Legal Backgrounder

Washington Legal Foundation
Advocate for freedom and justice®
2009 Massachusetts Avenue, NW
Washington, DC 20036
202.588.0302

Vol. 20 No. 28 July 1, 2005

ERISA-RELATED SECURITIES LITIGATION IMPOSES UNDUE BURDEN ON PENSION PLANS AND PARTICIPANTS

by

Douglas E. Motzenbecker

In recent years, a wave of suits has been filed involving eligible individual account plans ("EIAPs") – that is, an employee benefit plan that may lawfully hold stock or other securities issued by the employer sponsoring the plan. EIAPs typically include employee stock ownership plans ("ESOPs"), 401(k) plans, and related plans. In general, the plaintiffs in these cases have alleged that the fiduciaries of such plans violated their duties under the Employee Retirement Income Security Act of 1974 ("ERISA"), 29 U.S.C. §§ 1001-1461, by allowing the plans, their participants, or both, to invest in employer securities during times when the employer was experiencing financial distress or, as in the Enron experience, concealing accounting irregularities. In certain instances, the market price of the employer's stock declined dramatically after those irregularities were disclosed, resulting in losses to the plans and their constituents. In light of this litigation, plan fiduciaries face difficult decisions over whether to allow their plans to continue to acquire or hold stock issued by the companies sponsoring such plans.

Companies have been facing litigation on two fronts – not only in traditional securities fraud actions but now in cases arising under ERISA. Although Congress adopted the Private Securities Litigation Reform Act, PUB. L. 104-67, 109 STAT. 737, to redress abuses in securities litigation, ERISA affords plaintiffs certain procedural and substantive advantages over traditional securities suits, and plaintiffs' lawyers have been exploiting this loophole in the law. To date, courts have delivered mixed results for defendants in these cases, making this litigation risky and unpredictable. Unless Congress intervenes or the federal courts change course, employers – and employees as a whole – stand to lose, because employers will likely offer less generous benefits as a result.

ERISA's Fiduciary Duties. ERISA's fiduciary duties are codified at 29 U.S.C. §§ 1101 to 1114. Fiduciaries must act solely in the interest of plan participants and beneficiaries, using the "care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims[.]" 29 U.S.C. § 1104(a)(1)(B). They must also diversify a plan's investments "to minimize the risk of large losses, unless under the circumstances it is clearly not prudent to do so[.]" 29 U.S.C. § 1104(a)(1)(C). A person whose breach of duty harms a plan may be held personally liable to the plan for all resulting damages. *See* 29 U.S.C. § 1109(a).

ERISA mandates that "every employee benefit plan shall be established and maintained pursuant to a written instrument." 29 U.S.C. § 1102(a)(1). The plan document requirement "has formed the cornerstone of a series of decisions [of the Third Circuit] and other courts limiting litigants to the language of the plan

Douglas E. Motzenbecker is a partner of the law firm of Podvey Meanor Catenacci Hildner Cocoziello & Chattman, P.C. in Newark, New Jersey, and concentrates in employment litigation on behalf of management.

document." *In re New Valley Corp.,* 89 F.3d 143, 149 (3d Cir. 1996), *cert. denied,* 519 U.S. 1110 (1997); *Gable v. Sweetheart Cup Co.,* 35 F.3d 851, 857 (4th Cir. 1994), *cert. denied,* 514 U.S. 1056 (1995). Provided the plan document complies with ERISA, fiduciaries have a "duty to follow the plan document in administering the plan and awarding (or denying) benefits." *Hlinka v. Bethlehem Steel Corp.,* 863 F.2d 279, 286 (3d Cir. 1988).

ERISA generally prohibits a plan fiduciary from initiating transactions with insiders and other parties in interest, and from investing in employer securities or real estate. However, eligible individual account plans, or EIAPs, are different. The statute defines an EIAP as a profit-sharing, stock bonus, thrift, or savings plan; an ESOP; or a specified money purchase plan that was in existence when ERISA was enacted. *See* 29 U.S.C. § 1107(d)(3)(A), 26 U.S.C. § 4975(d)(13). As an exception to the prohibited transaction rules, an EIAP may lawfully hold qualifying employer securities or real property, since such plans are also exempt from ERISA's diversification duties, and may borrow from the plan sponsor.

Although the same issues largely apply to all EIAPs, ESOPs have received special attention because their portfolios consist almost exclusively of employer stock. "[A]n ESOP is a type of ERISA plan that invests primarily in the stock of the employer creating the plan." *Roth v. Sawyer-Cleator Lumber Co.,* 16 F.3d 915, 917 (8th Cir. 1994); *see also* 29 U.S.C. § 1107(d)(6)(A). As one court has noted, "[t]he ESOP concept is the brainchild of Louis O. Kelso, who has promoted it as a device for expanding the national capital base among employees – an effective merger of the roles of capitalist and worker." *Donovan v. Cunningham,* 716 F.2d 1455, 1458 (5th Cir. 1983), *cert. denied*, 467 U.S. 1261 (1984). ESOPs help employers finance their operations through the acquisition of qualified employer securities, and Congress – believing that employee ownership yields positive economic results – has enacted substantial tax incentives to encourage the formation of ESOPs.[1]

Like other defined contribution plans, ESOPs offer no guarantee of benefits at retirement. An employee's stake in an ESOP is merged with his employer's financial success or failure. As such, "an ESOP places employee retirement assets at much greater risk than does the typical diversified ERISA plan." *Martin v. Feilen,* 965 F.2d 660, 664 (8th Cir. 1992), *cert. denied,* 506 U.S. 1054 (1992).

Moench v. Robertson. The U.S. Court of Appeals for the Third Circuit's decision in *Moench v. Robertson* remains the landmark case with respect to whether a fiduciary of a plan holding employer stock may continue to invest in such securities. *Moench v. Robertson,* 62 F.3d 553 (3d Cir. 1995), *cert. denied,* 516 U.S. 1115 (1996). Although *Moench* involved an ESOP, the decision has been applied to other kinds of EIAPs. *See, e.g.*, *In re McKesson HBOC, Inc. ERISA Litig.*, 2002 WL 31431588, *4-5 (N.D. Cal. Sept. 30, 2002) (involving 401(k) plan); *In re Dynegy, Inc. ERISA Litigation*, 309 F. Supp. 2d 861, 876 (S.D. Tex. 2004) (401(k) savings plan).

In *Moench*, an ESOP's trustees used employee contributions to purchase employer stock for the employees' individual accounts. The employer, a bank, was financially weak when the trustees continued to purchase stock, and it later failed. When the participants sued, the trustees argued that the plan document required them to so invest the contributions, arguing they were following the plan, as ERISA requires. The district court accepted that argument and dismissed the participants' claims. However, the court of appeals reversed, imposing the following rule on ESOP fiduciaries:

---

[1]*See, e.g.,* 26 U.S.C. §§ 404(a)(9) (permitting deductions for employer contributions to facilitate acquisition of employer stock); 26 U.S.C. § 1042(b)(1)(A) (deferring capital gains taxes for certain sales of qualified stock to an ESOP, on acquisition of specified replacement property); 26 U.S.C. § 4975(d)(3) (excepting loans to ESOP from prohibited transaction rules); *see also United States v. Carlton*, 512 U.S. 26 (1994) (acknowledging favorable estate tax treatment for sales of stock to ESOPs).

Copyright © 2005 Washington Legal Foundation

ISBN 1056 3059

> In light of the analysis detailed above, keeping in mind the purpose behind ERISA and the nature of ESOPs themselves, we hold that in the first instance, an ESOP fiduciary who invests the assets in employer stock is entitled to a presumption that it acted consistently with ERISA by virtue of that decision. However, the plaintiff may overcome that presumption by establishing that the fiduciary abused its discretion by investing in employer securities.

Id. at 571. Citing § 227 of the RESTATEMENT (SECOND) OF TRUSTS (1959), the Third Circuit noted that in attempting to rebut the presumption "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 expectations of how a prudent trustee would operate." *Id.* In other words, a plaintiff must prove that the employer who founded the ESOP would never have expected that a reasonable trustee would continue to hold or acquire the employer's stock under such circumstances.

Comments on Moench. Despite the simplicity of the *Moench* rule, it is difficult to imagine that an employer would expect its ESOP's fiduciaries to jettison the company's own stock. Not surprisingly, *Moench* has seemingly been followed more in principle than in practice, and the decision has its detractors. Prior to *Moench*, the U.S. Court of Appeals for the Tenth Circuit reached a contrary result, concluding that an ESOP's trustee acted properly in continuing to hold employer stock during a period when its price was declining significantly. *Ershick v. United Missouri Bank of Kansas City, N.A.*, 948 F.2d 660 (10th Cir. 1991). Although the Sixth Circuit adopted the *Moench* rule shortly after it was announced, the court nevertheless affirmed the entry of summary judgment in favor of the plan defendants. *Kuper v. Iovenko,* 66 F.3d 1447, 1457 (6th Cir. 1995). The Seventh Circuit, in turn, recently affirmed a grant of summary judgment for ESOP trustees who invested sixty-five percent of the plan's assets in employer securities. It acknowledged *Moench*, but reasoned that if "ESOPs had to be diversified they would fail in their purpose of encouraging employees' ownership of their employer's stock." *Steinman v. Hicks*, 352 F.3d 1101, 1105 (7th Cir. 2003).

Limited Safe Harbors and Procedural Defenses. Most of the failure-to-diversify cases have alleged that the plan defendants – who are privy to information regarding possible irregularities occurring within the entity sponsoring an EIAP – harmed the plan and its constituents by making affirmative representations about the plan sponsor's financial condition. Some courts have held that FED. R. CIV. P. 9(b) requires that plaintiffs pleading fraud in fiduciary breach cases do so with adequate particularity. *See Vivien v. Worldcom, Inc.*¸ 2002 WL 31640557, *7 (N.D. Cal. July 26, 2002). Other courts, however, have disagreed. *See, e.g.*, *In Re Dynegy, Inc. ERISA Litig.*, 309 F. Supp. 2d 861, 867 (S.D. Tex. 2004) ("ERISA does not have heightened pleading requirements. Claims asserted under ERISA are subject to the notice pleading standard of [FED. R. CIV. P. 8][.]"); *Howell v. Motorola, Inc.*, 337 F. Supp. 2d 1079, 1089 (N.D. Ill. 2004).

ERISA requires that all plan assets be held by trustees. The statute, however, recognizes that some trustees – known as directed trustees – have substantially less discretion and control over a plan's assets, and, as such, relieves them of most liability under specified circumstances. In general, a directed trustee can escape liability if it relies upon proper instructions that are consistent with the governing plan documents and ERISA itself. *See, e.g., Maniace v. Commerce Bank, N.A.*, 40 F.3d 264, 267-68 (8th Cir. 1994), *cert. denied*, 514 U.S. 1111 (1995). But despite the statute's clarity, such trustees have had only mixed success in winning dismissal of breach of fiduciary duty claims.[2]

In addition, ERISA further provides that fiduciaries of participant-directed plans – in which participants have the power to structure and allocate their investments – will not be liable for any loss that results from the participant's exercise of control over their accounts, provided the defendant can satisfy

[2]*Cf. In re WorldCom, Inc. ERISA Litig.*, 354 F. Supp. 2d 423, 449 (S.D.N.Y. 2005) (granting directed trustee's motion for summary judgment where plaintiffs failed to prove that reliable public information existed showing impending collapse of company) with *In re Sprint Corp. ERISA Litig.*, 2004 WL 1179371, *23 (D. Kan. May 27, 2004) (denying directed trustee's motion to dismiss on ground that plaintiffs adequately alleged that trustee could have known it was following instructions contrary to ERISA).

Copyright © 2005 Washington Legal Foundation

ISBN 1056 3059

various conditions. 29 U.S.C. § 1104(c). The defense, however, is "inapplicable to shield plan fiduciaries from liability for imprudently selecting the plan's investment options and overseeing their performance." *In re EDS Corp. ERISA Litig.*, 224 F.R.D. 613, 624 (E.D. Tex. 2004).

ERISA does, however, provide certain safeguards for fiduciaries, and it would be inaccurate to suggest that the case law has been universally adverse to defendants. ERISA does not, for example, allow plaintiffs to recover punitive damages, *see, e.g., Metropolitan Life Ins. Co. v. Taylor,* 481 U.S. 58, 62 (1987) (citation omitted), or permit trial by jury. *See, e.g., DeFelice v. American Int'l Life Assurance Co.,* 112 F.3d 61, 64-65 (2d Cir. 1997). One court recently dismissed a complaint with prejudice in an ESOP failure-to-diversify case, despite allegations that the employer improperly recognized revenue from certain transactions and the price of the employer's stock dropped significantly as a result. *In re Duke Energy ERISA Litig.*, 281 F. Supp. 2d 786, 794-95 (W.D.N.C. 2003). Other courts have held that fiduciaries are not required to violate the federal securities laws by trading on inside information to satisfy their fiduciary duties. *See, e.g., McKesson*¸ 2002 WL 31431588, *6 ("Not even a fiduciary acting in its fiduciary capacity is permitted to engage in insider trading. Fiduciaries are not obligated to violate the securities laws in order to satisfy their fiduciary duties."). Likewise, it is doubtful that a fraud-on-the-market presumption would apply in ERISA class actions, which should mean that a plaintiff proceeding on a securities claim must prove individualized reliance on the defendant's misrepresentations, which can be a roadblock to class certification.

Congress Could Stem the Tide of ERISA Litigation Involving Employer Securities. Through the Tax Reform Act of 1976, Congress announced it was concerned that various regulations and rulings were "reduc[ing] the freedom of the employee trusts and employers to take the necessary steps to implement [ESOPs], and which [were] otherwise block[ing] the establishment and success of these plans." Tax Reform Act of 1976, PUB. L. NO. 94-455, § 803(h), 90 STAT. 1590 (1976). It would be ironic if employers began offering fewer ESOPs and other EIAPs because the federal courts imposed obligations that Congress never intended, particularly when fiduciaries are required to follow the governing plan documents in administering the plan. It is one thing to require diversification when a plan's fiduciaries know the plan sponsor is about to collapse, or that fraud or serious irregularities are occurring. It is another thing, however, to force diversification when the plan sponsor is experiencing financial distress as a result of a national recession, high labor costs, rising energy prices, competition from abroad, or other external factors. If a trustee were to diversify an ESOP in those circumstances, or advise participants that the employer's stock is no longer worth holding, the trustee would be telling creditors, investors, and employees that the corporation has lost faith in itself. Not surprisingly, few fiduciaries, if any, have heeded *Moench*'s requirement that they eliminate or limit the stock held by their plans. Such an announcement could easily force the company into bankruptcy and wipe out the participants' accounts. One court has cogently acknowledged the point: "It is possible that had the Committee Defendants followed the suggested conduct they would simply have accelerated the demise of the Household stock held by the fund. Their duty as fiduciaries was to prevent such losses." *Cokenour v. Household Intern., Inc.*, 2004 WL 725973, *5 (N.D.Ill. Mar 31, 2004). To require diversification would, in effect, shift to fiduciaries the risk of loss that Congress has otherwise placed on employees.

Accordingly, the federal courts simply must take into account the second-guessing to which plan defendants are subjected in failure-to-diversify cases. ERISA litigation can unnecessarily burden fiduciaries with substantial defense costs and require them to make bet-the-company decisions whether to try or settle a case. When cases are settled or judgments are paid, those expenses are ultimately borne by the plan sponsor through greater plan expenses, including higher insurance premiums. It is intuitively obvious that as plan expenses increase, employers will curtail the benefits they offer their employees. Plaintiffs espousing diversification should be expected to carry a heavy burden before the risks of stock ownership may be shifted to a plan's fiduciaries and, in turn, the plan sponsor and its insurers. If the current wave of ERISA litigation continues unchecked, Congress will have to intervene to clarify the gray areas that *Moench* and its progeny have created, to establish more demanding pleading standards for fiduciary liability litigation involving employer securities, and to improve the safe harbors for fiduciaries that run ESOPs and other EIAPs. The status quo is otherwise unacceptable.

Copyright © 2005 Washington Legal Foundation

ISBN 1056 3059