Learning the True Meaning of Fiduciary, the Hard Way

Sub: As 401(k) values plummet, pensioners look to employers and question their performances

By Evan Miller and Alison Cera
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Although securities and accounting issues have dominated recent headlines, many companies that have suffered stunning declines in their stock value also face significant class action pension litigation under the Employee Retirement Income Security Act of 1974, as amended (ERISA).

Just look at companies as diverse as Enron, Global Crossing, WorldCom, Williams Cos., Lucent Technologies, Providian Financial, Qwest, Rite Aid and Ikon Office Solutions. Each sponsored a 401(k) plan that allowed investment in company stock. The share price of each plummeted, and, as a result, their 401(k) plans and employee participants lost hundreds of millions of dollars. Now these companies, and many of their executives, are being sued by their 401(k) participants under ERISA for breach of fiduciary duty.

The sheer size of the losses, particularly given that they appear largely borne by rank-and-file employees, offers an equitable foundation for finding liability. But like many cases involving heart-wrenching facts, resolution of the legal issues will not be easy. The suits raise the formidable issue of whether employers and executives, given their special knowledge or access to special knowledge of company affairs, have duties of care and disclosure to 401(k) participants that a third-party investment manager would not have.

These cases will force courts to resolve how ERISA should regulate the relationship between an employer's legitimate business interest in promoting its stock and its ERISA fiduciary responsibility to act fairly toward pension-plan participants. This article identifies some of the claims raised by this recent spate of cases, discusses several possible defenses and notes some of the difficulties courts will face in resolving them. The 401(k)s in these cases are participant-directed. Employers do not make the actual investment decision, but instead make available to participating employees a set of possible investment options through which participants invest both salary deferrals and, in some cases, employer contributions. One of those options is an account that invests in employer stock. The employer's investment management role is somewhat passive: It merely selects the investment alternatives. The actual investing is turned over to the employee-participant.

IMPRUDENCE AND DISCLOSURE

Claims in these suits fall largely into two categories: "imprudent investor" claims and "disclosure" claims. In the imprudent investor claims, participants argue that the company's or executives' knowledge of its business required them to take an activist role in connection with the plan's employer stock account.

Claims in this category allege that because the defendants knew, or should have known, of the company's dim financial prospects (or in situations like Enron, Global Crossing and Rite Aid, the company's improper accounting practices), they breached their duty to exercise prudence in one or more ways. These include:

· Making company matching contributions in company stock.
· Failing to investigate and monitor the continued suitability of company stock as an investment option, thus allowing participants to continue to purchase company stock.
· Failing to take steps to override participant investments and liquidate employer stock holdings, in order to reduce participants' exposure to the prospect of share-price loss.
· Imposing and maintaining age, service or other restrictions on the ability of plan participants to liquidate company stock.

The disclosure category focuses on the disparity between the company's and its executives' knowledge of inside financial information and lack of such knowledge by participants. Plaintiffs argue that the employer and executives had a duty to communicate their knowledge to participants, so that participants could make informed investment decisions.

They claim that defendants, because they knew or should have known of the company's true precarious financial condition, breached their disclosure duty by:

· Making material misrepresentations regarding the company's true financial condition.
· Failing to disclose to participants the true financial condition of the company and, in some instances, the material fact that the company stock price was artificially inflated through improper accounting.

In deciding the imprudent-investor claims, courts may choose to apply a hypothetical prudent fiduciary standard. Under this standard, courts determine whether a hypothetical prudent fiduciary, acting under similar circumstances to those of the defendants, would have made a different decision than the defendants did regarding the 401(k)'s investment in, or holding of, company stock. If a court concludes that the hypothetical prudent fiduciary would have taken the same actions, then the defendants are held not to have breached their fiduciary duties. See, e.g., *Kuper v. Iovenko*, 66 F.3d 1447 (6th Cir. 1995).

In applying the standard, courts tend to attribute a defendant's actual knowledge to the hypothetical prudent fiduciary. When the defendant fiduciary has committed corporate fraud -- in a nonfiduciary capacity -- and undertaken conduct that would seriously impair the value of the company, courts, not surprisingly, have held that a hypothetical prudent fiduciary, armed with knowledge, would have acted affirmatively to protect plan participants.

Thus, in *Canale v. Yegen*, 782 F. Supp. 963 (D.N.J. 1992), the defendants were officers serving as plan trustees and were alleged, among other things, to have falsified financial statements to conceal the deteriorating condition of the company. *Canale* held "that where plan fiduciaries can be charged with knowledge of fraudulent actions undertaken by an entity in which the plan has invested; and a reasonably prudent person acting in a like capacity would conclude that those fraudulent acts threaten to impair and diminish the value of the plan's investment," a hypothetical prudent fiduciary would have taken affirmative steps to "protect [the] plan's assets from the loss." If the actual fiduciary did not take such protective action, then he will be held liable under ERISA. Id. at 969.

In contrast, in *Landgraff v. Columbia/HCA Healthcare Corp*., 2000 WL 33726564 (M.D. Tenn. 2000), the defendants were company executives serving as members of the retirement committee who, despite their general knowledge of a government investigation into the company's alleged illegal billing and coding practices, continued to allow plan investment in company stock. Id. at *1, *12.

However, the defendants had no direct actual knowledge of the practices under investigation. Accordingly, *Landgraff* found that a hypothetical prudent fiduciary would have based the decision whether to continue to offer company stock as an investment on objective facts known generally in the marketplace.

Landgraff concluded that because the company's stock price fluctuated and company fundamentals were sound, a reasonable fiduciary would have determined that investment in company stock was not imprudent and defendants did not commit a breach. Id. at *19.

COMMITTEE AS FIDUCIARY

In some cases, the named fiduciary of the pension plan is a committee comprised of midlevel executives, individuals who have no actual knowledge of corporate wrongdoing engaged in by superiors that caused the stock price's decline. Cases like *Landgraff* suggest that, in the absence of proof of such knowledge, the fiduciary has no duty to undertake conduct other than what an independent third-party investment manager would do.

Yet the complaints suggest that there was some heightened duty of conduct that should have been undertaken. They suggest that generalized knowledge of wrongdoing or the greater personal access of fiduciaries to those with detailed knowledge of the company's prospects makes it incumbent upon inside fiduciaries to engage in greater investigation of their company's prospects.

WHAT TRIGGERS A HIGHER DUTY?

But such a rule may not make sense in the context of corporations, where water-cooler rumors abound. In addition, securities law already provides the pension plan, as an investor, with legal recourse when nonfiduciary corporate officers engage in fraud or other accounting misconduct.

As for the disclosure claims alleging that defendants made material misrepresentations regarding the company's true financial condition, ERISA, of course, prohibits fiduciaries from lying or making material misrepresentations. See *Varity Corp. v. Howe*, 116 S. Ct.

1065 (1996). But when should a corporate communication to shareholders or employees be deemed made by an ERISA fiduciary? Are CEO statements at a shareholders' meeting ERISA fiduciary conduct? Should it make a difference if the CEO is a member of the pension committee that is named fiduciary of its 401(k) plan? Should it make a difference if the statements are made to employees who invest in a 401(k) employer-stock fund? Existing fiduciary case law does not offer much guidance.

Moreover, when should fiduciary communications be considered materially misleading? Should fiduciaries have an affirmative obligation to disclose their knowledge to participants when it is beyond what is required to be disclosed to the general public?

The U.S. Supreme Court has expressly declined to address the issue of whether ERISA imposes an affirmative duty of disclosure. *Varit*y, 116 S. Ct. at 1075. Lower courts have split on the issue. Compare, *Pocchia v. Nynex Corp.,* 81 F.3d 275, 278 (2d Cir. 1996), with *Glaziers & Glassworkers Union Local No. 252 Annuity Fund v. Newbridge Securities Inc*., 93 F.3d 1171 (3d Cir. 1996).

At least one court hinted it might be inclined to find that a fiduciary who has knowledge of financial fraud has an affirmative duty to disclose such information to participants. See *In re Ikon Office Solutions Inc*. Sec. Lit., 191 F.R.D. 457, 464 n.7. It is worth noting, however, that settlement has been announced in the Ikon Office Solution case.

SWORN TO SECRECY?

Even if courts were inclined to find that a fiduciary who has knowledge of a company's financial difficulties or fraud has a duty to disclose it to participants, such duty may potentially conflict with restrictions under federal securities law.

Rule 10b-5 of the Securities Exchange Act of 1934 prohibits a corporate insider who possesses material, nonpublic information from disclosing or "tipping" such information to any other party so that the other party may either trade in the corporation's securities or "tip" yet another party. The SEC's Regulation FD similarly prohibits, absent an available exemption, selective disclosure of material, nonpublic information. In turn, ERISA § 514(d) provides that ERISA should not be construed in a manner that would abridge or impair the enforcement of other federal laws.

As such, defendants who are both ERISA fiduciaries and corporate insiders may raise as an affirmative defense to disclosure claims the argument that Rule 10b-5 (and possibly Regulation FD) prohibited them from disclosing the company's true financial condition or fraud to participants. Whether courts will accept such a defense is unclear.

CROOKED OR CLEAN?

Courts may draw a distinction between a "crooked" insider fiduciary and a "clean" insider fiduciary. In the case of a nefarious insider fiduciary who had knowledge of the false financials because he participated in fraud, the defense would allow the defendant to use Rule 10b-5 to perpetuate the original securities law violation. Therefore, courts may be inclined to reject the defense. In the case of the clean insider fiduciary, it is even more difficult to predict how courts will resolve the apparent conflict between ERISA fiduciary disclosure obligations and securities law insider trading and selective disclosure prohibitions.

The defendants also will likely present as a defense the argument that they are protected from liability by ERISA § 404(c), which provides that in participant-directed 401(k) plans, if a participant exercises control over his account, then "no person who is otherwise a plan fiduciary shall be liable" under ERISA for any loss which results from such exercise of control.

Under the Department of Labor's § 404(c) regulations, this safe harbor does not apply to a fiduciary's decision to offer employer securities as an investment and therefore, § 404(c) is not a defense to claims regarding selection and maintenance of an employer stock fund. Moreover, a fiduciary is relieved of liability only if the participant exercised independent control over the investment with sufficient information to make informed investment decisions. Thus, the success of a § 404(c) defense to the disclosure claims likely hinges on whether the plaintiffs can prove that the defendants' statements were materially misleading.

DAMNED IF YOU DO...OR DON'T?

Perhaps the best indication of the dilemma facing a company and its officer in deciding whether to liquidate employer securities or limit participant investment in employer stock may be found in *Tatum v. R.J. Reynolds Tobacco Co.*, No. 1:02 CV 00373 (M.D.N.C. filed May 13, 2002). In Tatum, the plaintiffs alleged that plan fiduciaries breached their duties by not continuing to offer company stock as an investment option. The parent company of R.J. Reynolds and Nabisco spun off the tobacco companies. The plaintiffs alleged that the fiduciaries to the R.J. Reynolds 401(k) plan acted imprudently by forcing sale of the plan's Nabisco stock when prices were at an all-time low and analysts were advising investors to buy or hold Nabisco stock.

When viewed in comparison to cases involving 401(k) plans that have suffered significant employer stock losses, Tatum illustrates just how unpredictable the current legal environment is for fiduciaries of 401(k)s with employer stock funds. It is predictable, though, that these cases will create new ERISA law that will impact a significant number of Americans.

Evan Miller, who represents certain former in-house trustees of the Rite Aid 401(k) plan, is a partner at Washington, D.C.'s Hogan & Hartson. Alison Cera is an associate at the firm.