with financial advisors. Based on its continuing review of the company and its prospects, the Committee determined that it was appropriate to continue offering the Company Stock Fund as an investment option in the Plan. Additionally, US Airways provided participants with publications concerning investment diversification. The court found that the Plan and the Company Stock Fund did not suffer from the problems alleged in the *Enron* lawsuit, as the Plan did not compel participants to invest in Stock Fund and, in contrast with the *Enron* case, there was no allegation of fraud or deception on the part of US Airways.

Prior to its bankruptcy filing in August 2002, US Airways, a high-cost legacy airline carrier, experienced serious financial setbacks. These difficulties were exacerbated by the terrorist attacks of September 11, 2001. Much of the trial centered on the reasonableness of US Airways's business plan for surviving 9/11 and putting the airline back on the road to profitability.

After a six-day bench trial, the court soundly rejected the claims of the plaintiff class. The court held that employer stock, while admittedly a riskier investment, is a favored investment under ERISA and is an appropriate choice to offer as part of a diversified retirement portfolio. Citing modern portfolio theory and the Department of Labor's regulations on prudent investing, the court found that "ERISA requires that the prudence of selecting a particular investment be viewed in light of its contribution to the risk and return of the entire portfolio, and not in light of its individual risk." The court also found the continued offering of US Airways stock for investment to be prudent based on evidence of US Airways's business plan to improve its prospects, despite the eventual failure of the plan and the company's subsequent filing for bankruptcy. In so ruling, the court rejected expert testimony from the plaintiff class that US Airways should have used a bankruptcy prediction model to forecast its own bankruptcy, and testimony that investment in US Airways stock was "imprudent."

Several important conclusions can be readily drawn from the court's decision. First, of course, is the obvious conclusion that a full trial can have a decided refining effect on claims of fiduciary "imprudence" with respect to 401(k) plans generally and company stock funds in particular. While numerous courts have wrestled with stock drop issues in the context of motions to dismiss, no post-*Enron* court had yet addressed these matters on a fully developed record, where plaintiffs no longer enjoy the benefit of doubt as they do on a motion to dismiss.

Second, the case involved a plan sponsor that eventually filed for chapter 11 bankruptcy protection, resulting in a complete loss of value in the common stock. The court focused not on the ultimate outcome but on the viability of the company's restructuring plan and the soundness of the process the fiduciaries used to monitor the Company Stock Fund. This reinforces the need for fiduciary committees to engage in regular, systematic monitoring of employer stock along with all other 401(k) investment options.

Finally, the court's explicit endorsement of modern portfolio theory brings a much-needed framework to the problem of how to evaluate the prudence of employer stock within a defined contribution plan. The plaintiff class urged the court to consider employer stock in isolation and to evaluate its prudence as a stand-alone investment. While there was also strong evidence that US Airways stock was a suitable investment in its own right, the court found plaintiff's approach to be inconsistent with both modern portfolio management theory and the Department of Labor's regulations under Section 404(a) of ERISA. In short, employer stock must be viewed not in isolation but as part of an overall diversified retirement portfolio.

Evidence, Witnesses and Testimony: Where the Plaintiff's Case Fell Apart

The plaintiffs in US Airways sought to prove their claim of "imprudence" by calling former US Airways executives, members of the Pension Committee, expert witnesses, and the named plaintiff himself. Plaintiffs also called the independent fiduciary (Aon Fiduciary Counselors) that took over management of the Company Stock Fund six weeks before bankruptcy was filed. Contrary to what plaintiffs expected, the evidence from these witnesses not only failed to establish plaintiff's claims, it affirmatively demonstrated that US Airways at all times fulfilled its fiduciary obligations.

1. *Evidence of US Airways' Business Plan for Returning to Profitability.* Plaintiffs thought that the mid-2001 failure of the proposed merger between United Air Lines and US Airways and the financial stress of the September 11, 2001 terrorist attacks demonstrated that investment in US Airways stock was necessarily "imprudent." However, the testimony at trial established that US Airways began implementing cost-reduction plans after the United merger was called off; implemented dramatic cost reductions after the 9/11 terrorist attacks (including substantial layoffs and parking unused airplanes); obtained operating grants from the Air Transportation Safety Board (ATSB) and large loans from General Electric; ended year 2001 with almost $1 billion in cash; hired new management to revamp the airline in the spring of 2002; embarked on another massive cost-cutting initiative during spring 2002; sought (and received) conditional approval from the ATSB for a $900 million loan guarantee; and saw its efforts to restructure fail at the eleventh hour primarily because of the last-minute refusal of certain labor groups to agree to concessions. These facts put the lie to plaintiff's argument that US Airways stock was a speculative and unworthy investment because bankruptcy was inevitably just around the corner.

2. "*Substantive Prudence" Evidence.* The evidence at trial demonstrated that US Airways at all times made full disclosure of its financial condition; the plaintiff himself confirmed that he was fully informed as to all Plan investment options; plan participants as a group were diversified across investment options; and defendant's expert testimony established that US Airways stock was held by numerous retirement plans.

3. "*Procedural Prudence" Evidence.* At trial plaintiffs woodenly attempted to focus on documents contained in the files of the Pension Committee and its members, suggesting that, if every decision and discussion was not meticulously recorded in some contemporaneous document, then the fiduciaries must not have exercised their obligations as fiduciaries. The evidence, however, powerfully refuted this contention. The testimony of the fiduciaries themselves demonstrated that they considered the investment performance of US Airways stock, that attorney advice was sought as to the suitability of company stock as an investment option, and that the fiduciaries considered the advisability of engaging an independent fiduciary to manage the Company Stock Fund when bankruptcy was identified as an option if voluntary restructuring was not successful. In addition, the responsible fiduciaries were intimately engaged in US Airways business operations, and thus were fully apprised of the company's prospects at all times.

4. *Failure of Plaintiff's Merits Experts.* Both of plaintiff's "prudence" experts fell far short in their effort to establish that US Airways stock was unsuitable as an investment option. One expert performed a valuation analysis and concluded that US Airways stock was a "speculative" investment and therefore unsuitable for a retirement plan. However, she admitted that having about 5% of a plan's assets in company stock was permissible, not realizing that the US Airways plan had between 4% and 7% invested in US Airways stock during the relevant period. Plaintiff also called an expert in bankruptcy prediction who testified that under his proprietary model, US Airways had a high probability of bankruptcy. This expert admitted to having re-characterized the US Airways debt rating from the CCC+ rating of Standard & Poors to D (his debt rating "equivalent"), and predicted that US Airways was doomed to bankruptcy because S&P statistics showed that companies with D-rated debt were likely to go bankrupt imminently. However, on cross-examination the expert admitted that the S&P statistics showed that CCC+-rated companies like US Airways had a 1 in 5 chance of going bankrupt within a year – in other words, that the odds were four to one against bankruptcy, and that under the actual S&P ratings and statistics the odds were against imminent bankruptcy. The expert's bankruptcy prediction model was further undermined when the independent fiduciary called by the plaintiff testified on cross-examination that ERISA fiduciaries rely upon debt ratings by S&P and Moody's, not upon the bankruptcy model of plaintiff's expert.

5. *Failure of Plaintiff's Damages Experts.* The court's ruling on liability made it unnecessary to consider damages. Nevertheless, the trial testimony of plaintiff's damages experts raised serious doubts about many of their underlying assumptions. For instance, plaintiff's damages model rested on the assumed ability of the fiduciaries to liquidate the large holdings in the Company Stock Fund without adversely affecting the Fund, the company stock generally, or the participants themselves. The plaintiff's expert on this issue (a manager of several small hedge funds) admitted, however, there were no real-world examples of this having ever occurred, and that he had no first-hand experience trading large blocks of public securities. This expert had assumed that the fiduciaries could have sold off 11 million shares of US Airways stock in less than 90 days with only a minimal negative impact on the price. The court was understandably skeptical of this theory given the complete lack of empirical data to support it, as well as the testimony of US Airways's expert that an "orderly sale" was impossible because any announcement by company insiders that the stock was an imprudent investment would have sent shock waves through the market and immediately depressed the stock price, thus causing certain and immediate harm to the participants.

6. *Additional Defenses Asserted.* Among other defenses asserted by US Airways were that company stock investment was subject to a standard of deferential review by the court; that Section 404(c)'s safe harbor shielded the fiduciaries from any review at all; and that Article III and statutory standing constraints eliminated or greatly reduced US Airways liability. Although the court did not opine on certain defenses, partially accepted others and rejected still others, US Airways retains all of these arguments as additional reasons for defending the judgment in its favor.

The Litigation and Settlement Calculus in the Aftermath of the US Airways Trial

The US Airways trial demonstrates that, at least in ERISA "stock drop" cases, there is a vast difference between making conclusory allegations and proving a fiduciary violation at trial. While the plaintiffs' bar may be quick to attempt to distinguish the US Airways decision based on its specific facts – such as the full disclosures made by US Airways and the complete absence of any allegation of fraud or misrepresentation – the most significant impacts of the decision go well beyond its particular facts. There is a statutory preference for investing in company stock, and the offering of diverse options to participants is not only good investment strategy but a good defense to breach of fiduciary duty claims. Moreover, many ERISA stock cases do not have the most difficult component present in the US Airways case – a company that went into bankruptcy and whose stock thereafter became worthless. If the facts, testimony and rulings of US Airways are instructive for cases in which company stock has become worthless, the decision should have even greater force for those many cases in which the sponsoring employer has strong, ongoing viability but has experienced a temporary stock fluctuation.

Many defense lawyers may well conclude, for the reasons that we have explained, that the US Airways case calls for a more rigorous settlement assessment from the plaintiffs' bar. Many stock drop cases are easier to allege than prove. However, it would be too much to suppose that one trial will work any sea change in plaintiffs' approach to these cases. Attorneys on the defense side share many stories about the failure of plaintiffs' counsel to conduct a genuine risk analysis of ERISA stock claims, a failure no doubt promoted, in part, by the lucrative settlements that have been paid in some cases. We believe that settlements should be pursued whenever possible and that clients need the peace and repose that finality brings. However, the overall settlement calculus for these cases should, for the reasons we argue above, be reassessed. The defense bar can punctuate this conclusion by doing all it can to work vigorously for fiduciary defense verdicts in those cases that plaintiffs refuse to settle for a reasonable, merits-based amount.

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