CHAPTER FORTY

Fiduciary Duties Regarding 401(k) and ESOP Investments in Employer Stock

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I. Overview

There has been substantial Employee Retirement Income Security Act (ERISA) fiduciary litigation challenging eligible individual account plan (EIAP) investments in employer stock. One strand, which has continued apace, is litigation challenging fiduciary duties related to employee stock ownership plans (ESOPs) of closely held companies. This type of litigation has been around since ESOPs were first formed in the late 1970s. This traditional ESOP claim arises in the context of a closely held company typically wholly or majority-owned by the ESOP. The participants in these ESOPs generally do *not* have the ability to direct their investments; rather, they acquire ownership in the company through the tax-advantaged ESOP as part of their compensation package. Claims unique to these cases are discussed in this chapter (see Section VII, below). These cases consider valuation of stock issues and the extent of the ESOP's control of the company, as well as where ESOP fiduciary duties begin and management of the company ends.

What has changed in the employer stock arena is the growth in litigation challenging 401(k) or like plan investments in a public company's stock. Stock market downturns have led to numerous cases claiming that ERISA fiduciaries breached their fiduciary duties related to an eligible individual account plan's (typically a 401(k) plan) investments in employer stock. In these 401(k) plans, the employer stock fund is one of several investment options offered to participants. The 401(k) plan often offers an employer match and, prior to the 2006 Pension Protection Act,[1] the plan often required this match to be invested in the employer stock fund. Because of tax changes effective in 2002,[2] many of these 401(k) plans also have designated the employer stock fund as an ESOP.[3]

Investment in employer stock, whether through ESOPs or through other eligible individual account plans such as 401(k) plans, puts into play the fundamental tension between Congress's strong encouragement of employee ownership through the Internal Revenue Code (Code) and ERISA and the fact that Congress placed these tax-favored investments in ERISA plans. These plans subject fiduciaries to what have been called the "highest duties known to law."[4] When an employer goes bankrupt or suffers serious setbacks, the employees often loses not only their job, but also a substantial part of their retirement savings. Such losses often lead to lawsuits, which generally[5] involve two types

[1]Pub. L. No. 109-280, 120 Stat. 780 (Aug. 17, 2006).

[2]*See* Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Pub. L. No. 107-16, §662(a), 115 Stat. 38 (June 7, 2001), *amending* I.R.C. §404(k)(2)(a) (for tax years beginning after Dec. 31, 2001, allowing employers to deduct dividends paid on ESOP shares when those dividends are, at election of participants, paid to ESOP and then reinvested in employer stock).

[3]Department of Labor (DOL) and Internal Revenue Service (IRS) regulations specifically permit this: "An ESOP may form a portion of a plan the balance of which includes a qualified pension, profit-sharing, or stock bonus plan which is not an ESOP. A reference to an ESOP includes an ESOP that forms a portion of another plan." 29 C.F.R. §2550.407d-6(a)(4); Treas. Reg. §54.4975-11(a)(5); *see also In re* Duke Energy ERISA Litig., 281 F. Supp. 2d 786, 792–93, 30 EB Cases (BNA) 2781 (W.D.N.C. 2003) (rejecting argument that ESOP stock fund in 401(k) plan is not entitled to ESOP presumption); *In re* Schering-Plough Corp. ERISA Litig., 2004 U.S. Dist. LEXIS 16265, at *11–14, 33 EB Cases (BNA) 1023 (D.N.J. June 28, 2004), *rev'd & remanded on other grounds*, 420 F.3d 231, 35 EB Cases (BNA) 1801 (3d Cir. 2005) (noting that employer stock fund in savings plan is an ESOP).

[4]*E.g.*, Donovan v. Bierwirth, 754 F.2d 1049, 6 EB Cases (BNA) 1033 (2d Cir. 1985).

[5]Plaintiffs also sometimes allege a free-floating "duty of loyalty" claim. Instead of tying an alleged breach of loyalty to particular conduct, the plaintiffs allege a separate claim that a breach of the duty of loyalty exists because plan fiduciaries allegedly had interests (e.g., incentive compensation schemes or insider sales of stock) adverse to the plan. Because ERISA specifically allows plan fiduciaries to have interests adverse to the plan (e.g., ERISA §408(c)(3) (Pegram v. Herdrich, 530 U.S. 211, 225–26, 24 EB Cases (BNA) 1641 (2000)), some courts have dismissed this claim on the pleadings. *See In re* Lehman Bros. Secs. & ERISA Litig., 683 F. Supp. 2d 294, 303, 48 EB Cases (BNA) 1838 (S.D.N.Y. 2010) (no allegations that fiduciary had any knowledge that should have been disclosed); *In re* Constellation Energy Grp., Inc., 2010 WL 3221821, at *8, 49 EB Cases (BNA) 2139 (D. Md. Aug. 13, 2010); Harris v. Amgen, Inc., 2010 WL 744123, at *8, 48 EB Cases (BNA) 2153 (C.D. Cal. Mar. 2, 2010) (merely alleging directors' compensation tied to stock performance is insufficient); Herrera v. Wyeth, 2010 WL 1028163, at *7 (S.D.N.Y. Mar. 17, 2010) (allegations of directors selling their stock insufficient to survive

of claims regarding investments:

1. *The prudent investment claim*: The fiduciaries knew or should have known that the employer stock was not a prudent investment option for the plan.
2. *The disclosure claim*: The fiduciaries made misrepresentations on or failed to disclose material adverse information affecting the value of the employer stock.[6]

For ESOP investments in closely held companies, the valuation of the employer's stock can be an issue,[7] and plaintiffs often claim that corporate mismanagement and corporate transactions implicate various fiduciary duties under ERISA. Plaintiffs also often claim co-fiduciary breaches under ERISA Section 405(a).[8] Some assert the derivative[9] claim that those (often the company's directors or senior

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motion to dismiss); *In re* Bank of Am. Secs., Derivative & ERISA Litig., 2010 WL 3448197, at *21–22 (S.D.N.Y. Aug. 27, 2010) (same); Johnson v. Radian, 2010 WL 2136562, at *14, 47 EB Cases (BNA) 2066 (E.D. Pa. May 26, 2010) (same); Crocker v. KV Pharm. Co., 782 F. Supp. 2d 760, 785 (E.D. Mo. 2010) (same); *In re* Harley Davidson, Inc., Sec. Litig., 660 F. Supp. 2d 953, 968–69, 47 EB Cases (BNA) 2618 (E.D. Wis. 2009); Morrison v. MoneyGram Int'l, Inc., 607 F. Supp. 2d 1003, 1058, 46 EB Cases (BNA) 1673 (D. Minn. 2009); Benitez v. Humana, Inc., 2009 WL 3166651, at *11–12, 47 EB Cases (BNA) 2441 (W.D. Ky. Sept. 30, 2009); *In re* Citigroup ERISA Litig., 2009 WL 2762708, at *26–27, 47 EB Cases (BNA) 2025 (S.D.N.Y. Aug. 31, 2009); Johnson v. Radian Grp., Inc., 2009 WL 2137241, at *21–22 (E.D. Pa. July 16, 2009); *In re* Avon Prods., Inc. ERISA Litig., 2009 WL 848083, at *17 (S.D.N.Y. Mar. 3, 2009), *report and recommendation adopted by* 2009 WL 884687, at *17 (S.D.N.Y. Mar. 30, 2009); Halaris v. Viacom, Inc., 2008 WL 3855044 (N.D. Tex. Aug. 19, 2008); Edgar v. Avaya, Inc., 2006 WL 1084087, at *10–11 (D.N.J. Apr. 25, 2006) (merely alleging dual loyalties for directors who act as fiduciaries is insufficient), *aff'd*, 503 F.3d 340, 41 EB Cases (BNA) 2249 (3d Cir. 2007). Other courts have allowed this claim to go forward at the pleading stage. *See, e.g.*, Dann v. Lincoln Nat'l Corp., 708 F. Supp. 2d 481, 48 EB Cases (BNA) 2761 (E.D. Pa. 2010); Patten v. Northern Trust Co., 703 F. Supp. 2d 799, 814–15, 48 EB Cases (BNA) 2345 (N.D. Ill. 2010); Banks v. Healthways, Inc., 2009 WL 211137, at *4–5 (M.D. Tenn. Jan. 28, 2009); Urban v. Comcast Corp., 2008 WL 4739519, at *15 (E.D. Pa. Oct. 28, 2008); *In re* Guidant Corp. ERISA Litig., 2008 WL 2498127, at *6 (S.D. Ind. June 19, 2008); *In re* Diebold ERISA Litig., 2008 WL 2225712, at *11 (N.D. Ohio May 28, 2008).

[6]For a discussion of claims related to ERISA fiduciary disclosure duties, including a discussion of the Supreme Court's decision in *Varity Corp. v. Howe*, 516 U.S. 489, 19 EB Cases (BNA) 2761 (1996), see Chapter 39, Fiduciary Duty as a Basis for Recovery for Misrepresentation and Nondisclosure.

[7]Some plaintiffs have claimed that because the publicly traded employer stock was inflated through fraud, the plan paid more than "adequate consideration" for that stock. For publicly traded stock, however, because ERISA §3(18) defines "adequate consideration" as "the price of the security prevailing on a national securities exchange") such claims were rejected in Pietrangelo v. NUI Corp., 2005 WL 1703200, at *13 (D.N.J. July 20, 2005 and; *In re* CMS Energy ERISA Litig., 312 F. Supp. 2d 898, 917, 32 EB Cases (BNA) 2613 (E.D. Mich. 2004).

[8]Under ERISA §405(a)(1) and (a)(3), the plaintiffs must prove that the fiduciary had actual knowledge of the breach and either knowingly (1) participated in, (2) undertook to conceal, or (3) failed to take reasonable efforts to remedy the breach. Under ERISA §405(a)(2), the plaintiffs must show that the fiduciary's own breach enabled another to commit a breach. *See, e.g.*, *In re* Sprint Corp. ERISA Litig., 2004 U.S. Dist. LEXIS 19125, at *23, 33 EB Cases (BNA) 2196 (D. Kan. Sept. 24, 2004); *cf. In re* Syncor ERISA Litig., 351 F. Supp. 2d 970, 988 (C.D. Cal. 2004) (dismissing co-fiduciary claims absent allegations of actual knowledge); *In re* AOL Time Warner, Inc., 2005 WL 563166, at *6 (S.D.N.Y. Mar. 10, 2005) (same).

[9]Plaintiffs also bring derivative-type claims against *nonfiduciaries* for "knowing participation" in a fiduciary's breach. Although such a claim is limited to "appropriate equitable relief" under §502(a)(3) and it still requires proof of the primary violation, from the plaintiffs' perspective it allows access to additional defendants and thus to potential additional sources of funds for a settlement or judgment. After *Harris Trust v. Salomon Smith Barney, Inc.*, 530 U.S. 238, 24 EB Cases (BNA) 1654 (2000), it is clear that a "knowing participation" claim can be based on knowing participation in a prohibited transaction, a §406 violation. The law is still developing, however, on whether a nonfiduciary can be liable for knowing participation in a fiduciary breach under §404. *See* Mertens v. Hewitt Assocs., 508 U.S. 248, 253–54, 16 EB Cases (BNA) 2169 (1993) (strongly suggesting no such claim); Reich v. Stangl, 73 F.3d 1027, 1031–32, 19 EB Cases (BNA) 2473 (10th Cir. 1996) (distinguishing between allowing knowing participation claims based on ERISA §406 and prohibiting those based on ERISA §404); *In re* Wachovia Corp. ERISA Litig., 2010 WL 3081359, at *17 (W.D.N.C. Aug. 6, 2010) (dismissing claim at pleading stage as alleged against employer); *In re* Constellation Energy Grp., Inc., 2010 WL 3221821, at *8 (D. Md. Aug. 13, 2010) (same); *In re* Pfizer, Inc. ERISA Litig., 2009 WL 749545, at *15–16 (S.D.N.Y. Mar. 20, 2009) (dismissing claim at pleading stage because the relief sought from an alleged nonfiduciary was not permissible under ERISA §502(a)(3)); *In re* Bausch & Lomb, Inc. ERISA Litig., 2008 WL 5234281, at *12 (W.D.N.Y. Dec. 12, 2008) (dismissing claim in an employer stock drop case against the plan sponsor). *But see* Noa v. Keyser, 519 F. Supp. 2d 481, 42 EB Cases (BNA) 1013 (D.N.J. 2007) (recognizing knowing participation in breach of fiduciary duty claim under ERISA §404, but dismissing claim because there was no fiduciary breach); *In re* Enron Corp. Secs., Derivative & ERISA Litig. (Tittle v. Enron Corp.), 284 F. Supp. 2d

officers) who appointed the fiduciaries failed in their responsibility to monitor and prevent the appointees' alleged breach of duty regarding plan investments or disclosures.

Plaintiffs have also brought derivative-type claims against *nonfiduciaries* for "knowing participation" in a fiduciary's breach and seek "appropriate equitable relief" under ERISA §502(a)(3). After the Supreme Court holding in *Harris Trust v. Salomon Smith Barney, Inc.*,[10] , it is clear that a "knowing participation" claim can be based on knowing participation in a prohibited ERISA Section 406 transaction. The law is still developing, however, on whether a nonfiduciary can be liable for knowing participation in a fiduciary breach under ERISA §404. In *Noa v. Keyser*,[11] the district court recognized that a knowing participation by a non-fiduciary in a fiduciary's violation of Section 404 would be actionable under *Harris*, but the court dismissed the claim because there was no fiduciary breach. In *In re Enron Corp. Secs., Derivative & ERISA Litig. (Tittle v. Enron Corp.)*,[12] the district court accepted the viability of "knowing participation" claims based on a fiduciary breach in an employer stock case. Another district court held that attorneys who knowingly participated in a breach of duty could be liable to return legal fees received in that improper transaction.[13] However, in *In re Pfizer, Inc. ERISA Litigation*,[14] the district court dismissed the claim because the relief sought from a nonfiduciary was akin to money damages – not the equitable damages that are available under Section 502(a)(3).

II. Statutory Language

ERISA Section 404
Fiduciary Duties

(a) (1) Subject to §§403(c) and (d), 4042, and 4044, a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and—

(A) for the exclusive purpose of:

(i) providing benefits to participants and their beneficiaries; and

(ii) defraying reasonable expenses of administering the plan;

(B) with 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;

(C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and

(D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this title and Title IV.

(2) In the case of an eligible individual account plan (as defined in §407(d)(3)), the diversification requirement of paragraph (1)(C) and the prudence requirement (only to the extent that it requires diversification) of paragraph (1)(B) is not violated by acquisition or holding of qualifying employer real property or qualifying employer securities (as defined in §407(d)(4)

511, 571–72, 31 EB Cases (BNA) 2281 (S.D. Tex. 2003) (suggesting viability of "knowing participation" claims based on a fiduciary breach in an employer stock case); L.I. Head Start Child Dev. Servs. v. Frank, 165 F. Supp. 2d 367, 26 EB Cases (BNA) 2419 (E.D.N.Y. 2001) (following Diduck v. Kaszycki & Sons Contractors, 974 F.2d 270, 279–81, 15 EB Cases (BNA) 2585 (2d Cir. 1992), and finding that attorneys alleged to have knowingly participated in a breach of duty could be liable to return legal fees received in that improper transaction).

[10] 530 U.S. 238, 24 EB Cases (BNA) 1654 (2000).

[11] 519 F. Supp. 2d 481, 42 EB Cases (BNA) 1013 (D.N.J. 2007).

[12] 284 F. Supp. 2d 511, 571–72, 31 EB Cases (BNA) 2281 (S.D. Tex. 2003)

[13] L.I. Head Start Child Dev. Servs. v. Frank, 165 F. Supp. 2d 367, 26 EB Cases (BNA) 2419 (E.D.N.Y. 2001) (following Diduck v. Kaszycki & Sons Contractors, 974 F.2d 270, 279–81, 15 EB Cases (BNA) 2585 (2d Cir. 1992).

[14] 2009 WL 749545, at *15–16 (S.D.N.Y. Mar. 20, 2009).

and (5)).

(b) Except as authorized by the Secretary by regulation, no fiduciary may maintain the indicia of ownership of any assets of a plan outside the jurisdiction of the district courts of the United States.

(c) (1) In the case of a pension plan which provides for individual accounts and permits a participant or beneficiary to exercise control over assets in his account, if a participant or beneficiary exercises control over the assets in his account (as determined under regulations of the Secretary)

(A) such participant or beneficiary shall not be deemed to be a fiduciary by reason of such exercise, and

(B) 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.

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ERISA Section 406
Prohibited Transactions

(a) Except as provided in §408:

(1) A fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he knows or should know that such transaction constitutes a direct or indirect—

(A) sale or exchange, or leasing, of any property between the plan and a party in interest;

(B) lending of money or other extension of credit between the plan and a party in interest;

(C) furnishing of goods, services, or facilities between the plan and a party in interest;

(D) transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan; or

(E) acquisition, on behalf of the plan, of any employer security or employer real property in violation of §407(a).

(2) No fiduciary who has authority or discretion to control or manage the assets of a plan shall permit the plan to hold any employer security or employer real property if he knows or should know that holding such security or real property violates §407(a).

(b) A fiduciary with respect to a plan shall not—

(1) deal with the assets of the plan in his own interest or for his own account,

(2) in his individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries, or

(3) receive any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan.

(c) A transfer of real or personal property by a party in interest to a plan shall be treated as a sale or exchange if the property is subject to a mortgage or similar lien which the plan assumes or if it is subject to a mortgage or similar lien which a party-in-interest placed on the property within the 10-year period ending on the date of the transfer.

ERISA Section 407
Limitations With Respect to Acquisition and Holding Employer Securities and Employer Real Property by Certain Plans

(a) Except as otherwise provided in this section and §414:

(1) A plan may not acquire or hold—

(A) any employer security which is not a qualifying employer security, or

(B) any employer real property which is not qualifying employer real property.

(2) A plan may not acquire any qualifying employer security or qualifying employer real property, if immediately after such acquisition the aggregate fair market value of employer securities and employer real property held by the plan exceeds 10 percent of the fair market value of the assets of the plan.

…

(b) (1) Subsection (a) of this section shall not apply to any acquisition or holding of qualifying employer securities or qualifying employer real property by an eligible individual account plan.

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III. Procedural and Remedy Issues

Litigation over 401(k) investments in publicly traded employer stock has raised many procedural issues. At the initial pleading stage, the Supreme Court's decisions in *Bell Atlantic Corp. v. Twombly*[15] and *Ashcroft v. Iqbal*[16] now require plaintiffs to plead a "plausible" claim to survive a motion to dismiss.

Plaintiffs face additional procedural hurdles when bringing an employer stock claim. For example, in *Hastings v. Wilson*,[17] the plaintiffs brought a putative class action due to the stock losses precipitated by Northwest Airlines' voluntary filing for Chapter 11 bankruptcy in September 2005. The stock benefits at issue arose out of collective bargaining under the Railway Labor Act and were subject to a collective bargaining agreement. On appeal, the Eighth Circuit held that the ERISA fiduciary claim was barred because the matter was subject to the exclusive, mandatory jurisdiction of labor arbitrators under the Railway Labor Act and that the plaintiffs lacked standing to sue certain fiduciaries because the named plaintiffs were not participants in the plan for which the defendants were fiduciaries.[18]

In *Brown v. Medtronic*,[19] the named plaintiff brought a putative class action claiming that Medtronic's stock was an imprudent plan investment for the 401(k) plan because it was artificially inflated.[20] On an issue on which the courts are in conflict, the Eighth Circuit held the plaintiff failed to show he had constitutional standing under Article III, reasoning that because he sold his shares during the period in which he alleged the stock was artificially inflated, he suffered no requisite "injury in fact" from the claimed fiduciary breach.[21]

In *Brown v. Owens Corning Investment Review Committee*,[22] the Sixth Circuit affirmed summary judgment for the defendants, holding that the participants' claims were untimely. The named plaintiffs brought a class action following a bankruptcy filing by Owens Corning.[23] The Sixth Circuit held, based on the plaintiffs' claim, that the plaintiffs' knowledge of Owens Corning's bankruptcy triggered ERISA's three-year statute of limitations for actual knowledge of a fiduciary breach.[24] In refuting the plaintiffs' claim that they did not know that fiduciaries managed the plan (and thus did not have "actual

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[15]550 U.S. 544 (2007).
[16]129 S. Ct. 1937 (2009).
[17]516 F.3d 1055, 1057–58, 43 EB Cases (BNA) 1001 (8th Cir. 2008).
[18]*Hastings*, 516 F.3d at 1059–60.
[19]628 F.3d 451, 50 EB Cases (BNA) 1490 (8th Cir. 2010).
[20]*Brown*, 628 F.3d at 453.
[21]*Id*. at 445–56; *see also* Taylor v. KeyCorp., 2010 WL 3702423, at *4–5, 49 EB Cases (BNA) 2135 (N.D. Ohio Aug. 12, 2010). *But see* Moore v. Comcast Corp., 268 F.R.D. 530 (E.D. Pa. 2010) (named plaintiff still could have suffered injury in fact despite sale of stock options during alleged period of artificial inflation); Patten v. Northern Trust Co., 703 F. Supp. 2d 799, 806–08 (N.D. Ill. 2010) (same).
[22]622 F.3d 564, 49 EB Cases (BNA) 2505 (6th Cir. 2010).
[23]*Brown v. Owens Corning*, 622 F.3d at 567–68.
[24]*Id*. at 570–72.

knowledge" of the facts needed to bring a claim), the Sixth Circuit held that the plaintiffs could not avoid actual knowledge of the contents of the summary plan descriptions (SPDs) when they had been provided access to those SPDs.[25]

Other procedural issues can be distilled down to two categories. One set involves how the ERISA case interrelates with any parallel securities fraud lawsuit. Because many of these cases arise out of facts involving alleged securities fraud, another issue is whether Rule 9(b) of the Federal Rules of Civil Procedure and its plead-fraud-with-particularity standards apply to the claims of fiduciary breach under ERISA. Finally, because the remedies available for claims for individual relief under ERISA Section 502(a)(3) are limited to traditional forms of equitable relief (which typically does not include investment losses),[26] plaintiffs bring the case as a derivative class action brought on behalf of the plan under ERISA Section 502(a)(2).

A. Relationship Between the ERISA Case and the Securities Fraud Case

The initial issues that arise relate to consolidation of the cases and coordination of discovery. The securities and ERISA cases (and any federally filed derivative cases) are typically combined and brought before one judge for coordinated or consolidated proceedings (referred to as multi-district litigation or MDL) because they arise out of a common nucleus of operative fact.[27] The MDL judicial panel typically provides that the transferee judge maintains discretion to establish separate tracks for the ERISA cases.[28] The Private Securities Litigation Reform Act (PSLRA) provides, however, that there "shall be" a stay of discovery in the securities case pending ruling on a motion to dismiss.[29] The transferee judge thus typically grants "ERISA unique" discovery while staying the rest of discovery pending resolution of the securities motion to dismiss.[30] Depending on the particular facts of the case, the court may lift the PSLRA stay as to documents produced to government agencies.[31]

How these coordinated cases are managed and tried is worked out on a case-by-case basis. Often the numerous distinctions between the securities fraud and ERISA cases (e.g., bench versus jury trial, fiduciary duties versus scienter issues) lead to separate but coordinated case tracks.[32] Cases include the following situations:

[25] *Id*. at 571.

[26] ERISA §502(a)(3) allows claims for individual relief for fiduciary breaches, (see *Varity Corp*. *v*. *Howe*, 516 U.S. 489, 507–15, 19 EB Cases (BNA) 2761 (1996)) but only appropriate equitable relief is available. *But see* CIGNA Corp. v. Amara, 131 S. Ct. 1866, 50 EB Cases (BNA) 2569 (2011) (appropriate equitable relief authorizes district court to reform the terms of a pension plan and enforce the reformed plan as remedy); Great-West Life & Annuity Ins. Co. v. Knudson, 534 U.S. 204, 211–15, 27 EB Cases (BNA) 1065 (2002); Mertens v. Hewitt Assocs., 508 U.S. 248, 256, 16 EB Cases (BNA) 2169 (1993). Because of the limitation on equitable relief, §502(a)(3) has not been construed to provide a remedy for claimed investment losses. *E.g*., Coan v. Kaufman, 457 F.3d 250, 263–64, 38 EB Cases (BNA) 1609 (2d Cir. 2006) (invested 401(k) funds were invested in funds that earned less than benchmark funds); Rego v. Westvaco Corp., 319 F.3d 140, 144–45, 29 EB Cases (BNA) 2680 (4th Cir. 2003); Helfrich v. PNC Bank, Ky., Inc., 267 F.3d 477, 482–83, 26 EB Cases (BNA) 2281 (6th Cir. 2001); Kerr v. Charles F. Vatterott & Co., 184 F.3d 938, 945, 23 EB Cases (BNA) 1328 (8th Cir. 1999); Alderfer v. Clemens Mkts., Inc., 2010 WL 5258070, 50 EB Cases (BNA) 1706 (E.D. Pa. Dec. 23, 2010).

[27] *E.g*., *In re* WorldCom, Inc., Secs. & "ERISA" Litig., 226 F. Supp. 2d 1352, 1353–55 (J.P.M.L. Oct. 8, 2002).

[28] *E.g*., *id*. at 1354–55.

[29] 15 U.S.C. §78u-4(b)(3)(B).

[30] *See, e.g*., *In re* AOL Time Warner, Inc. Secs. & "ERISA" Litig., 2003 U.S. Dist. LEXIS 16895, 31 EB Cases (BNA) 3037 (S.D.N.Y. Sept. 26, 2003) (staying all non-ERISA-specific discovery so as to protect the stay under the PSLRA).

[31] *See, e.g*., *In re* WorldCom, Inc. Secs. Litig., 234 F. Supp. 2d 301, 304–06 (S.D.N.Y. 2002) (ordering discovery of documents produced to government agencies and creditors' committee and also noting documents would likely soon be in hands of ERISA plaintiffs); *cf. In re* AOL Time Warner, Inc. Secs. & "ERISA" Litig., 2003 U.S. Dist. LEXIS 12846, at *4–7 (S.D.N.Y. July 25, 2003) (rejecting same; no prejudice from stay where company is not in bankruptcy).

[32] In contrast, in the insurance context, in *Federal Insurance Co*. *v*. *Raytheon Co*., 426 F.3d 491, 36 EB Cases (BNA) 1333 (1st Cir. 2005), the First Circuit applied a "substantial overlap" test to conclude an ERISA lawsuit fell within an ERISA fiduciary policy's "prior and pending" litigation exclusion from the earlier securities litigation.

- Many plans use unitized employer stock funds,[33] in which—because of netting and aggregating—the participants' orders to buy or sell do not necessarily result in open market trades by the plan. Two courts have held or suggested that the individual participants were nonetheless "purchasers" under the securities laws and therefore were entitled to share in the settlement proceeds based on those individual "purchases."[34]
- One district court held that a final court-approved securities settlement barred ERISA plaintiffs "from seeking additional damages related to the value of the stock for the time period covered by [the securities] lawsuit,"[35] whereas another district court held that a securities settlement of claims based on "open market" purchases does not bar claims based on the employer match.[36]
- A district court approved an objector's modification to exclude ERISA claims from a proposed securities settlement, noting that plan fiduciaries may have breached fiduciary duties by not protecting the participants' interests in the securities settlement in the following ways: (i) the plan fiduciaries would have benefitted from the broadly worded securities release; (ii) the plan participants had nonfrivolous claims; and (iii) the plan fiduciaries failed to provide notice to the participants of the proposed securities settlement.[37]

The Department of Labor (DOL) has also issued guidance in this area through its promulgation of a prohibited transaction class exemption (PTCE) for the release of claims related to litigation.[38] Although the DOL admits that it is unclear whether the settlement of claims in the ERISA or securities litigation constitutes a prohibited transaction, most defendants comply with this exemption's requirements, because the point of settling claims is to end litigation, not to create new and novel issues to litigate.[39] The primary requirement imposed is that the plan must retain an independent fiduciary to review and approve the settlement of an ERISA case or a securities case if that settlement releases "parties in interest," which include the company as employer and its directors and officers.[40]

B. Federal Rules of Civil Procedure Rule 9(b)'s "Plead Fraud With Particularity" Requirements for ERISA Fiduciary Claims

Employer stock cases are often predicated on alleged underlying securities fraud. The threshold issue is whether these are "disclosure" claims or whether they are "prudent investment" claims. If the claim arises out of fiduciary duties related to prudent investments, the courts typically hold that only the "notice pleading" standard of Rule 8(a) of the Federal Rules of Civil Procedure applies.[41]

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[33] Because unitization lowers transaction costs and allows participants to invest their money on the day of the fund exchange, most employer stock funds for publicly traded companies (some surveys suggest around 90%) are unitized.

[34] Great Neck Capital Appreciation Inv. P'ship v. Pricewaterhouse Coopers (*In re* Harnischfeger Indus., Inc. Secs. Litig.), 212 F.R.D. 400, 414 (E.D. Wis. 2002); Kurzweil v. Philip Morris Cos., 2001 U.S. Dist. LEXIS 83, at *9 (S.D.N.Y. Jan. 10, 2001).

[35] *In re* Waste Mgmt., Inc. Secs. Litig., 2003 U.S. Dist. LEXIS 4281, at *6–7 (N.D. Ill. Mar. 19, 2003).

[36] Koch v. Dwyer, 1999 U.S. Dist. LEXIS 11101, at *37–38 (S.D.N.Y. July 22, 1999).

[37] *Great Neck Partnership*, 212 F.R.D. at 414.

[38] *See* 68 Fed. Reg. 75,632 (Dec. 31, 2003) (PTCE 2003-39).

[39] *See* Mark Machiz, Nell Hennessy, & Christopher Capuano, *Understanding the DOL's New Class Exemption for the Release of Claims in Connection With Litigation*, 31 PENS. & BEN. REP. (BNA) 2 (Jan. 13, 2004). What creates the potential prohibited transaction is the release of a claim by the plan against a party in interest, e.g., the company and its directors and officers. For the securities claim, the issue is whether the plan or the participants (as beneficial owners of the stock) are the ones with the securities claim; if it is only the participants who have a valid claim, there would be no prohibited transaction involved in settling with just them. *Id*. For the ERISA claim, the issue is whether the plan is actually releasing any claim, since the plan is not an enumerated party with standing to bring suits for fiduciary breaches. *Id*.

[40] 68 Fed. Reg. at 75,634–35; *see also* 72 Fed. Reg. 65,597 (Nov. 21, 2007) (proposed amendment to class exemption).

[41] *E.g.*, *In re* Beazer Homes USA, Inc., 2010 WL 1416150, at *3, 49 EB Cases (BNA) 1791 (N.D. Ga. Apr. 2, 2010); Stein v. Smith, 270 F. Supp. 2d 157, 166–67, 30 EB Cases (BNA) 2421 (D. Mass. 2003).

Depending on the facts and theories alleged, the courts may hold that the disclosure claims sound in fraud and so must meet Rule 9(b)'s "plead fraud with particularity" requirement.[42] Although the holdings are somewhat disparate, the distinction suggested in *In re Electronic Data Systems "ERISA" Litigation*[43] and *In re Xcel Energy, Inc., Securities, Derivative & "ERISA" Litigation*[44] between alleging that the fiduciary breached a duty to disclose and alleging that the fiduciary was engaged in fraudulent conduct when acting as a fiduciary (such as through intentional misrepresentations) may develop into a principled method for determining whether and when ERISA fiduciary claims are subject to Rule 9(b).

C. Class Actions on Behalf of the Plan Under Section 502(a)(2) of ERISA

To invoke the "make whole" relief of Section 409 of ERISA, plaintiffs frame their 401(k) cases as class actions brought derivatively on behalf of the plan under ERISA Section 502(a)(2), with the payment to the participants' individual accounts being the relief sought. These claims typically involve participant-directed plans in which the participant decides where to invest the money among the options provided by the plan. Notably, in *CIGNA Corp. v. Amara*,[45] the Supreme Court suggested that monetary relief may be available for individual claims under ERISA Section 502(a)(3) through the equitable remedy of "surcharge."

In *LaRue v. DeWolff, Boberg & Associates*,[46] the Supreme Court held that ERISA Section 502(a)(2) permits a participant to sue to recover for breaches of fiduciary duty that impair the value of plan assets in a participant's individual account. The plaintiff participated in his employer's 401(k) plan, which permitted him to direct his investments among a menu of investment options. The plaintiff alleged that the plan fiduciaries breached their duties by failing to carry out his investment instructions, resulting in a loss of $150,000 to his individual account.[47] In concluding that the plaintiff stated a claim under Section 502(a)(2), the Court distinguished between claims brought by participants in defined benefit plans and those brought by participants in defined contribution plans.[48] In the defined

[42]*Examples of Courts Concluding that Rule 9(b) Applies:* Harris v. Koenig, 722 F. Supp. 2d 44, 55 (D.D.C. 2010) (finding that allegations sound in fraud and concealment where plaintiffs argue same in support of application of six-year statute of limitations); Crocker v. KV Pharm. Co., 782 F. Supp. 2d 760, 783 (E.D. Mo. 2010) (holding that although word "fraud" was not used, claims were still averments sounding and fraud and 9(b) applied); *In re* General Motors ERISA Litig., 2006 WL 897444, at *13–16 (E.D. Mich. Apr. 6, 2006) (applying Rule 9(b) to disclosure and misrepresentation claims); Rogers v. Baxter Int'l, Inc., 417 F. Supp. 2d 974, 984–85 (N.D. Ill. 2006) (applying Rule 9(b) to claims alleging breach of duty of loyalty); *In re* Calpine Corp. ERISA Litig., 2005 WL 3288469 (N.D. Cal. Dec. 5, 2005) (applying to disclosure and misrepresentation claims); *In re* Westar Energy ERISA Litig., 2005 WL 2403832, at *26–28 (D. Kan. Sept. 29, 2005) (applying to claims alleging misrepresentations and material omissions).

Examples of Courts Concluding that Rule 9(b) Does Not Apply: Smith v. Aon Corp., 2006 WL 1006052, at *6 (N.D. Ill. Apr. 12, 2006) (Rule 9(b) not applicable to ERISA fiduciary claims); *In re* Cardinal Health, Inc. ERISA Litig., 424 F. Supp. 2d 1002, 1015–16 (S.D. Ohio 2006) (same); *In re* Marsh ERISA Litig., 2006 WL 3706169, at *2 (S.D.N.Y. Dec. 14, 2006) (same); *In re* Polaroid ERISA Litig., 362 F. Supp. 2d 461, 469–70 (S.D.N.Y. 2005) (concluding that despite allegations of fraud, claim was for fiduciary breach); Pietrangelo v. NUI Corp., 2005 WL 1703200, at *9 (D.N.J. July 20, 2005) (declining to apply unless breach is fraudulent act itself); Howell v. Motorola, Inc., 337 F. Supp. 2d 1079, 1089, 33 EB Cases (BNA) 2202 (N.D. Ill. 2004) (claim alleging negligent misrepresentation and failure to disclose); *In re* Xcel Energy, Inc., Secs., Derivative & "ERISA" Litig., 312 F. Supp. 2d 1165, 1179 (D. Minn. 2004) (Rule 9(b) does not apply because defendants' duty to act arose out of adverse conditions that were concealed by company's fraudulent conduct, not alleged fraud); *In re* Electronic Data Sys. Corp. "ERISA" Litig., 305 F. Supp. 2d 658, 672 (E.D. Tex. 2004) (Rule 9(b) does not apply to claims of breach of duty to inform unless plaintiffs also plead that it is part of scheme to defraud).

[43]305 F. Supp. 2d 658, 672 (E.D. Tex. 2004).

[44]312 F. Supp. 2d 1165, 1179 (D. Minn. 2004).

[45]131 S. Ct. 1866, 1879 (2011).

[46]552 U.S. 248, 42 EB Cases (BNA) 2857 (2008). The Seventh Circuit applied *LaRue* in the employer stock drop context in *Rogers v. Baxter International, Inc.*, 521 F.3d 702, 705, 43 EB Cases (BNA) 1769 (7th Cir. 2008), to hold that participants who suffered a loss with respect to their individual account holdings of employer stock may bring suit under ERISA §502(a)(2) even though not all accounts in the plan suffered a loss as a result of the breach of fiduciary duty.

[47]*LaRue*, 128 S. Ct. at 1022–23.

[48]*Id*. at 1025–26.

contribution plan context, the Court reasoned that fiduciary errors affecting plan assets do not need to threaten the entire plan's solvency to cause a participant to lose benefits, and thus an ERISA Section 502(a)(2) claim may be proper.[49] The Court made clear, however, that its ruling did not determine whether defenses such as exhaustion applied to this claim.[50]

Whether these claims may go forward as class actions raises a host of issues, particularly in light of *LaRue*'s recognition that the financial injury to the individual participants is the basis for these claims, defendants have challenged whether the claims are properly raised as class actions. In the wake of the Supreme Court's rulings in *Wal-Mart Stores, Inc. v. Dukes*[51] and *Comcast Corp. v. Behrend*,[52] a district court held that a proposed class failed to satisfy the typicality requirement.[53] Some courts have held that releases may bar claims;[54] but others have refused to recognize the validity of such releases.[55] One district court struck a class because the class representative was inadequate because of a lack of knowledge or understanding about the lawsuit.[56] District the courts split as to whether a plaintiff lacked standing because he sold his stock during the very period in which it is alleged the stock was artificially inflated and thus suffered no actual injury from the claimed fiduciary breach.[57] Courts have also concluded that reliance issues would defeat class certification of disclosure claims related to investments in employer stock, but in class action case, *Harris v. Amgen, Inc*.,[58] the Ninth Circuit applied a "fraud on the market" theory to create a presumption of detrimental reliance on the allegedly false communications about the health of the company.

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[49]*Id*.; *see also Rogers*, 521 F.3d 702.

[50]*LaRue*, 128 S. Ct. at 1024 n.3.

[51]131 S. Ct. 2541 (2011) (decertifying nationwide class of female employees because there were no common answers to allegations of discriminatory pay and promotion practices). *Dukes* is analyzed in detail in Supplement Chapter 23, Class Actions.

[52]133 S. Ct. 1426 (2013) (decertifying class for failure to show "predominance" under Rule 23(b)(3) because plaintiffs did not establish that their damages model sufficiently supported the theory of harm to obtain class treatment). *See also* Robert Rachal, Page Griffin, and Madeline Rea, *Labor and Employment and ERISA Class Actions After Wal-Mart and Comcast—Practice Points for Defendants* (Part I – Commonality) (Oct. 10, 2013); (Part II – Rule 23(b)) (Oct. 25, 2013); (Part III – Experts) (Nov. 13, 2013) (all published in Bloomberg BNA).

[53]Groussman v. Motorola, Inc., 2011 WL 5554030 at *3-*5, 52 EB Cases (BNA) 1965 (N.D. Ill. Nov. 15, 2011) (declining to certify class of 401(k) participants invested in employer stock fund; finding that the proposed class consisted of participants who employed varied investment strategies and patterns, which necessitates individualized damages inquiries, and that plaintiffs also failed to satisfy the typicality requirement because of the individualized inquiries needed to determine each class member's understanding of the company's financial state at the time when each class member made his or her investment decisions).

[54]*See, e.g.*, Langbecker v. EDS, 476 F.3d 299, 39 EB Cases (BNA) 2352 (5th Cir. 2007) (concluding releases can exclude participants from any recovery); Howell v. Motorola Inc., 2005 U.S. Dist. LEXIS 22137, 35 EB Cases (BNA) 2708 (N.D. Ill. Sept. 30, 2005) (dismissing 401(k) case when named plaintiff signed release of ERISA claims), *aff'd*, 633 F.3d 552, 50 EB Cases (BNA) 1865 (7th Cir. 2011); Ogden v. Americredit Corp., 225 F.R.D. 529, 537 n.9 (N.D. Tex. 2005) (noting issue).

[55]Moore v. Comcast Corp., 268 F.R.D. 530, 536 (E.D. Pa. 2010) (release did not preclude class certification and did not preclude named plaintiff from serving as class representative); *Yost v. First Horizon National Corp*., 2011 WL 2182262, at *11, 51 EB Cases (BNA) 1897 (W.D. Tenn. June 3, 2011) (holding that general releases had no impact on its class certification ruling because such agreements do not bar later claims brought on behalf of the plan); *In re* Williams Cos. ERISA Litig., 231 F.R.D. 416 (N.D. Okla. 2005) (allowing plaintiffs to cure by adding a named plaintiff who had signed a release); *In re* ADC Telecomms. ERISA Litig., 2005 U.S. Dist. LEXIS 20224, at *11 (D. Minn. Sept. 15, 2005) (reserving decision whether releases bar claims on behalf of the plan under §502(a)(2) until after discovery was completed); *see also* Nelson v. IPALCO Enters., Inc., 2005 U.S. Dist. LEXIS 16090, at *21, 35 EB Cases (BNA) 2724 (S.D. Ind. Aug. 11, 2005) (concluding that release excluding benefits due under thrift plan did not release fiduciary breach claim for investments in employer stock).

[56]*Ogden*, 225 F.R.D. 529.

[57]**Dismissed for lack of injury:** Taylor v. KeyCorp., 2010 WL 3702423, at *3–5, 49 EB Cases (BNA) 2135 (N.D. Ohio Aug. 12, 2010); Brown v. Medtronic, 619 F. Supp. 2d 646, 650–51 (D. Minn. 2009), *aff'd*, 628 F.3d 451, 50 EB Cases (BNA) 1490 (8th Cir. 2010); *In re* Boston Sci. Corp. ERISA Litig., 254 F.R.D. 24, 30 (D. Mass. 2008). **Complaint not dismissed:** Moore v. Comcast Corp., 268 F.R.D. 530, 533–34, 49 EB Cases (BNA) 1857 (E.D. Pa. Apr. 6, 2010)); Patten v. Northern Trust Co., 703 F. Supp. 2d 799, 806–08, 48 EB Cases (BNA) 2345 (N.D. Ill. 2010).

[58] 717 F.3d 1042, 1058-59 (9th Cir. 2013).

The Second Circuit in *Coan v. Kaufman*[59] and the Fifth Circuit in *Langbecker v. Electronic Data Systems Corp. ERISA Litigation*[60] suggested that the due process concerns embodied in the Federal Rules of Civil Procedure impose limits on a plaintiff's ability to pursue claims "on behalf of the plan" absent some mechanism to protect the interests of the absent plan participants. These concerns can arise for many reasons, including because participants have conflicting interests over their actions (e.g., some may want to continue investing in the stock fund) and over which claims to pursue.[61] Similarly, in an ESOP case, a district court found class conflicts existed between current and former employees because the current employee participants were being harmed by the litigation's interference with the business success of and ability to sell the ESOP-owned company.[62]

IV. Substantive Issues Common to Failure to Disclose and the Prudent Investment Claims

A. Damages and Duties in Light of the Securities Laws' "Disclose or Abstain" Rule

Plaintiffs often claim that the employer stock was an imprudent plan investment because it was artificially inflated in value. However, these claims may come into conflict with the rule[63] that fiduciaries or participants cannot trade while in the possession of material, nonpublic information.[64] Known as the securities laws' "disclose or abstain" rule, it prohibits a fiduciary or participant from trading prior to disclosure of the material, nonpublic information to the market. Once the information has been made public, the participants may suffer a loss as the stock falls to its "true price." These

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[59] 457 F.3d 250, 38 EB Cases (BNA) 1609 (2d Cir. 2006).

[60] 476 F.3d 299, 39 EB Cases (BNA) 2352 (5th Cir. 2007).

[61] *Langbecker*, 476 F.3d at 315–16.

[62] *See* Hans v. Tharaldson, 2010 WL 1856367, at *6–8 (D.N.D. May 7, 2010).

[63] The DOL notes this in its preamble to its §404(c) regulation. 57 Fed. Reg. 46,906, 46,923 (Oct. 13, 1992). The courts are in accord. *E.g.*, *In re* McKesson HBOC, Inc. ERISA Litig., 2002 U.S. Dist. LEXIS 19473, at *24, 29 EB Cases (BNA) 1229 (N.D. Cal. Sept. 30, 2002) (plan fiduciaries cannot trade on material, adverse, nonpublic information); Hull v. Policy Mgmt. Sys. Corp., 2001 U.S. Dist. LEXIS 22343, at *26–27 (D.S.C. Feb. 9, 2001) (same). The SEC has long held that corporate fiduciaries cannot use their fiduciary duties to justify trading on inside information. *In re* Cady, Roberts & Co., 40 SEC 907, 1961 SEC LEXIS 385, at *22–23 (Nov. 8, 1961).

[64] The courts have also generally rejected the notion that plan participants or fiduciaries are entitled to access to inside information. *See* Rogers v. Baxter Int'l, Inc., 521 F.3d 702, 706, 43 EB Cases (BNA) 1769 (7th Cir. 2008) (suggesting same); Nelson v. Hodowal, 512 F.3d 347, 42 EB Cases (BNA) 2064 (7th Cir. 2008) (holding no affirmative duty to provide participants with inside information as to executives' company stock sales); Edgar v. Avaya, Inc., 503 F.3d 340, 349–51, 41 EB Cases (BNA) 2249 (3d Cir. 2007) (no fiduciary duty to provide participants with inside corporate developments in advance of public earnings announcements and securities filings); Fisher v. JP Morgan Chase & Co., 703 F. Supp. 2d 374, 386–87 (S.D.N.Y. 2010) (no affirmative duty to disclose nonpublic information); *In re* Bank of Am. Secs., Derivative & ERISA Litig., 2010 WL 3448197, at *23 (S.D.N.Y. Aug. 27, 2010) (same); Gearren v. McGraw-Hill Cos., 690 F. Supp. 2d 254, 271–72 (S.D.N.Y. 2010) (no affirmative duty to disclose financial information); Patten v. Northern Trust Co., 703 F. Supp. 2d 799, 813–14 (N.D. Ill. 2010) (same); *In re* Wachovia Corp. ERISA Litig., 2010 WL 3081359, at *16 (W.D.N.C. Aug. 6, 2010) (same); Herrera v. Wyeth, 2010 WL 1028163, at *7 (S.D.N.Y. Mar. 17, 2010) (same); Harris v. Amgen, Inc., 2010 WL 744123, at *13, 48 EB Cases (BNA) 2153 (C.D. Cal. Mar. 2, 2010) (same); Banks v. Healthways, Inc., 2009 WL 211137, at *3–4 (M.D. Tenn. Jan. 28, 2009) (dismissing claim for nondisclosure of company stock information to the extent it was based on information that was nonpublic or not required to be disclosed under ERISA); Sims v. First Horizon Nat'l Corp., 2009 WL 3241689, at *25–28 (W.D. Tenn. Sept. 30, 2009) (same); *In re* Citigroup ERISA Litig., 2009 WL 2762708, at *20–25, *26 (S.D.N.Y. Aug. 31, 2009) (same); Shirk v. Fifth Third Bancorp., 2009 WL 692124, at *16–19 (S.D. Ohio Jan. 29, 2009) (same); *In re* Bausch & Lomb, Inc. ERISA Litig., 2008 WL 5234281, at *8–9 (W.D.N.Y. Dec. 12, 2008) (no affirmative duty under ERISA to disclose non-public information with participants); *see also* SEC Release Nos. 33-7881 & 34-43154 at pt. III (A)(2) (Final Rule Selective Disclosure and Insider Trading), 2000 WL 1201556, at *24 (Oct. 23, 2000) (cannot influence the buying or selling of shares by a plan while in the possession of material, nonpublic information). *But see* Brieger v. Tellabs, 629 F. Supp. 2d 848, 865–66, 46 EB Cases (BNA) 2569 (N.D. Ill. 2009) (although the court dismissed plaintiff's disclosure and misrepresentation claims after trial, the court rejected defendants' argument that the investment committee was unable to disclose certain information out of fear of violating securities laws, when other options might exist).

claims also raise issues of the measure of damages[65] and whether a "loss causation" requirement applies to such claims.[66]

As discussed in more detail in Part V.B, in *Fifth Third Bancorp v. Dudenhoeffer*[67] the Supreme Court recently confirmed that plan fiduciaries cannot trade or take other actions based on inside information in violation of the securities laws. The *Fifth Third* Court also made clear that a plan fiduciary would have to conclude that taking extraordinary action based on inside information – such as stopping purchases or making a unilateral disclosure – would not spook the market, and cause more harm than benefit to the plan and its investments in employer stock.[68]

B. Directors and Officers and the Duty to Monitor

Directors and officers who appointed the plan committee may be sued in employer stock litigation on the theory that they failed in their duty to monitor the acts of the committee. The duty to monitor claim is also often coupled with co-fiduciary claims made against all defendants. In *Woods v. Southern Co.*,[69] the court rejected an attempt to use plan terms to avoid this claim. In *Woods*, the plan was amended to name the various employment positions (e.g., vice-president of human resources) that would serve as fiduciaries.[70] The court reasoned that because the person hired for that position has fiduciary duties, the hiring decision and the monitoring of that person's job performance create fiduciary duties on the part of the employer.[71]

Merely because an individual is a director or officer does not makes him or her a fiduciary. Plaintiffs must show either that an officer or director was appointed as a fiduciary or that the officer or director *exercised* discretionary authority or control over the fiduciary conduct at issue.[72] A director or officer, who appoints plan committee members,[73] has a duty to monitor.[74] The DOL has held that the

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[65]*Cf.* RESTATEMENT (SECOND) TRUSTS, §205, cmt. (e) (when fiduciary breached duties by paying too much for an asset, damages are measured by the difference in price between what was paid and what should have been paid); Donovan v. Bierwirth, 754 F.2d 1049, 1055, 6 EB Cases (BNA) 1033 (2d Cir. 1985) (citing RESTATEMENT (SECOND) TRUSTS §205, cmt. (e) as controlling when ERISA claim is that stock price was inflated or manipulated from hidden information).

[66]*See* Dura Pharms., Inc. v. Broudo, 544 U.S. 336 (2005); *cf.* Nelson v. Hodowal, 512 F.3d 347, 351, 42 EB Cases (BNA) 2064 (7th Cir. 2008) (suggesting loss causation requirements apply to ERISA claim).

[67] 2014 WL 2864881 at *12 (U.S. June 25, 2014).

[68] *Id.*

[69]396 F. Supp. 2d 1351, 1372–73, 35 EB Cases (BNA) 2793 (N.D. Ga. 2005).

[70]*Woods*, 396 F. Supp. 2d 1372–73.

[71]*Id*.

[72]*E.g., In re* RCN Litig., 2006 WL 753149, at *5 (D.N.J. Mar. 21, 2006) (concluding that the compensation committee, a subset of the board of directors, was not a fiduciary per the plan documents, and plaintiffs must thus show they exercised fiduciary function); *In re* Calpine Corp. ERISA Litig., 2005 U.S. Dist. LEXIS 9719, at *21, 35 EB Cases (BNA) 1181 (N.D. Cal. Mar. 31, 2005) (directors not fiduciaries simply because of status as directors; must show they also exercised fiduciary function); *In re* AOL Time Warner, Inc. Secs. & ERISA Litig., 2005 U.S. Dist. LEXIS 3715, at *12, 34 EB Cases (BNA) 2683 (S.D.N.Y. Mar. 10, 2005) (same for officers); Henry v. Champlain Enters., Inc., 288 F. Supp. 2d 202, 222, 31 EB Cases (BNA) 2005 (N.D.N.Y. 2003) (director not fiduciary for ESOP transaction simply because of status as director), *rev'd & remanded on other grounds*, 445 F.3d 610 (2d Cir. 2006); *In re* WorldCom, Inc. ERISA Litig., 263 F. Supp. 2d 745, 757–58, 30 EB Cases (BNA) 2035 (S.D.N.Y. 2003); Cosgrove v. Circle K Corp., 884 F. Supp. 350, 353 (D. Ariz. 1995) (CEO's involvement in transaction on behalf of employer who was purchasing assets from plan does not make him fiduciary unless he sought to unduly influence or dominate trustees' decision).

[73]A director or officer can undertake duties beyond the mere appointment and removal of fiduciaries. *See* Rankin v. Rots, 278 F. Supp. 2d 853, 871–872, 30 EB Cases (BNA) 2761 (E.D. Mich. 2003) (court relied on plan terms that did not clearly allocate fiduciary authority and imposed duties on directors greater than duty to appoint and remove fiduciaries); Keach v. United States Trust Co., 234 F. Supp. 2d 872, 882–83, 29 EB Cases (BNA) 1552 (C.D. Ill. 2002) (although nominally only appointed ESOP trustee, corporate officers may have exercised "de facto" control over transaction because, among other things, they conceived of concept, solicited valuation opinions, set up structure of transaction, and appointed new trustee to put transaction in place); Newton v. Van Otterloo, 756 F. Supp. 1121, 1130–32, 13 EB Cases (BNA) 1532 (N.D. Ind. 1991) (CEO became fiduciary by influencing ESOP committee's actions).

[74]*See, e.g.*, *In re* RCN Litig., 2006 WL 753149, at *5 (D.N.J. Mar. 21, 2006) (concluding that plaintiffs' allegations concerning the company and board of directors' duty to monitor were sufficient to withstand a motion to dismiss); *In re* JDS Uniphase Corp. ERISA Litig., 2005 WL 1662131, at *10 (N.D. Cal. July 15, 2005) (same); Howell v. Motorola, Inc., 337 F.

appointing fiduciary must follow some type of procedure to periodically review the performance of the appointee.[75] Within limits, courts have generally followed this guidance.[76] When courts have recognized a breach of the duty to monitor, in some cases the appointing fiduciary has known of or participated in fraud or self-dealing.[77]

Although a director's or officer's appointment power does not generally trigger a fiduciary duty to disclose,[78] this rule has been challenged in two circumstances. The first involves allegations of potential self-dealing or undue influence over the fiduciaries. For example, one court concluded that a CEO may have become a fiduciary with disclosure obligations by exercising "de facto" control over an ESOP transaction involving the purchase of his shares, as he conceived of the concept, solicited the ESOP valuation opinions, set up the structure of the transaction, and appointed the new trustee to put in place the transaction.[79] The second involves substantial factual allegations that the director or officer, who is either an appointed or de facto fiduciary, knew of or participated in fraud that harmed the

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Supp. 2d 1079, 1097–99, 33 EB Cases (BNA) 2202 (N.D. Ill. 2004) (same); *In re* Sprint Corp. ERISA Litig., 2004 U.S. Dist. LEXIS 9622, at *54–59, 33 EB Cases (BNA) 1287 (D. Kan. May 27, 2004)(same); *In re* Dynegy Inc. ERISA Litig., 309 F. Supp. 2d 861, 900–904, 32 EB Cases (BNA) 1999 (S.D. Tex. 2004) (absent allegations that defendant exercised de facto control over appointees or participated in or had notice of breaches by appointees, fiduciary duty is limited to power to appoint and remove); Crowley v. Corning, Inc., 234 F. Supp. 2d 222, 229–30, 29 EB Cases (BNA) 2406 (W.D.N.Y. 2002), *aff'd on motion to amend*, 2004 U.S. Dist. LEXIS 758 (W.D.N.Y. Jan. 14, 2004) (directors' fiduciary powers limited to appointing, retaining, and removing committee members). Kling v. Fidelity Mgmt. Trust Co., 323 F. Supp. 2d 132, 142–45, 33 EB Cases (BNA) 1035 (D. Mass. 2004) (appointment power includes duty to monitor; may also be liable as co-fiduciary for breaches of appointees); ADC Telecomms., Inc., ERISA Litig., 2004 U.S. Dist. LEXIS 14383, at *23, 33 EB Cases (BNA) 1260 (D. Minn. July 26, 2004) (finding that plaintiffs' "broad allegations under the rubric of the ill-defined and limited duty to monitor" were sufficient to withstand a motion to dismiss); Cokenour v. Household Int'l, Inc., 2004 U.S. Dist. LEXIS 5286, at *23–27, 32 EB Cases (BNA) 1783 (N.D. Ill. Mar. 31, 2004) (denying motion to dismiss to extent that claim was based on fiduciaries' duty to monitor investment and administrative committees, but rejecting any claim that they had duty to disclose information to committees); *In re* Williams Cos. ERISA Litig., 271 F. Supp. 2d 1328, 1338–39, 30 EB Cases (BNA) 2529 (N.D. Okla. 2003) (board of directors had fiduciary obligations with respect to appointing, retaining, and removing members of Benefits Committee).;

[75]*See* 29 C.F.R. §2509.75-8. *Compare* D-4 Q & A (stating "appoint and remove" liability is limited to just those duties), *with* FR-17 Q & A (suggesting there is some duty at reasonable intervals to check performance of appointed fiduciary).

[76]*See In re* Westar, Inc., Energy ERISA Litig., 2005 U.S. Dist. LEXIS 28585, at *89 (D. Kan. Sept. 29, 2005); *cf. In re* Williams Cos. ERISA Litig., 2003 U.S. Dist. LEXIS 25042, at *5 n.1, 31 EB Cases (BNA) 1870 (N.D. Okla. Oct. 27, 2003) (rejecting DOL's amicus claim that directors as appointing fiduciaries have continuous duty to monitor appointees); Newton v. Van Otterloo, 756 F. Supp. 1121, 1132, 13 EB Cases (BNA) 1532 (N.D. Ind. 1991) (no breach of duty to monitor appointees absent notice of "possible misadventure" by appointees).

[77]*See* Leigh v. Engle, 727 F.2d 113, 133–36, 4 EB Cases (BNA) 2702 (7th Cir. 1984) (discretionary authority over selection and retention of plan fiduciaries includes duty to monitor activities and to act when the "appointers" knew of and profited from use of plan assets to support corporate control contests). For other examples of the "knowledge of fraud" problems, see *In re* Enron Corp. Secs., Derivative & "ERISA" Litig. (Tittle v. Enron Corp.), 284 F. Supp. 2d 511, 660–62, 31 EB Cases (BNA) 2281 (S.D. Tex. 2003) (fiduciaries cannot ignore or conceal internal warnings of massive fraud at company); Canale v. Yegen, 782 F. Supp. 963, 967–69, 14 EB Cases (BNA) 2653 (D.N.J. 1992) (fiduciaries have duty to act, including suing themselves, based on fraud they committed in their corporate roles).

[78]*See*, *e.g*., Pennsylvania Fed'n v. Norfolk S. Corp. Thoroughbred Ret. Inv. Plan, 2004 U.S. Dist. LEXIS 1987, at *13–18, 32 EB Cases (BNA) 2267 (E.D. Pa. Feb. 4, 2004); *In re* Dynegy Inc. ERISA Litig., 309 F. Supp. 2d 861, 900–04, 32 EB Cases (BNA) 1999 (S.D. Tex. 2004) (absent allegations defendant exercised de facto control over appointees or participated in or had notice of breaches by appointees, fiduciary duty is limited to power to appoint and remove); *In re* Williams Cos. ERISA Litig., 271 F. Supp. 2d 1328, 1339, 30 EB Cases (BNA) 2529 (N.D. Okla. 2003) (directors had no duty to communicate plan information); Crowley v. Corning, Inc., 234 F. Supp. 2d 222, 229–30, 29 EB Cases (BNA) 2406 (W.D.N.Y. 2002), *aff'd on motion to amend*, 2004 U.S. Dist. LEXIS 758 (W.D.N.Y. Jan. 14, 2004) (directors' limited appointment fiduciary duties *do not* include power to control investment options or to communicate plan information); Hull v. Policy Mgmt. Sys. Corp., 2001 U.S. Dist. LEXIS 22343, at *11–14 (D.S.C. Feb. 9, 2001) (director's duty to appoint does not extend to duties to disclose). Some courts, however, have allowed these claims to go forward because of the low pleading standards applied to a motion to dismiss. *See In re* Electronic Data Sys. ERISA Litig., 305 F. Supp. 2d 658, 672 (E.D. Tex. 2004).

[79]*See* Keach v. United States Trust Co., 234 F. Supp. 2d 872, 882–83, 29 EB Cases (BNA) 1552 (C.D. Ill. 2002). The court found after trial that the CEO and other *Keach* defendants did not breach any fiduciary duty. Keach v. United States Trust Co., 313 F. Supp. 2d 818, 32 EB Cases (BNA) 2398 (C.D. Ill. 2004).

plan.[80]

C. Company Status as a Plan Fiduciary

If the company is named as a fiduciary, it is a fiduciary; if it is not named, it is not. Plaintiffs, however, have aggressively pursued theories asserting the company is a fiduciary under respondeat superior principles for the fiduciary acts of its directors, officers, or employees. The Supreme Court held, however, in *National Labor Relations Board v. Amax Coal Co*.,[81] that when an employee is acting in a fiduciary capacity, that employee is barred by law from acting as an agent or representative of the employer. Simply put, a director, officer, or employee who puts on his fiduciary "hat" to act in a fiduciary capacity, is not acting as an agent or representative of the employer.

Courts follow *Amax Coal*, but in many cases the employer has sufficient control of the plan assets to be considered a co-fiduciary.[82] The majority view is that ERISA imposes personal liability for a breach.[83] In a 1986 case, the Fifth Circuit held that a party does not become a fiduciary because of the acts of another unless that party usurps the fiduciary function by exercising de facto control.[84]

D. Directed Trustees and Plan Investments in Employer Stock

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[80]*See* Pension & ESOP Admin. Comm. of Cmty. Bancshares v. Patterson, 547 F. Supp. 2d 1230, 44 EB Cases (BNA) 1241 (N.D. Ala. 2008) (ESOP fiduciary breached duty by not informing other fiduciaries of his fraud while serving as ESOP fiduciary and CEO of the company); *In re* WorldCom, Inc. ERISA Litig., 263 F. Supp. 2d 745, 764–65, 30 EB Cases (BNA) 2035 (S.D.N.Y. 2003) (CEO not assumed to have forgotten information he learned in his corporate role and has duty to tell other fiduciaries of material information he had as to prudence of investing in employer securities); Rankin v. Rots, 278 F. Supp. 2d 853, 873–78, 30 EB Cases (BNA) 2761 (E.D. Mich. 2003) (adopting *WorldCom* analysis); *In re* Sears Roebuck & Co. ERISA Litig., 2004 U.S. Dist. LEXIS 3241, at *16–19, 32 EB Cases (BNA) 1699 (N.D. Ill. Mar. 3, 2004) (adopting *WorldCom* analysis); *Dynegy Inc*., 309 F. Supp. 2d at 879–82 (adopting *WorldCom* analysis); *In re* Enron Corp. Secs., Derivative & "ERISA" Litig. (Tittle v. Enron Corp.), 284 F. Supp. 2d 511, 555–67, 31 EB Cases (BNA) 2281 (S.D. Tex. 2003) (special circumstances and extreme impact of Enron fraud may have triggered duties to disclose; no conflict with securities laws because of obligation to make public disclosure to correct fraud).

[81]453 U.S. 322, 331–32 (1981).

[82]*Compare In re* Bank of Am. Corp. Secs., Derivative & ERISA Litig., 2010 WL 3448197, at *13 (S.D.N.Y. Aug. 27, 2010) (dismissing respondeat superior claim for failure to plead sufficient facts that company exercised de facto control over ERISA fiduciary employees), *In re* Beazer Homes USA, Inc. ERISA Litig., 2010 WL 1416150, at *5 (N.D. Ga. Apr. 2, 2010) (dismissing respondeat superior claim as not cognizable under ERISA), *In re* Bausch & Lomb, Inc. ERISA Litig., 2008 WL 5234281, at *11 (W.D.N.Y. Dec. 12, 2008) (dismissing respondeat superior claim because no primary breach claim survived dismissal and holding that Second Circuit does not recognize a respondeat superior fiduciary claim), Halaris v. Viacom, Inc., 2008 WL 3855044 (N.D. Tex. Aug. 19, 2008) (holding that company was improper party because plaintiffs failed to allege sufficiently that company was de facto fiduciary), *and In re* Williams Cos. ERISA Litig., 271 F. Supp. 2d 1328, 1337–38, 30 EB Cases (BNA) 2529 (N.D. Okla. 2003) (rejecting claim that company was fiduciary based on theory that board was agent of company), *with* Graden v. Conexant Sys., Inc., 574 F. Supp. 2d 456, 469–70 (D.N.J. 2008) (permitting claim to survive low pleading threshold because sufficient facts stated that plan sponsor may have exercised authority and control with plan administration and plan assets), DiFelice v. US Airways, Inc., 397 F. Supp. 2d 735, 758, 35 EB Cases (BNA) 2281 (E.D. Va. 2005) (concluding co-fiduciary liability provisions of §405(a) of ERISA, not common law agency principles, define whether a company is liable for the acts of its employees), *In re* AOL Time Warner, Inc., Secs. & "ERISA" Litig., 2005 U.S. Dist. LEXIS 3715, at *12 nn.4 & 5, 34 EB Cases (BNA) 2683 (S.D.N.Y. Mar. 10, 2005) (rejecting respondeat superior theory, but finding allegation that company exercised "ultimate control" over fiduciary functions sufficient), Smith v. Delta Air Lines, Inc., 422 F. Supp. 2d 1310 (N.D. Ga. 2006) (same), *In re* Cardinal Health, Inc. ERISA Litig., 424 F. Supp. 2d 1002, 38 EB Cases (BNA) 1523 (S.D. Ohio 2006) (concluding respondeat superior liability applies), *and* Kling v. Fidelity Mgmt. Trust Co., 323 F. Supp. 2d 132, 146–47, 33 EB Cases (BNA) 1035 (D. Mass. 2004) (same).

[83]*See* Kayes v. Pacific Lumber Co., 51 F.3d 1449, 1468–61, 19 EB Cases (BNA) 1116 (9th Cir. 1995) (ERISA imposes personal liability); Musmeci v. Schwegmann Giant Super Mkts., 332 F.3d 339, 350–51, 30 EB Cases (BNA) 1833 (5th Cir. 2003) (same). *But see* Confer v. Custom Eng'g Co., 952 F.2d 34, 36–38, 14 EB Cases (BNA) 2067 (3d Cir. 1991) (individual officers not personally liable when acting through corporate form). Corporate bylaws and corporate law may require the corporation to indemnify an individual fiduciary for a liability for a breach. If so, the use of company (not plan) funds to indemnify a breach does not implicate ERISA.

[84]Sommers Drug Emp. Profit Sharing Plan v. Corrigan Enters., 793 F.2d 1456, 1459–60, 7 EB Cases (BNA) 1782 (5th Cir. 1986).

ERISA Section 403(a) requires all assets of a pension plan to be held in trust by a trustee. Section 403(a)(1), however, allows a plan to designate a "directed trustee" who is not is relieved of discretionary fiduciary as to the plan assets as long as the directed trustee follows "proper directions." This allows qualified, independent financial institutions to have custody and control of over plan assets without subjecting them to the potential liabilities that accompany serving as a fiduciary. In the past, courts struggled with how directed trustees fit within ERISA fiduciary obligations regarding investments in employer stock.[85] This uncertainty led plaintiffs to routinely add directed trustees (typically large financial institutions) as named defendants in employer stock lawsuits. In 2004, however, the DOL issued guidance articulating its views on the duties of a directed trustee in relation to plan investments in publicly traded employer stock.[86] The DOL's guidance states that directed trustees are fiduciaries, but with "significantly narrower" duties than discretionary trustees based on Section 403(a), which statutorily requires a directed trustee to follow directions that are "proper."[87] Pursuant to Section 403(a)(1), a direction is "proper" if it is "made in accordance with the terms of the plan"[88] and is "not contrary to [ERISA]." In determining whether the direction is "not contrary to ERISA," the DOL notes that a directed trustee does not have an independent obligation to determine or second-guess the prudence of every direction.[89] Rather, the DOL limits a directed trustee's duty to question directions to narrowly circumscribed circumstances, depending on whether the directed trustee is in the possession of material, nonpublic information.[90]

According to the DOL, if a directed trustee has material, nonpublic information, the directed trustee has a duty to inquire into whether the named fiduciary also has knowledge ofthis information.[91] The DOL states, however, that this knowledge will *not* be imputed across an organization if the organization maintains procedures designed to prevent the illegal disclosures of such information under securities, banking, or other laws.[92]

In regard to the more common situation in which a directed trustee is not privy to material, nonpublic information, the DOL stated in Field Assistance Bulletin No. 2004-03:

> *Duty to act on public information*. Absent material non-public information, a directed trustee, given its limited fiduciary duties as determined by statute, will rarely have an obligation under ERISA to question the prudence of a direction to purchase publicly traded securities at the market price solely on the basis of publicly available information. Three considerations counsel in favor of this view: (1) markets generally are assumed to be efficient so that stock prices reflect publicly available information and known risks; (2) in the case of employer securities, the securities laws impose substantial obligations on the company, its officers, and its accountants to state their financial records accurately; and (3) ERISA section 404 requires the

[85] Courts have also struggled with the scope of a directed trustee's duties in the context of traditional ESOP transactions, such as those involving purchases of stock from company insiders. *See* Beam v. HSBC Bank USA, 2003 U.S. Dist. LEXIS 15744, at *7–14, 31 EB Cases (BNA) 1257 (W.D.N.Y. Aug. 19, 2003) (ESOP stock sale by insiders three years before company went bankrupt; denying summary judgment motion pending further discovery on what directed trustee knew or should have known); *cf*. Beauchem v. Rockford Prods. Corp., 2003 U.S. Dist. LEXIS 5546, at *6–8, 30 EB Cases (BNA) 2342 (N.D. Ill. Mar. 24, 2003) (because directed trustee did not have responsibility or authority over ESOP transaction and employer stock, directed trustee was not fiduciary for those activities; motion to dismiss granted).

[86] U.S. Department of Labor, Field Assistance Bull. No. 2004-03 (Dec. 17, 2004) (fiduciary responsibilities of directed trustees).

[87] *Id*. at 2.

[88] Regarding the "consistent with plan terms" provision, the DOL stated that the directed trustee has a duty to request and review all of the documents and instruments governing the plan relevant to the directed trustee's duties. If the relevant plan documents are ambiguous, the directed trustee should request a clarification from the fiduciary responsible for interpreting the plan and, if the directed trustee does so, it may rely on that interpretation. *Id*. at 3.

[89] *Id*. at 4.

[90] *Id*.

[91] *Id*.

[92] *Id*. at 5. The DOL declined to opine on the effect of procedures designed to limit the cross-organizational disclosure of information when those procedures are not based on legal requirements. *Id*. at 5 n.2.

> instructing fiduciary to adhere to a stringent standard of care. Furthermore, because stock prices fluctuate as a matter of course, even a steep drop in a stock's price would not, in and of itself, indicate that a named fiduciary's direction to purchase or hold such stock is imprudent and, therefore, not a proper direction.[93]

The DOL limited any duty on the part of directed trustees to question whether to follow plan directions based on public information to "limited, extraordinary circumstances" involving "clear and compelling public indicators" that the direction given was not itself prudent.[94] The DOL limited these public indicators to those that seriously question the company's viability as a going concern[95] or those that disclose that the company's officers have been formally charged by state or federal regulators with financial irregularities. As discussed in more detail in Part V.B, the Supreme Court's recent ruling in *Fifth Third Bancorp v. Dudenhoeffer*[96] calls into question whether the DOL's "serious question of viability" is the correct standard to evaluate the prudence of investment in employer stock.

A district court followed the DOL's guidance in *In re WorldCom Inc. ERISA Litigation*,[97] where the directed trustee was granted summary judgment, the district court reasoned that, prior to WorldCom's announcement of its massive accounting restatement and NASDAQ freeze, there was no "reliable public information that call[ed] into serious question [WorldCom's] short-term viability as a going concern."[98] Analyst recommendations to sell WorldCom did not call into question the company's viability. Indeed, sophisticated investors continued to invest in WorldCom based on a belief that the company's stock was underpriced.[99] Thus, the directed trustee did not breach its fiduciary duty when it failed to investigate whether the continued investment in WorldCom stock was imprudent.[100]

In *DiFelice v. US Airways, Inc.*,[101] a district court applied the DOL's guidance and dismissed the claims against the directed trustee after US Airways had publicly and extensively commented on its increasing financial distress and had commented that bankruptcy might be inevitable. US Airways declared bankruptcy in August 2002.[102]

The district court first analyzed whether a directed trustee's discretion regarding managing cash liquidity of a company stock fund somehow made the directed trustee a discretionary fiduciary regarding investing that stock fund. The court held not, reasoning that the discretion regarding cash management was granted for a limited, specific purpose—to maintain fund liquidity, not to manipulate investment returns—while the discretion whether to offer the stock fund was specifically allocated to the plan fiduciaries under the plan documents.[103] The district court then addressed the appropriate standard for judging a directed trustee's exercise of its fiduciary duties, under ERISA Section 403(a):

> If § 403(a) were read to impose a duty of ordinary care on directed trustees to consider the financial merits of a named fiduciary's directions concerning plan investment options and follow only prudent directions, it takes little imagination to see the disputes and litigation such an arrangement would spawn. Congress plainly did not intend such a result. Instead, as the plain language of § 403(a) makes clear, and as is confirmed in the legislative history, Congress intended that directed trustees defer to the investment judgments of the named fiduciary and not second guess the wisdom of these judgments.[104]

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[93] *Id*. at 5.

[94] *Id*. at 5–6.

[95] *Id*. The DOL noted that mere public speculation about a company's viability was insufficient, and contrasted this with 8-K or bankruptcy filings by the employer calling its own viability into question. *Id*. at 5–6 & n.5. The DOL also noted that the fact of bankruptcy would not itself be dispositive, as the circumstances of the bankruptcy could mean equity holders may still receive value for their investments. *Id*. at 6 n.7.

[96] 2014 WL 2864881 at *10-11 (U.S. June 25, 2014).

[97] 354 F. Supp. 2d 423, 34 EB Cases (BNA) 1545 (S.D.N.Y. 2005).

[98] *WorldCom*, 354 F. Supp. 2d at 449.

[99] *Id*. at 449 n.26.

[100] *Id*. at 451.

[101] 397 F. Supp. 2d 735, 35 EB Cases (BNA) 2281 (E.D. Va. 2005). Some of the subsequent proceedings in the *US Airways* litigation are discussed *infra* V.B.

[102] *DiFelice*, 397 F. Supp. 2d at 746.

[103] *Id*. at 749.

[104] *Id*. at 748–49.

The court concluded that a directed trustee that possesses only publicly available information has a duty to challenge a direction only after the named fiduciary files for bankruptcy, and even then only "under circumstances which make it unlikely that there would be any distribution to equity-holders with any value."[105] Public information on US Airways' failed merger with United Airlines and statements that US Airways might enter bankruptcy were insufficient to warrant objecting to the direction to continue to include company stock as an investment option.[106]

V. The Prudent Investment Claims

A. The Distinction Between a Settlor and a Fiduciary in Regard to Plan Investments

The rules regarding investments in employer stock are often set by the terms of the plan, e.g., whether the employer stock fund must be offered as an investment option, whether the employer match must be invested in that fund, and how long that match must remain in that fund. These decisions made by the settlor are not fiduciary acts.[107] As discussed below, making the employer stock fund an ESOP or a mandatory investment option in an eligible individual account plan (EIAP) typically triggers the presumption that it is prudent to offer this fund.

B. The Standard of Prudence Regarding Investments in Employer Stock

Many plans offer the company's stock as a plan investment option for participants. The Pension Protection Act of 2006 (PPA) also permits the employer to provide matches by contributing employer stock, but the plan must allow participant to divest the employer's stock and reinvest in other plan investment options. The plan cannot impose restrictions or conditions on the sale of employer stock that are not imposed on the sale of investments in other plan investment options.[108] Although ERISA 404(a)(2) exempts the fund from any limit on the amount of holdings of employer stock,[109] plaintiffs nonetheless often argue that because of the inherent risk of investment in a single stock, this investment warrants imposing an enhanced duty to investigate its prudence. While some courts have ruled that there is no such enhanced duty,[110] other courts have held that plan terms and exceptional

[105]*Id.* at 752.

[106]*Id.* at 756–57; *see also In re* General Motors ERISA Litig., 2006 U.S. Dist. LEXIS 16782, at *53–66, 37 EB Cases (BNA) 1951 (E.D. Mich. Apr. 6, 2006) (granting directed trustee's motion to dismiss); Summers v. UAL Corp., 2005 U.S. Dist. LEXIS 23918, 36 EB Cases (BNA) 1019 (N.D. Ill. 2005) (granting summary judgment to directed trustee; CEO's open letter to employees stating company might perish next year absent certain changes in its business did not mean company faced imminent collapse), *aff'd*, 453 F.3d 404, 38 EB Cases (BNA) 1065 (7th Cir. 2006).

[107]*E.g.*, *In re* Sprint Corp. ERISA Litig., 2004 U.S. Dist. LEXIS 9622, 33 EB Cases (BNA) 1287 (D. Kan. May 27, 2004) (defendants act in settlor capacity when setting plan terms regarding company stock fund); *see also* Steinman v. Hicks, 352 F.3d 1101, 1105, 31 EB Cases (BNA) 2415 (7th Cir. 2003) (trust to trust transfer is not fiduciary act); Kuper v. Iovenko, 66 F.3d 1447, 1456–57, 19 EB Cases (BNA) 1969 (6th Cir. 1995) (decision to authorize trust-to-trust transfer of ESOP assets in sold division is settlor decision). *Cf* Eaves v. Penn, 587 F.2d 453, 457–59, 1 EB Cases (BNA) 1592 (10th Cir. 1978) (in ESOP case involving use of preexisting plan assets in self-dealing transaction, court held that person who recommended and designed ESOP was fiduciary because he received "indirect" compensation for his advice).

[108]Pub. L. No. 109-280, 120 Stat. 780 (Aug. 17, 2006) & I.R.C. §401(a)(35)(B), (D)(ii).

[109]*See* ERISA §404(a)(2).

[110]*E.g.*, Hull v. Policy Mgmt. Sys. Corp., 2001 U.S. Dist. LEXIS 22343, at *26–27 (D.S.C. Feb. 9, 2001) (holding ERISA does not impose different standard of care regarding investments in company stock as opposed to other stock); *see also* Howell v. Motorola, Inc., 337 F. Supp. 2d 1079, 1089–92, 33 EB Cases (BNA) 2202 (N.D. Ill. 2004) (no reason plan committee members knew or should have known of massive fraud inflicted on company by major customer); Crowley v. Corning Inc., 234 F. Supp. 2d 222, 230, 29 EB Cases (BNA) 2406 (W.D.N.Y. 2002) (no reason plan committee members knew or should have known company filings were false or misleading); Thompson v. Avondale Indus., Inc., 2003 U.S. Dist. LEXIS 2318, at *70–71, 29 EB Cases (BNA) 2865 (E.D. La. Feb. 14, 2003) (in access-to-information-claim, court held it was proper to treat ESOP as any other third-party shareholder); *Avondale*, 2003 U.S. Dist. LEXIS 2318, at *47–49 (fiduciaries are not charged to be smarter than or to outguess market on company value).

facts may trigger such duties.[111] Even in the unusual circumstance in which such a duty may be imposed, the plaintiff must show a causal link between the lack of investigation by the fiduciary and injury to the plaintiff.[112]

The key issue in these cases is what standard applies to the duty of prudence regarding investments in employer stock? From 1995 to mid-2014, the standard adopted and used by the overwhelming majority of courts was the "*Moench* presumption of prudence," in which investment in an employer's stock was presumed prudent absent extraordinary circumstances, such as the impending collapse of the company.[113] In June 2014, in *Fifth Third Bancorp v. Dudenhoeffer*[114] the Supreme Court unanimously rejected *Moench* and instead adopted standards that focused on whether the imprudence claim is based on public or non-public information. As detailed below, for claims based on public information, the Court appears to be adopting a new "presumption of implausibility" that may turn out to be irrebuttable as a practical matter, and for claims based on non-public information, the Court held that several major defenses can apply.[115] *Fifth Third* clearly upended prior precedent, however, and whether that prior precedent still applies will have to be worked out in the lower courts.

Fifth Third arose out of the financial crisis that led to the Great Recession. Fifth Third is a large bank, and plaintiffs alleged that investments in Fifth Third's stock had become imprudent, that is overvalued and excessively risky, by July 2007 for two separate reason: First, based on public information that gave early warning Fifth Third's business in subprime lending was headed to a collapse, and second, based on inside information that Fifth Circuit's officers had allegedly deceived the market by making material misstatements about the company's financial prospects, causing the stock to be overvalued.[116] The lower courts disagreed over when and how *Moench's* presumption of prudence applied to investments in employer stock, and the Court granted certiorari to decide the standard of prudence applicable to these investments.[117]

In a unanimous opinion, the Court held ERISA does not create a special presumption favoring investments in employer stock, other than the important statutory exemption from the duty to diversify to avoid the risk of large loss.[118] Fifth Third argued that Congress enacted a statement of intent encouraging ESOPs as tools of corporate finance and employee ownership, and that stated Congress was concerned these goals could be thwarted by "rulings that treat [ESOPs] as conventional retirement plans."[119] Fifth Third tied this to that the standard of prudence is based on how a prudent fiduciary would act in an "enterprise of a like character and like aims" to argue that advancing the goals of employee ownership justified use of an over-arching presumption of prudence for investments in employer stock.[120] The Court rejected this, holding that prudence must be evaluated in relation to the

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[111]*E.g., In re* Williams Cos. ERISA Litig., 271 F. Supp. 2d 1328, 1343, 30 EB Cases (BNA) 2529 (N.D. Okla. 2003) (assuming company stock fund was not mandatory plan investment option and that stock price was fraudulently inflated, might be a breach of duty to address whether fund should be eliminated); *see also* Patten v. Northern Trust Co., 703 F. Supp. 2d 799, 809–10 (N.D. Ill. 2010) (same); *In re* Hartford Fin. Servs. Grp., 2010 WL 135186, at *2 (D. Conn. Jan. 13, 2010) (same); *In re* Enron Corp. Secs., Derivative & "ERISA" Litig. (Tittle v. Enron Corp.), 284 F. Supp. 2d 511, 665–70, 31 EB Cases (BNA) 2281 (S.D. Tex. 2003) (when savings plan imposed duty to diversify, fiduciaries had duty to investigate large concentration of plan assets invested in employer stock); *but see In re* Constellation Energy Grp., Inc., 2010 WL 3221821, at *5 (D. Md. Aug. 13, 2010) (regardless of whether duty to diversify is present, prudent investment claim fails where plaintiff merely alleges that adoption of risky business model makes stock fund imprudent).

[112]Wright v. Oregon Metallurgical Corp., 360 F.3d 1090, 1098–99, 32 EB Cases (BNA) 1417 (9th Cir. 2004); Kuper v. Iovenko, 66 F.3d 1447, 1459 (6th Cir. 1995).

[113] *See, e.g., Moench v. Robertson*, 62 F.3d 553, 571–72, 19 EB Cases (BNA) 1713 (3d Cir. 1995); In re Citigroup, 662 F.3d 128, 140, 51 EB Cases (BNA) 1737 (2d Cir. 2011); White v. Marshall & Isley Corp., 714 F.3d 980, 989-91 (7th Cir. 2013); *Lanfear v. Home Depot, Inc*., 679 F.3d 1267, 53 EB Cases (BNA) 1261 (11th Cir. 2012).

[114] 2014 WL 2864881 at *7 (U.S. June 25, 2014).

[115] *Id.* at *10-12.

[116] *Id.* at *3.

[117] *Id.* at *4.

[118] *Id.* at *7.

[119] *Id.* at *5 (quoting Tax Reform Act of 1976, § 803(h), 90 Stat, 1590.

[120] *Id.* at *7.

"exclusive purpose" imposed on ERISA fiduciaries to provide benefits while defraying reasonable expenses of plan administration:

> Taken in context, § 1104(a)(1)(B)'s reference to "an enterprise of a like character and with like aims" means an enterprise with what the immediately preceding provision calls the "exclusive purpose" to be pursued by all ERISA fiduciaries: "providing benefits to participants and their beneficiaries" while "defraying reasonable expenses of administering the plan." Read in the context of ERISA as a whole, the term "benefits" in the provision just quoted must be understood to refer to the sort of financial benefits (such as retirement income) that trustees who manage investments typically seek to secure for the trust's beneficiaries. The term does not cover nonpecuniary benefits like those supposed to arise from employee ownership of employer stock.[121]

The Court also rejected that the presumption of prudence was needed to weed-out meritless litigation, noting "[t]he proposed presumption makes it impossible for a plaintiff to state a duty-of-prudence claim, no matter how meritorious, unless the employer is in very bad economic circumstances. Such a rule does not readily divide the plausible sheep from the meritless goats."[122] The Court set forth instead that "careful" judicial scrutiny of complaints under the *Iqbal* and *Twombly* plausibility standard should weed out meritless claims.[123] The Court then discussed how these plausibility standards applied to imprudence claims based on public or inside information.

Plaintiff had claimed that Fifth Third stock was too risky and overvalued based on public information. In reversing the Sixth Circuit's conclusion that this could state a plausible claim, the Court begin by stating that "where a stock is publicly traded, allegations that a fiduciary should have recognized from publicly available information alone that the market was over- or undervaluing the stock are implausible as a general rule, at least in the absence of special circumstances."[124] In discussing "special circumstances" the court defined it in relation to the reliability of the market price of the security: "whether plaintiffs could show special circumstances "affecting the reliability of the market price as 'an unbiased assessment of the security's value in light of all public information,' that would make reliance on the market's valuation imprudent."[125]

For claims of imprudence based on public information, the Court thus may have tendered a "unicorn-like" standard for plaintiffs, one that may be tempting to look for, but that has never been seen in real life. Notably, the Court had earlier observed that employer stock funds are inherently imprudent absent the pass from the duty to diversify, and that using an "impending collapse" or like standard did not make sense for screening out plausible from implausible claims of imprudence.[126] Moreover, in reversing the "too risky" claim lodged against Fifth Third, the Court said the question on remand was whether there was some special circumstance that made a fiduciary's reliance on the market's assessment of Fifth Third's value (whatever that value was) imprudent.[127] Thus, unless there is some unusual market defect rendering the market materially inefficient in reflecting a stock's value (*e.g.*, perhaps a small cap stock in a very thinly traded market), it may be that such a claim will never be plausible.[128]

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[121] *Id.* at *7 (citations omitted).

[122] *Id.* at *10.

[123] *Id.* at *10.

[124] *Id.* at *11.

[125] *Id.* at 11.

[126] *Id.* at *5-6 & *9-10.

[127] *Id.* at *11.

[128] The *Fifth Third* Court's citation to its ruling issued three days before in *Halliburton Co. v. Erica P. John Fund, Inc.*, 2014 WL 2807181 (U.S. June 23, 2014), supports this conclusion. In *Halliburton* the Court rejected challenges to the "efficient market" theory underlying the Court's presumption of reliance on market prices in securities fraud cases. In so doing, the Court concluded that most investors rely on market price as the best reflection of value, and that regardless of whether markets are fully efficient, most economists recognize that it is very difficult to outsmart the markets on a consistent

For claims that a stock was overvalued and imprudent based on non-public information, the Court again gave fiduciaries substantial defenses. First, the Court made clear that ERISA fiduciaries cannot sell stock based on inside information, since such would violate the federal securities laws. The Court also observed that claims ERISA plan fiduciaries should make unilateral disclosures or refrain from trading by using inside information to stop the plan and participants from making what was a planned trade (such as by blocking a participant's decision to invest into the fund or a company's funding of the employer match with stock) may be precluded by the securities laws, and noted the U.S. Securities & Exchange Commission's ("SEC's") views on this may well be relevant.[129] Finally, the Court noted that courts should carefully scrutinize whether plaintiffs have plausibly alleged that unilateral disclosures or shutting down the stock fund would not do more harm than good by spooking the market and "causing a drop in the stock price and a concomitant drop in the value of the stock already held by the fund."[130]

It is hoped the SEC will speak to these issues in the near future. The SEC has generally taken a dim view of using inside information to favor others at the expense of the shareholders in the public markets, and has previously suggested that a plan administrator or investment manager should not use inside information to "time" the trades of investments by employees.[131] Further, cases such as *Pugh v. Tribune Co.*,[132] may offer guidance on how courts should respond to claims that fiduciaries should have taken extraordinary action based on inside information.

In *Pugh*, the plaintiffs brought class action suits under ERISA and federal securities laws. In the ERISA suit, the plaintiffs alleged that the stock was imprudent based on an investigation that revealed that circulation numbers for two newspapers at subsidiaries were inflated over several years.[133] Among other things, the Seventh Circuit rejected the plaintiffs' claim that the ERISA fiduciaries had a duty to investigate and to uncover the fraud at an earlier time. The court observed that "ERISA imposes no duty on plan fiduciaries to continuously audit operational affairs," reasoning instead that a duty to investigate arises only when there is some "red flag" of possible misconduct.[134] In *Pugh*, the red flag was an advertiser lawsuit. In response to that suit, Tribune commenced an investigation that eventually revealed the fraud. The court reasoned that the defendant was entitled to a reasonable amount of time to investigate until it had a full story to disclose.[135]

Pugh may provide a possible roadmap for fiduciaries to lawfully comply with their fiduciary duties when a company is facing allegations of fraud or other misconduct. *Pugh* suggests that fiduciaries can rely on the corporate investigation and reporting process unless they have some reason to believe it is broken. In *Pugh*, fiduciaries could reasonably rely on the fact that the company had commenced an investigation, and was timely reporting the fraud as the facts were verified and uncovered. Particularly since *Fifth Third* admonished courts to consider whether extraordinary actions by ERISA fiduciaries may spook the market and do more harm than good, the analysis in *Pugh* fostering reliance on the corporate reporting process (absent strong reason to believe it is broken) may carry more weight going forward.

Finally, a decision to sell employer stock does not occur in a vacuum. Under standard plan terms for EIAPs and ESOPs (and often because of tax considerations applicable to ESOPs), the fiduciaries are obligated to invest the employer stock fund "primarily" in employer stock. If the fiduciary determines that the plan should consider divesting itself of part or all of this stock, the general practice is for the employer to amend the plan to grant that discretion to the plan fiduciaries or to a specially

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basis. *Id.* at *9-10.

[129] *Id.* at *12.

[130] *Id.* at *12.

[131] *See* SEC Release Nos. 33-7881 & 34-43154 at pt. III (A)(2) (Final Rule Selective Disclosure and Insider Trading), 2000 WL 1201556, at *24 (Oct. 23, 2000); 17 C.FR. § 240.10b5-1(c)(1)(i)(B)(3).

[132] 521 F.3d 686, 43 EB Cases (BNA) 1772 (7th Cir. 2008).

[133] *Pugh*, 521 F.3d at 690–92.

[134] *Id.* at 700.

[135] *Id.*

appointed independent fiduciary. The courts have generally agreed that any subsequent divestment was prudent.[136] Courts have also held or noted, however, that a fiduciary who divests an EIAP of employer stock in violation of plan terms or participant direction exposes himself to substantial risk of liability.[137] In other cases, when the employer stock subsequently rebounded, participants have sued, sometimes successfully, because they were forced to divest their employer stock investments.[138]

C. Section 404(c) of ERISA and Fund Selection

ERISA Section 404(c) provides that when a plan permits participants to direct the investments of the assets in their individual accounts, (1) a participant is not deemed to be a fiduciary by reason of the exercise of such control, and (2) no other fiduciary has any liability for any loss, or by reason of any breach, resulting from such exercise of control. A participant-directed 401(k) plan and its operation must satisfy DOL regulations regarding "control."[139] The burden of proof is on the party seeking the protection of Section 404(c) to demonstrate that participants exercised control over their plan accounts. Courts refuse to grant the statutory protection if such a demonstration is not made.[140]

Section 404(c) provides an affirmative defense to a claim of a fiduciary breach if the participants lose money on their investments. As the House Conference Report explained, "if the participant instructs the plan trustee to invest the full balance of his account in, e.g., a single stock, the trustee is not liable for any loss because of a failure to diversify or because the investment does not meet the prudent man standards."[141]

Plan fiduciaries may be liable if they do not act prudently in the selection of the investment options available in a participant-directed 401(k) plan.[142] The plan sponsor acting as a fiduciary must prudently select investments and "periodically evaluate the performance of such vehicles to determine, based on that evaluation, whether the vehicles should continue to be available as participant investment options."[143]

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[136] *See* Thompson v. Avondale Indus., Inc., 2003 U.S. Dist. LEXIS, at *35–40, 29 EB Cases (BNA) 2865 (E.D. La. Feb. 14, 2003) (decision to diversify was prudent: fiduciaries retained expert advice; stock had been volatile and business was very risky because it depended on one major client, the Navy; and older age of participants made them less able to weather downturn).

[137] *E.g.*, *Edgar*, 503 F.3d at 348–49; Kuper v. Iovenko, 66 F.3d 1447, 1459, 19 EB Cases (BNA) 1969 (6th Cir. 1995); LaLonde v. Textron, Inc., 270 F. Supp. 2d 272, 280, 30 EB Cases (BNA) 2358 (D.R.I. 2003), *aff'd in part, rev'd in part*, 369 F.3d 1, 32 EB Cases (BNA) 2217 (1st Cir. 2004); Schoenholtz v. Doniger, 657 F. Supp. 899, 909, 8 EB Cases (BNA) 2031 (S.D.N.Y. 1987) (rejecting argument that it would have been imprudent to invest in employer stock); *see also*, *e.g*., Montgomery v. Aetna Plywood, Inc., 39 F. Supp. 2d 915, 929, 934 (N.D. Ill. 1998) (imposing over $7 million judgment for selling closely held ESOP's stock at too low a price, e.g., court suggested stock was valued when company was at low point in its business and business cycle).

[138] *See, e.g*., Stanford v. Foamex L.P., 822 F. Supp. 2d 455, 472, 52 EB Cases (BNA) 1677 (E.D. Pa. 2011) (holding fiduciary breached plan terms by unilaterally selling employer stock and ordering trial on whether this caused harm); Bunch v. W.R. Grace & Co., 555 F.3d 1, 45 EB Cases (BNA) 2505 (1st Cir. 2009) (affirming summary judgment that defendants did not breach fiduciary duties for divesting plan of company stock); Tatum v. R.J. Reynolds Tobacco Co., 392 F.3d 636, 34 EB Cases (BNA) 1071 (4th Cir. 2004); Noa v. Keyser, 519 F. Supp. 2d 481, 42 EB Cases (BNA) 1013 (D.N.J. 2007).

[139] 29 C.F.R. §2440.404c-1.

[140] *See, e.g*., Allison v. Bank One–Denver, 289 F.3d 1223, 27 EB Cases (BNA) 2746 (10th Cir. 2002) (trustee liable for plan losses that occurred prior to time plan became self-directed); *In re* Unisys Sav. Plan Litig., 74 F.3d 420, 19 EB Cases (BNA) 2393 (3d Cir. 1996) (remanded to determine whether plan participants had sufficient control over their investment choices to permit the plan fiduciary to invoke §404(c)); *In re* Xerox Corp. ERISA Litig., 483 F. Supp. 2d 206, 41 EB Cases (BNA) 1259 (D. Conn. 2007) (§404(c) protection not available where participants are not given full and accurate disclosure).

[141] H.R. CONF. REP. NO. 93-1280 (1974), *reprinted in* 1974 U.S.C.C.A.N. 5086.

[142] DiFelice v. US Airways, Inc., 497 F.3d 410, 418, 41 EB Cases (BNA) 1321 (4th Cir. 2007) (404(c) safe harbor "does not apply to a fiduciary's decisions to select and maintain certain investment options within a participant-driven 401(k) plan").

[143] Preamble to Final Regulations Regarding Participant Directed Individual Account Plans, 57 Fed. Reg. 46,906, 46,924 n.27 (Oct. 13, 1992); *see also* Rogers v. Baxter Int'l, Inc., 2007 U.S. Dist. LEXIS 74268, 42 EB Cases (BNA) 2800 (N.D. Ill. Oct. 4, 2007); Franklin v. First Union Corp., 84 F. Supp. 2d 720, 732, 23 EB Cases (BNA) 2817 (E.D. Va. 2000) (noting that plan fiduciary must be prudent in selecting and monitoring plan investment alternatives).

In *Howell v. Motorola, Inc.*,[144] the Seventh Circuit held that Section 404(c) is not a defense to the selection of investment funds for a defined contribution plan. The court stated that the 404(c) defense was designed as a safe harbor only with respect to decisions that participants can make, and that the decision as to what investments will be offered by a plan are not within a participant's discretion.[145] Therefore, the Seventh Circuit adopted the DOL's view that Section 404(c)'s safe harbor defense is not applicable to the selection of plan investment options.[146]

The Sixth Circuit adopted *Howell's* reasoning,[147] and district courts from a variety of other jurisdictions have also questioned whether Section 404(c) is a defense to the selection and retention of employer stock funds.[148] However, in *Langbecker v. Electronic Data Systems Corp. ERISA Litigation*,[149] the Fifth Circuit rejected the DOL's position that Section 404(c) may never be a defense to selection or retention of a plan investment option. The court examined the statutory language and the text of the DOL's regulation and concluded that the applicability of the Section 404(c) defense depends on the particular facts and circumstances at issue.[150]

In *Jenkins v. Yager*,[151] the Seventh Circuit rejected the claim that the failure of a plan to comply with Section 404(c) meant that the plan violated ERISA. The court noted that because Section 404(c) is a safe harbor, the failure to satisfy its requirements meant only that the plan fiduciary was not shielded from liability for losses or breaches that resulted from the plan participant's exercise of control. "It does not necessarily mean that such a plan violates ERISA; instead the actions of the plan trustee, when delegating decision-making authority to plan participants, must be evaluated to see if they violate the trustee's fiduciary duty."[152] On the facts before it, the court found no breach of fiduciary duty in either the initial selection of the investment options or the failure to alter those options over time or in allowing participants to direct their investments.

VI. "Failure to Disclose" Claims

"Failure to disclose" claims are based on the theory that the fiduciary had an affirmative duty to disclose material information related to plan investments.[153] Other claims rely on the Supreme Court case *Varity Corp. v. Howe*[154] and assert the fiduciary made affirmative material misrepresentations regarding plan investments. The issue of whether these claims are properly brought as class claims often arises; class actions are briefly discussed above in Section III.C of this chapter. The next section

[144] Howell v. Motorola, Inc., 633 F.3d 552, 50 EB Cases (BNA) 1865 (7th Cir. 2011).

[145] *Id.* at 558.

[146] *Id.*

[147] Pfeil v. State Street Bank & Trust Co, 671 F.3d 585, 597, 52 EB Cases (BNA) 1641 (6th Cir. 2012).

[148] Yost v. First Horizon Nat'l Corp., 2011 WL 2182262, at *9, 51 EB Cases (BNA) 1897 (W.D. Tenn. June 3, 2011) (in dicta, stating that "it is far from clear that the § 404(c) safe harbor is available" for imprudent selection and retention claims); *In re* YRC Worldwide, Inc. ERISA Litig., 2011 WL 1457288, at *4 (D. Kan. Apr. 15, 2011) (striking defendants' §404(c) defense with respect to plaintiffs' prudence claims); *In re* American Int'l Grp., Inc. ERISA Litig. II, 2011 WL 1226459, at *4, 50 EB Cases (BNA) 2377 (S.D.N.Y. Mar. 31, 2011) (holding that §404(c) does not foreclose claims of imprudent selection and maintenance of investment options in a participant-directed plan structure).

[149] 476 F.3d 299, 39 EB Cases (BNA) 2352 (5th Cir. 2007).

[150] *Langbecker*, 476 F.3d at 309–13; *see also* Pfeil v. State St. Bank & Trust Co., 2010 WL 3937165, 50 EB Cases (BNA) 1004 (E.D. Mich. Sept. 30, 2010) (granting motion to dismiss and holding that because plans were 404(c) plans defendants could not be liable for investment claim pertaining to stock fund). *But see Howell*, 633 F.3d at 558 (holding §404(c) defense applies to fund selection but not to selection of fund investment).

[151] 444 F.3d 916 (7th Cir. 2006).

[152] *Jenkins*, 444 F.3d at 924.

[153] The standard of materiality for ERISA investment decisions is the same used under the federal securities laws, i.e., is there a substantial likelihood that a reasonable investor would have found the information important in making an investment decision? *Cf., e.g., In re* Duke Energy ERISA Litig., 281 F. Supp. 2d 786, 791–92, 30 EB Cases (BNA) 2781 (W.D.N.C. 2003) (round trip trades accounting for less than one-third of one percent of overall revenue are immaterial as matter of law; claimed qualitative control problems and alleged masking of lack of revenue growth do not negate nonmateriality).

[154] 516 U.S. 489, 19 EB Cases (BNA) 2761 (1996).

discusses some of the substantive issues that have arisen.

A. Communications and Fiduciary Status

Securities and Exchange Commission (SEC) filings and statements made to the market regarding a company's business and financial information are generally made in a corporate, not a fiduciary, capacity.[155] Neveretheless, plaintiffs claim that the dissemination of these SEC filings to plan participants triggers ERISA fiduciary duties. The securities laws require that plan participants be offered access to SEC filings that are provided to other potential purchasers or owners of the employer's stock.[156] Thus, these filings are disseminated by the company in its role as the issuer of the stock. If the plan is a participant-directed plan intended to comply with ERISA Section 404(c) , the DOL's Section 404(c) regulation also imposes dissemination requirements. These requirements are typically met by incorporating, by reference, a company's SEC filings into the plan's prospectus/SPD.[157] The SPD is itself part of the prospectus required to be distributed by the federal securities laws.[158] Likewise, the DOL has taken the position in its Section 404(c) regulation and its

[155] *Cases Holding that SEC Filings Are Made in Corporate Capacity:* Kirschbaum v. Reliant Energy, Inc., 526 F.3d 243, 257, 43 EB Cases (BNA) 2281 (5th Cir. 2008); *In re* Bank of Am. Secs., Derivative & ERISA Litig., 2010 WL 3448197, at *24 (S.D.N.Y. Aug. 27, 2010); *In re* Wachovia Corp. ERISA Litig., 2010 WL 3081359, at *16 (W.D.N.C. Aug. 6, 2010); Lanfear v. Home Depot, Inc., 718 F. Supp. 2d 1364, 1381 (N.D. Ga. 2010); Herrera v. Wyeth, 2010 WL 1028163, at *7 (S.D.N.Y. Mar. 17, 2010); *In re* Bausch & Lomb, Inc., 2008 WL 5234281, at *7–8 (W.D.N.Y. Dec. 12, 2008); Shirk v. Fifth Third Bancorp., 2009 WL 692124, at *16–19 (S.D. Ohio Jan. 29, 2009); *In re* Harley Davidson, 660 F. Supp. 2d 953, 967, 47 EB Cases (BNA) 2618 (E.D. Wis. 2009); Sims v. First Horizon Nat'l Corp., 2009 WL 3241689, at *25–28 (W.D. Tenn. Sept. 30, 2009); *In re* Citigroup ERISA Litig., 2009 WL 2762708, at *20–26, (S.D.N.Y. Aug. 31, 2009); *In re* Avon Prods., Inc. ERISA Litig., 2009 WL 848083 (S.D.N.Y. Mar. 3, 2009), *report and recommendation adopted by* 2009 WL 884687, at *12–16 (S.D.N.Y. Mar. 30, 2009); Crowley v. Corning, Inc., 234 F. Supp. 2d 222, 228, 29 EB Cases (BNA) 2406 (W.D.N.Y. 2002), *aff'd on motion to amend*, 2004 U.S. Dist. LEXIS 758 (W.D.N.Y. Jan. 14, 2004) (holding as matter of law that these statements to market are not made in fiduciary capacity).

Cases Holding at the Motion to Dismiss Stage That SEC Filings May Implicate Fiduciary Duties: In re Regions Morgan Keegan ERISA Litig., 692 F. Supp. 2d 944, 955–56, 49 EB Cases (BNA) 1208 (W.D. Tenn. 2010) (at motion to dismiss stage, incorporation of SEC filings may implicate fiduciary duties where misrepresentations were made in information); *In re* Computer Scis. Corp. ERISA Litig., 635 F. Supp. 2d 1128, 1141 47 EB Cases (BNA) 1542 (C.D. Cal. July 13, 2009) (explaining, in Ninth Circuit, SEC filings can give rise to ERISA liability when the defendant intentionally incorporates them into plan documents, e.g., prospectuses); *In re* Dell, Inc. ERISA Litig., 563 F. Supp. 2d 681, 695–96, 45 EB Cases (BNA) 1346 (W.D. Tex. 2008) (denying dismissal of disclosure claim and holding a question of fact existed); *In re* Reliant Energy ERISA Litig., 336 F. Supp. 2d 646, 660–63, 670–71 (S.D. Tex. 2004) (filing Form S-8 may confer fiduciary status on the defendant to the extent that the defendant had discretion with regard to the information to include in the form, but the mere fact that the form incorporates by reference future SEC filings does not confer fiduciary status on the defendants); *In re* IKON Office Solutions Secs. Litig., 86 F. Supp. 2d 481, 491–92 (E.D. Pa. 2000) (at motion to dismiss stage allowing further factual development on whether company acted in fiduciary role regarding communication of information related to its company stock).

[156] The federal securities laws mandate that when a corporation sponsors a 401(k) or like voluntary, contributory plan that offers an employer's securities, it must file a Form S-8 registration statement with the SEC. *See In re* WorldCom, Inc. ERISA Litig., 263 F. Supp. 2d 745, 766, 30 EB Cases (BNA) 2035 (S.D.N.Y. 2003). When securities are being offered pursuant to a registration statement on Form S-8, a prospectus meeting the requirements of §10(a) of the Securities Exchange Act is required. 15 U.S.C. §77j; Securities Act, Rule 428, 17 C.F.R. §230.428. The prospectus must be disseminated to all employees who are eligible to become plan participants. 15 U.S.C. §77j; Securities Act, Rule 428, 17 C.F.R. §230.428(b)(1)(i). Part II, Item 3 of Form S-8 provides the list of documents incorporated by reference in the registration statement and in the §10(a) prospectus. Among those documents incorporated by reference are reports filed pursuant to §13(a) or 15(d) of the Securities Exchange Act since the end of the fiscal year. Part II, Item 3, Form S-8. These documents include the 10K, 10Q, and 8K filings. *See* Securities Exchange Act, §13(a). For a detailed discussion of the history and import of the plan prospectus requirements, see Susan J. Stabile, *I Believed My Employer and Didn't Sell My Stock: Is There an ERISA (or 3 Act) Remedy for Me?*, 36 CONN. L. REV. 385, 394–96 (Winter 2004).

[157] *Cf., e.g., In re* Tyco Int'l, Ltd. MDL, 2004 U.S. Dist. LEXIS 24272, at *11, 34 EB Cases (BNA) 1577 (D.N.H. Dec. 2, 2004) (committee members who sign SEC filings on behalf of plan committee are acting in ministerial, not fiduciary, role in signing those filings).

[158] An SPD may be used to fulfill the plan information delivery requirements of the §10(a) prospectus provided that the SPD includes all material plan information required by Item 1 of Form S-8, or is supplemented with an additional document or documents containing the required information not included in the SPD; the required legend noting Securities

preamble that the regulation "is not intended to require a plan fiduciary to disclose information to the general public."[159] Because the securities laws' insider trading rules prohibit selective disclosures for purposes of trading, this suggests that the DOL's Section 404(c) regulation is not meant to require disclosures of a company's material, *nonpublic* business or financial information. In the preamble to its Section 404(c) regulation, the DOL further indicates that by providing these SEC filings, fiduciaries act in a "pass through" role.[160] As to the ERISA SPD requirements, the SPD is not required to include information concerning the relative merits of offered investments. Moreover, ERISA does not require plan fiduciaries to offer participants investment advice.[161]

Nonetheless, in *WorldCom*,[162] and in a few other cases,[163] courts have held an ERISA fiduciary duty may be triggered by mandated dissemination of these SEC filings—although these cases may be limited to a fiduciary who knowingly distributes fraudulent SEC filings.[164] In other cases, some courts have allowed this dissemination theory to survive a motion to dismiss under the theory that anything incorporated into the prospectus/SPD may be deemed a fiduciary communication.[165] Courts have allowed disclosure claims to proceed to discovery when the complaint alleges intentional

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Act registration is included in the forepart of the document; and the SPD is prepared early enough to ensure timely delivery of current plan information to participants under the federal securities laws. *See WorldCom*, 263 F. Supp. 2d at 760; *see also Registration and Reporting Requirements for Employee Benefit Plans*, 46 S.E.C. 518, at 4, SEC Release No. 6867, 28094, 33-6867, 34-28094, 1990 WL 310688 (June 6, 1990); Maldonado, Kirk F., & Daley, Susan J., *Securities Law Aspects of Employee Benefit Plans*, §IV (No. 44-4, BNA Corp. Practice Series). Delivery of the prospectus has to precede or accompany offers and sales of the registrant's securities. *See* Form S-8(A). Therefore, the SPD would have to be distributed prior to ERISA guidelines, as ERISA only requires that plan administrators furnish the SPD either within 90 days *after* an employee becomes a plan participant or within 120 days of the plan becoming subject to ERISA. *See also Registration and Reporting Requirements for Employee Benefit Plans*, 46 S.E.C. 518, at 4.

[159] 57 Fed. Reg. 46,906, 46,923 (Oct. 13, 1992).

[160] *See* 57 Fed. Reg. at 46,912 ("with the exception of certain plan and participant specific information, the information required to be furnished and made available to participants … is information which is typically furnished by, or readily available from, investment managers, investment advisers, and issuers of securities"); *id*. at 46,928 ("Information provided to non-plan shareholders of employer securities must be passed through to participants and beneficiaries invested in the [employer stock] fund.").

[161] *See, e.g.*, Pennsylvania Fed'n v. Norfolk S. Corp. Thoroughbred Ret. Inv. Plan, 2004 U.S. Dist. LEXIS 1987, at *13–16, 32 EB Cases (BNA) 2267 (E.D. Pa. Feb. 4, 2004) (noting same and concluding that SPD statement that employer stock fund is undiversified and more volatile than diversified investment is sufficient); *In re* Unisys Sav. Plan Litig., 74 F.3d 420, 441, 443 (3d Cir. 1996) (ERISA imposes no duty to provide investment advice).

[162] *WorldCom*, 263 F. Supp. 2d 745.

[163] *See* Vivien v. WorldCom, Inc., 2002 U.S. Dist. LEXIS 27666, at *18–25 (N.D. Cal. July 22, 2002) (distinguishing Hull v. Policy Mgmt. Sys. Corp., 2001 U.S. Dist. LEXIS 22343 (D.S.C. Feb. 9, 2001) (incorporating SEC filings in SPD may trigger ERISA fiduciary duties because ERISA triggers duty to distribute SPD to plan participants); *WorldCom*, 263 F. Supp. 2d at 766 (same).

[164] *See* Vivien v. WorldCom, Inc., 2002 U.S. Dist. LEXIS 27666, at *18–25 (N.D. Cal. July 22, 2002) (distinguishing Hull v. Policy Mgmt. Sys. Corp., 2001 U.S. Dist. LEXIS 22343 (D.S.C. Feb. 9, 2001) (incorporating SEC filings in SPD may trigger ERISA fiduciary duties because ERISA triggers duty to distribute SPD to plan participants); *WorldCom*, 263 F. Supp. 2d at 766 (same).

[165] *See In re* Beazer Homes USA, Inc. ERISA Litig., 2010 WL 1416150, at *8 (N.D. Ga. Apr. 2, 2010) (refusing to dismiss plaintiffs' disclosure claims because incorporation of SEC filings may trigger ERISA fiduciary duties); Gee v. UnumProvident Corp., 2005 U.S. Dist. LEXIS 3183, at *52–53 (E.D. Tenn. Jan. 13, 2005) (incorporating SEC filings in SPD may trigger ERISA fiduciary duties because ERISA triggers duty to distribute SPD to plan participants); *In re* Sears Roebuck & Co. ERISA Litig., 2004 U.S. Dist. LEXIS 3241, at *16–17, 32 EB Cases (BNA) 1699 (N.D. Ill. Mar. 3, 2004) (adopting *WorldCom* analysis); *In re* Sprint Corp. ERISA Litig., 2004 U.S. Dist. LEXIS 9622, at *42–49, 33 EB Cases (BNA) 1287 (D. Kan. May 27, 2004) (refusing to dismiss plaintiffs' disclosure claim because alleged false filings were incorporated into prospectus/SPDs); Rankin v. Rots (Kmart), 278 F. Supp. 2d 853, 875–77, 30 EB Cases (BNA) 2761 (E.D. Mich. 2003) (quoting and applying *WorldCom*); *see also In re* Honeywell Int'l ERISA Litig., 2004 WL 3245931, at *8–10 (D.N.J. June 14, 2004) (same for those responsible for distributing the SPDs). For an apt example of the district courts' confusion in this area, see *In re* JDS Uniphase Corp. ERISA Litig., 2005 WL 1662131 (N.D. Cal. July 14, 2005), in which the district court first noted that the preparation of reports required by government is a ministerial function, *id*. at *2, and also that the plan prospectus is required to be disseminated by the corporation under the federal securities laws. *Id*. at *12. The court nonetheless concluded that these are ERISA fiduciary communications. *Id*.

misstatements by fiduciaries.[166] For example, in *Dudenhoefer*[167] the Sixth Circuit concluded that the incorporation of allegedly false SEC filings into summary plan descriptions created fiduciary communications, which established grounds for a fiduciary breach of duties claim.. See Chapter 6, Enumerated Parties.

Courts also have dismissed disclosure claims at the pleadings stage, finding that the allegations failed to connect public statements about a company's financial status to any ERISA fiduciary capacity.[168] For example, in *In re Tyco International Multidistrict Litigation*,[169] the court recognized that the challenged SEC filings were disseminated in a corporate capacity and dismissed fiduciary claims related to those filings, stating:

> [T]here is little evidence in the legislative history of either the Securities Act, which is the source of the disclosure requirements, or ERISA to support the view that an issuer of stock necessarily assumes fiduciary responsibilities in complying with its obligations under the securities laws if it chooses to allow its employees to invest in its stock as a part of an individual account plan. Although plaintiffs plainly had a right to expect that Tyco International would refrain from making material misstatements in its SEC filings, that expectation must be enforced under the securities laws rather than ERISA[170]

Subsequent to *WorldCom*, the Fifth Circuit in *Kirschbaum v. Reliant Energy, Inc.*,[171] held that SEC filings incorporated by reference in the plan's Form S-8 registration statement and Section 10(a) prospectus are still made in a corporate, not fiduciary, capacity because they are required to be distributed by the federal securities laws.[172] Courts, however, have found that incorporating a prospectus into the SPD raises ERISA fiduciary issues.[173]

In ESOP cases involving closely held companies, for purposes of deciding a motion to dismiss, some courts have allowed plaintiffs to pursue their claim that statements made by the chief executive officer (CEO) to the employees about the company's financial health and business prospects may have been made in a fiduciary capacity.[174]

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[166]Carr v. International Game Tech., 770 F. Supp. 2d 1080, 1094–95, 51 EB Cases (BNA) 1140 (D. Nev. 2011) (allegations of materially misleading SEC filings created viable disclosure claim, particularly when allegations included dissemination of false SEC statements to participants via plan documents); Hill v. State St. Corp., 2011 WL 3420439, at *34, 51 EB Cases (BNA) 2263 (D. Mass. Aug. 3, 2011) (noting allegations that fiduciaries omitted material information about company's financial performance from participants; holding "falsity of statement and materiality of a misstatement or omission are generally questions for a jury").

[167]692 F.3d 410, 422–23, 53 EB Cases (BNA) 2842 (6th Cir. 2012) (stating that no other circuit court had addressed issue of whether incorporation of SEC filings into ERISA communications was a fiduciary act), *petition for cert. filed*, 81 U.S.L.W. 3350 (Dec. 14, 2012).

[168]Lanfear v. Home Depot, Inc., 679 F.3d 1267, 1283–84, 53 EB Cases (BNA) 1261 (11th Cir. 2012) (holding preparation and filing of SEC documents was not a fiduciary act); Slaymon v. SLM Corp., 2012 WL 6684564, 54 EB Cases (BNA) 1929 (2d Cir. Dec. 26, 2012) (rejecting argument that incorporation of false or misleading SEC filings into plan documents created a plausible fiduciary breach claim because there was no showing that the allegedly false statements were made in a fiduciary capacity); *In re* GlaxoSmithKline ERISA Litig., 2012 WL 3798260, 54 EB Cases 1437 (2d Cir. Sept. 4, 2012) (same); *In re* Bear Stearns Cos., Secs., Derivative & ERISA Litig., 763 F. Supp. 2d 423, 577, 50 EB Cases (BNA) 2581 (S.D.N.Y. 2011) ("persons who prepare [Securities and Exchange Commission (SEC)] filings do not become ERISA fiduciaries through those acts and, consequently, do not violate ERISA if the filings contain misrepresentations") (internal quotations omitted).

[169]2004 U.S. Dist. LEXIS 24272, at *22–23, 34 EB Cases (BNA) 1577 (D.N.H. Dec. 2, 2004).

[170]*Id.*

[171]526 F.3d 243, 43 EB Cases (BNA) 2281 (5th Cir. 2008).

[172]*Kirschbaum*, 526 F.3d at 257.

[173] *E.g., Dudenhoeffer*, 692 F.3d at 423.

[174]*See In re* Sprint Corp. ERISA Litig., 2004 U.S. Dist. LEXIS 9622, at *49–53, 33 EB Cases (BNA) 1287 (D. Kan. May 27, 2004) (concluding that statements made in company newsletter regarding company's prospects could qualify as material misrepresentations made by defendants in their capacity as fiduciaries); Nelson v. IPALCO Enters., Inc., 2003 U.S. Dist. LEXIS 2431, at *10–14, 29 EB Cases (BNA) 2665 (S.D. Ind. Feb. 13, 2003) (refusing to dismiss allegation that defendant was fiduciary where statement made at shareholders meeting that merger was good deal for employees was accompanied by statement that speaker was acting as fiduciary for employees and shareholders); Stein v. Smith, 270 F. Supp. 2d 157, 173–74, 30 EB Cases (BNA) 2421 (D. Mass. 2003); Flake v. Hoskins, 55 F. Supp. 2d 1196, 1221 (D. Kan. 1999)

B. Affirmative Disclosure Duties Regarding a Company's Business and Financial Information

If a fiduciary knows plan assets have been misappropriated or are at risk because of self-dealing, courts have generally imposed a "duty to alert."[175] At least one court has refused to extend the "duty to alert" to nonfiduciaries who may know of the problems.[176] Plan fiduciaries can also be under a duty to inform because of language in plan documents or plan communications.[177] In contrast, there is no general duty to inform of contingent corporate events, regardless of their materiality.[178]

The analysis becomes more complicated when the issue involves a claimed duty to disclose material, adverse, nonpublic information that may affect the value of the investments in the employer stock fund. Insider trading rules prohibit selective disclosures of this information to participants, and generally ERISA disclosure obligations do not attach to those who are not charged to communicate plan information.[179] The Seventh Circuit held there is "no reason" for ERISA to be construed to require disclosures beyond those required by corporate or securities laws.[180] In *Baker v. Kingsley*,[181] the Seventh Circuit applied this principle to dismiss claims that fiduciaries misled them regarding the company's financial problems. In *Baker*, the plaintiffs alleged that the defendants breached their fiduciary duties by misleading them as to whether there was a "significant risk" that the company would falter and, as a result, that the health plan would be terminated. The court rejected this argument, holding that "vague allegations of 'assessments' of the general economic well-being of an employer, especially in the absence of specific allegations of intent to deceive, are not sufficient to state a claim for breach of fiduciary duty under ERISA."[182] The court observed that "the failure to disclose the likelihood of bankruptcy and plan termination may have been an innocent byproduct of the company's

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(communications that went only to ESOP participants soliciting their votes in sale of company may have been made in fiduciary capacity).

[175] *See* Barker v. American Mobil Power Corp., 64 F.3d 1397, 1402–04, 19 EB Cases (BNA) 2051 (9th Cir. 1995) (company commingled profit-sharing plan funds; fiduciary on administrative committee had suspicion this was occurring but never investigated or told participants; instead he sent letter that funds were earning interest); Glaziers & Glassworkers Local 252 Annuity Fund v. Newbridge Secs., 93 F.3d 1171, 1175–82, 20 EB Cases (BNA) 1697 (3d Cir. 1996) (fund advisor stole and wasted fund assets; securities firm failed to disclose it terminated advisor over concerns regarding advisor's integrity); Ream v. Frey, 107 F.3d 147, 153–56, 20 EB Cases (BNA) 2657 (3d Cir. 1997) (bank resigned as trustee and turned money over to company president when it knew company had financial difficulties and company president had not been complying with his fiduciary duties); Vescom v. American Heartland Health Adm'rs, Inc., 251 F. Supp. 2d 950, 959–60 (D. Me. Jan. 17, 2003) (plan administrator setting up "self-funded" plan with 100% reinsurance knew prior to renewal reinsurer was not paying claims timely and was in default); *cf.* Ershick v. United Missouri Bank, 1990 U.S. Dist. LEXIS 11929, at *12–14, 12 EB Cases (BNA) 2323 (D. Kan. Aug. 28, 1990), *aff'd*, 948 F.2d 660, 14 EB Cases (BNA) 1848 (10th Cir. 1991) (although ESOP directed trustee bank was also commercial lender to company, court granted bank summary judgment due to lack of knowledge where bank followed federal regulatory guidance by building "Chinese Wall" between commercial loan department and trust department).

[176] *See* CSA 401(k) Plan v. Pension Prof'ls Inc., 195 F.3d 1135, 1138–40, 23 EB Cases (BNA) 2241 (9th Cir. 1999) (third-party administrator discovered discrepancies between amounts withheld and amounts deposited and suspected embezzlement by trustee).

[177] *See* Franklin v. First Union Corp., 84 F. Supp. 2d 720, 733–36, 23 EB Cases (BNA) 2817 (E.D. Va. 2000) (court used SPD's "will be notified" language to impose duty to inform of changes to investment funds).

[178] Sweeney v. Kroger Co., 773 F. Supp. 1266, 1269, 14 EB Cases (BNA) 2057 (E.D. Mo. 1991) (claim that defendants should have informed participants that group had expressed interest in buying company; court held that "plan administrators are not required to inform all [p]lan participants and beneficiaries of every corporate event, especially contingent events, that might impact the value of the company's common stock"); *see also* Ervast v. Flexible Prods. Co., 346 F.3d 1007, 1016–17 & 1015 n.8, 31 EB Cases (BNA) 1321 (11th Cir. 2003) (in preemption context, suggesting same for pending merger of ESOP-owned company).

[179] The federal securities laws establish liability for disclosures in SEC filings and other statements to the market. Courts have used ERISA fiduciary law to impose duties and liabilities when the securities laws might not impose liability in cases involving allegations of massive fraud. *E.g.*, *In re* WorldCom, Inc. ERISA Litig., 263 F. Supp. 2d 745, 767, 30 EB Cases (BNA) 2035 (S.D.N.Y. 2003).

[180] Beach v. Commonwealth Edison Co., 382 F.3d 656, 660, 33 EB Cases (BNA) 1577 (7th Cir. 2004).

[181] 387 F.3d 649, 33 EB Cases (BNA) 2486 (7th Cir. 2004).

[182] *Baker*, 387 F.3d at 662.

efforts to keep from its creditors and competitors information that it had no duty to disclose,"[183] and that "if we were to create a new fiduciary duty, as plaintiffs request, we run the risk of disturbing the carefully delineated corporate disclosure laws."[184]

When faced with the issue of whether a fiduciary has a duty to disclose a company's business and financial information, the courts are divided at the motion to dismiss stage. In *Fifth Third Bancorp v. Dudenhoeffer*[185] the Supreme Court recently observed it has never imposed an ERISA fiduciary duty affirmatively to disclose business information, and noted the SEC's views on this may well be relevant. Prior to *Fifth Third*, on one side are cases such as *Edgar v. Avaya, Inc.*,[186] where the court held that that ERISA does not impose any supplemental disclosure duty. It concluded that disclosure obligations were satisfied by SPD statements warning that investing in the non-diversified employer stock fund was risky.[187] On the other side are the "bankruptcy implosion" cases of *WorldCom*, *Kmart*, and *Enron* and the decisions that have followed them where the courts have found a duty to disclose.[188] In the middle are cases such as *In re Dynegy Inc. ERISA Litigation*,[189] which concluded that there is no general fiduciary duty to correct a company's financial statements absent allegations that the plan fiduciaries knew they were false, but which also held that a prospectus/SPD statement that encouraged participants to review SEC filings triggered fiduciary duties regarding those SEC filings. As noted, *Pugh v. Tribune* suggests that, when "red flags" do arise, ERISA fiduciaries may be able to rely on the corporate investigation and reporting process unless they have some reason to believe it is broken.[190] I

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[183] *Id.*

[184] *Id.*

[185] 2014 WL 2864881 at *12 (U.S. June 25, 2014).

[186] 503 F.3d 340, 350, 41 EB Cases (BNA) 2249 (3d Cir. 2007); *see also* Pugh v. Tribune Co., 521 F.3d 686, 43 EB Cases (BNA) 1772 (7th Cir. 2008); Fisher v. JP Morgan Chase & Co., 703 F. Supp. 2d 374, 386–87 (S.D.N.Y. 2010) (no affirmative duty to disclose nonpublic information); *In re* Bank of Am. Secs., Derivative & ERISA Litig., 2010 WL 3448197, at *23 (S.D.N.Y. Aug. 27, 2010) (same); Gearren v. McGraw-Hill Cos., 690 F. Supp. 2d 254, 271–72 (S.D.N.Y. 2010) (same); *In re* Wachovia Corp. ERISA Litig., 2010 WL 3081359, at *16 (W.D.N.C. Aug. 6, 2010) (same); Fisher v. JP Morgan Chase & Co., 703 F. Supp. 2d 374, 386–87 (S.D.N.Y. 2010) (same); Herrera v. Wyeth, 2010 WL 1028163, at *7 (S.D.N.Y. Mar. 17, 2010) (same); Harris v. Amgen, Inc., 2010 WL 744123, at *13 (C.D. Cal. Mar. 2, 2010) (same); Patten v. Northern Trust Co., 703 F. Supp. 2d 799, 813–14 (N.D. Ill. 2010) (same); *In re* Harley Davidson, 660 F. Supp. 2d 953, 967–68, 47 EB Cases (BNA) 2618 (E.D. Wis. 2009); Sims v. First Horizon Nat'l Corp., 2009 WL 3241689, at *25–28 (W.D. Tenn. Sept. 30, 2009); Brieger v. Tellabs, 629 F. Supp. 2d 848, 865–66 (N.D. Ill. June 1, 2009); *In re* Avon Prods., Inc. ERISA Litig., 2009 WL 848083 (S.D.N.Y. Mar. 3, 2009), *report and recommendation adopted by* 2009 WL 884687, at *12–16 (S.D.N.Y. Mar. 30, 2009); Banks v. Healthways, Inc., 2009 WL 211137, at *3–4 (M.D. Tenn. Jan. 28, 2009); Graden v. Conexant Sys., Inc., 574 F. Supp. 2d 456, 465 (D.N.J. 2008); *In re* Bausch & Lomb, Inc., 2008 WL 5234281, at *7–8 (W.D.N.Y. Dec. 12, 2008); Urban v. Comcast Corp., 2008 WL 4739519, at *14–15 (E.D. Pa. Oct. 28, 2008).

[187] *Edgar*, 503 F.3d at 350.

[188] *See* Bacon v. Stiefel Labs. Inc., 741 F. Supp. 2d 1186, 1191 (S.D. Fla. 2010); Page v. Impac Mortg. Holdings, Inc., 2009 WL 890722, at *5–6 (C.D. Cal. Mar. 31, 2009); *In re* Computer Scis. Corp. ERISA Litig., 635 F. Supp. 2d 1128, 1141–42, 47 EB Cases (BNA) 1542 (C.D. Cal. 2009); Balsley v. Delta Star Emp. Stock Ownership, 2009 WL 4823196 (N.D. Cal. Dec. 10, 2009); *In re* Fremont Gen. Corp., 564 F. Supp. 2d 1156, 1159 (C.D. Cal. 2008); *In re* Guidant Corp. ERISA Litig., 2008 WL 2498127, at *5 (S.D. Ind. June 19, 2008); *In re* Diebold ERISA Litig., 2008 WL 2225712, at *10–11 (N.D. Ohio May 28, 2008); *In re* Sears Roebuck & Co. ERISA Litig., 2004 U.S. Dist. LEXIS 3241, at *16–18, 32 EB Cases (BNA) 1699 (N.D. Ill. Mar. 3, 2004) (adopting *WorldCom* analysis when financial statements were restated); Hill v. Bellsouth Corp., 313 F. Supp. 2d 1361, 1368–69, 32 EB Cases (BNA) 1993 (N.D. Ga. 2004) (asserting that plan fiduciaries have duty to disclose information about company in event of "special circumstance" that "trigger[s] those heightened obligations"); *In re* ADC Telecomms., Inc., ERISA Litig., 2004 U.S. Dist. LEXIS 14383, at *23–25, 33 EB Cases (BNA) 1260 (D. Minn. July 26, 2004) ("Company officers who act as plan fiduciaries may be required to draw upon their 'corporate' knowledge to properly fulfill their obligations to protect and prioritize the interests of plan beneficiaries"); *In re* WorldCom, Inc. ERISA Litig., 263 F. Supp. 2d 745, 766, 30 EB Cases (BNA) 2035 (S.D.N.Y. 2003) (incorporating SEC filings in SPD may trigger ERISA fiduciary duties to supplement or correct); Rankin v. Rots (Kmart), 278 F. Supp. 2d 853, 875–77, 30 EB Cases (BNA) 2761 (E.D. Mich. 2003) (adopting *WorldCom* analysis); *In re* Enron Corp. Secs., Derivative & "ERISA" Litig. (Tittle v. Enron Corp.), 284 F. Supp. 2d 511, 555–67, 31 EB Cases (BNA) 2281 (S.D. Tex. 2003) (special circumstances and extreme impact of Enron fraud may have triggered duties to disclose; no conflict with securities laws because of obligation to make public disclosure to correct fraud).

[189] 309 F. Supp. 2d 861, 879–80, 32 EB Cases (BNA) 1999 (S.D. Tex. 2004).

[190] *See* Pugh v. Tribune, 521 F.3d 686, 700, 43 EB Cases (BNA) 1772 (7th Cir. 2008).

C. ERISA Section 404(c) as a Defense to Disclosure Claims

The Seventh Circuit held that ERISA Section 404(c) is not a defense to fund selection but agreed that 404(c) can be a defense to a disclosure claim unless the fiduciary intentionally concealed material information.[191] Other courts have followed this approach.[192] The Third Circuit, in *In re Unisys Savings Plan Litig*ation, noted that a breach of the duty to disclose material information related to the plan investment may ultimately mean that the participant did not exercise the requisite "control" over those investments.[193] On remand, the district court found after trial, however, that Section 404(c) was a defense to the plaintiffs' claims.[194] Because Section 404(c) can require fact-intensive inquiries into the "total mix of information" on which each participant relied in order to determine whether the participant exercised the requisite control over his investments, some courts have found that the Section 404(c) defense defeats class status for participant-directed claims.[195]

VII. Special Issues in ESOPs of Closely Held Companies

Both publicly and closely held companies can create ESOPs as a means for employees to acquire tax-favored ownership.[196] Congress provided these tax subsidies for ESOPS because it believed that employee ownership is a social good:

> The committee believes that through the employee stock ownership plan, many corporate employers will be introduced to a new technique of corporate finance that will enable the company to build its own investment capital while providing equity ownership for their employees, and in this way benefit society as a whole.[197]

Congress, however, insisted on complex rules that must be complied with to qualify for those subsidies. Moreover, ERISA's fiduciary duties (other than the duty to diversify) govern those charged with ESOP administration. For closely held companies wholly or majority owned by the ESOP, any major business decision can have a substantial impact on the value of the ESOP's holdings of company stock. Not surprisingly, the interplay between ESOP administration and management of the company's business often gives rise to litigation that requires courts to determine at what point the company ends, and the ESOP and fiduciary duties begin.

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[191] Howell v. Motorola Inc., 633 F.3d 552, 50 EB Cases (BNA) 1865 (7th Cir. 2011).

[192] *See* Lingis v. Motorola, Inc., 649 F. Supp. 2d 861, 870–74, 47 EB Cases (BNA) 1099 (N.D. Ill. 2009) (applying §404(c) and dismissing plaintiff's disclosure claim); *In re* Electronic Data Sys. Corp. "ERISA" Litig., 224 F.R.D. 613, 624–26, 34 EB Cases (BNA) 2373 (E.D. Tex. 2004) (noting that §404(c) defense applies to disclosure claims; refusing to certify class on that claim because of individual issues raised by defense). *But see* Page v. Impac Mortg. Holdings, Inc., 2009 WL 890722, at *3–4 (C.D. Cal. Mar. 31, 2009) (rejecting the application of §404(c) defense to plaintiffs' disclosure claim).

[193] *See In re* Unisys Savs. Plan Litig., 74 F.3d 420, 445 n.22, 447, 19 EB Cases (BNA) 2393 (3d Cir. 1996).

[194] *In re* Unisys Savs. Plan Litig., 1997 U.S. Dist. LEXIS 19198, at *93 (E.D. Pa. Nov. 24, 1997), *aff'd*, 173 F.3d 145, 22 EB Cases (BNA) 2945 (3d Cir. 1999).

[195] *See Electronic Data Systems*, 224 F.R.D. at 624–26; Wiseman v. First Citizens Bank & Trust Co., 212 F.R.D. 482, 487–88, 29 EB Cases (BNA) 2805 (W.D.N.C. 2003) (class commonality and typicality requirements not met for participant-directed investments in 401(k) plan); *In re* First Am. Corp., 258 F.R.D. 610, (C.D. Cal. 2009) (same); Thomas v. Aris Corp., 219 F.R.D. 338, 340–43 (M.D. Pa. 2003) (detrimental reliance not presumed on ERISA disclosure claims and possibility of §404(c) defense renders each potential class member's claim significantly different from and atypical of each other). *But see In re* Schering-Plough Corp. ERISA Litig., 589 F.3d 585, 48 EB Cases (BNA) 1385 (3d Cir. 2009) (holding that ERISA §404(c) did not negate class certification under FED. R. CIV. P. Rule 23(b)(1), but leaving open for the district court to consider whether §404(c) may negate class certification under FED. R. CIV. P. Rule 23(b)(3)); Stanford v. Foamex L.P., 263 F.R.D. 156, 47 EB Cases (BNA) 2479 (E.D. Pa. 2009) (rejecting §404(c) as a basis for denying class certification); *In re* First Am. Corp., 258 F.R.D. 610, 619 (C.D. Cal. 2009) (same).

[196] *See generally* Donovan v. Cunningham, 716 F.2d 1455, 1458–59, 4 EB Cases (BNA) 2329 (5th Cir. 1983) (discussing purposes and goals of ESOPs).

[197] S. REP. NO. 94-36 (1975), *reprinted in* 1975 U.S.C.C.A.N. 54, 107 (legislative history to Tax Reduction Act of 1975, discussing new tax incentives for ESOP formation, eventually called Tax Credit Act Stock Ownership Plans, or TRASOPs); § 803(h) of Tax Reform Act of `976, Pub. L. 94-555 (same).

An ESOP is permitted to obtain a loan in order to invest in the employer's stock—a powerful technique of corporate finance that allows, for example, a company's founders to "cash out" while gradually transferring ownership of the company to its employees. In a leveraged ESOP, the loan is used to purchase stock, and the company's cash contributions to the ESOP are used to extinguish the loan. An ESOP-owned company that goes bankrupt before the loan is paid off raises issues as to the nature and amount of any damages if the original acquisition was flawed.[198] As the loan is paid off, shares are released from the ESOP's "suspense" account to be allocated to the individual accounts of the ESOP participants.[199]

Unlike an ESOP of a publicly traded company, the ESOP of a closely held company does not have a market to gauge the value of the company's stock. Consequently, the DOL and the Internal Revenue Service (IRS) have set forth guidelines governing the valuation of the stock held by the ESOP. In order for a closely held company offering an ESOP to obtain various tax benefits, the Code requires that the ESOP provide participants the right to sell their shares back to the company for a fair price.[200] A "put option" is the participant's right to redemption; the company's burden to repurchase those shares is called its "repurchase obligation." As a result, an ESOP of a closely held company must at least annually value those shares and forecast the company's financial obligations for the coming year. The method and how often a company chooses to conduct those valuations are typically left up to the ESOP trustee.[201]

A closely held ESOP's acquisition or sale of stock must meet not only the general fiduciary "prudence" standard of ERISA Section 404, but also the prohibited transaction rules of ERISA Section 406,.[202] which prohibits an ESOP from transacting with the company, its officers and directors, and any significant shareholders unless the ESOP pays or receives "adequate consideration" for the stock.[203] For ESOPs of closely held companies, ERISA Section 3(18)(B) defines "adequate consideration" as "the fair market value of the asset as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary [of Labor]." Failure to do this can create a per se violation of the prohibited transaction rules.[204] Much litigation surrounding ESOPs of closely held companies relates to whether "adequate

198 *See* Neil v. Zell, 767 F. Supp. 2d 933 (N.D. Ill. 2011).

199 *See* ABA Section of Labor & Employment Law, Employee Benefits Law, ch. 6, at I (Jeffrey Lewis, Myron D. Rumeld et al. eds., 3d ed. 2011); ERISA Fiduciary Law, ch. 11 (Susan P. Serota & Frederick A. Brodie et al. eds., 2d ed. 2006 & Supp. 2009); *Cunningham*, 716 F.2d at 1459. In *Fox v. Herzog, Heine, Geduld, Inc.*, 2005 U.S. Dist. LEXIS 36414, 36 EB Cases (BNA) 2112 (D.N.J. Dec. 27, 2005), a district court addressed whether the shares held in the suspense account of a leveraged ESOP were vested benefits belonging to the ESOP's participants. After a tender offer was approved by the trustee, the acquiring company decided to merge the ESOP in which the plaintiff was a participant into the acquiring company's ESOP, thereby merging the suspense account shares with those in the acquiring company's account and diluting the number of shares in the suspense account to allocate among the participants of the former company's ESOP. The plaintiffs filed suit under ERISA §§502(a)(2) and 502(a)(3), seeking the monetary value of the shares held in the suspense account of the former ESOP. The district court dismissed the plaintiffs' ERISA §502(a)(2) claims because plaintiffs could not demonstrate a loss to the plan as a whole "rather than to individual beneficiaries or a subclass of beneficiaries." *Id.* at *7. The district court also dismissed the plaintiffs' ERISA §502(a)(3) claims, holding that the plaintiffs had no vested right to the unallocated shares held in the suspense account because "those shares were not [accrued] benefits protected under ERISA." *Id.*

200 26 U.S.C. §409(h)(1)(B).

201 *See* ABA Section of Labor & Employment Law, Employee Benefits Law, ch. 6, at I. (Jeffrey Lewis, et al. eds., 3d ed. 2012); ERISA Fiduciary Law, ch. 11 (Susan P. Serota, Frederick A. Brodie et al. eds., 2d ed. 2006 & Supp. 2009); Donovan v. Cunningham, 716 F.2d 1455, 1459, 4 EB Cases (BNA) 2329 (5th Cir. 1983).

202 *See, e.g.*, *Cunningham*, 716 F.2d at 1463–65.

203 Specifically, ERISA §406(a) prohibits a plan from entering into a transaction with a party in interest regarding the purchase or sale of property. However, given that the very nature of an ESOP of a closely held company is to purchase stock from the company or its few shareholders—often directors or executives of the company—ERISA §408(e) provides an exemption to §406 if the purchase or sale is for "adequate consideration."

204 *See* Neil v. Zell, 753 F. Supp. 2d 744 (N.D. Ill. 2010) (because stock was unregistered it could not be a qualifying employer security).

consideration" was received or paid for the company's stock: in short, whether the stock was properly valued.[205]

A. Valuing the Company's Stock

Litigation arises at all stages of the valuation process:[206] at the inception of the ESOP, for merger purposes, when the ESOP redeems participants' shares, or when it is to be terminated.[207] The very nature of an ESOP for a closely held company entails frequent valuation, acquisition, redemption, and sale of the company's stock.[208] In 1983, in *Donovan v. Cunningham*,[209] the Fifth Circuit issued the first major decision addressing valuation of stock for closely held ESOPs. In *Cunningham*, a closely held corporation created an ESOP to buy out the company's chairman, Cunningham. The ESOP purchased shares from Cunningham in two transactions that took place over the span of seven months and, in both transactions, the ESOP purchased the shares for $200 a share. In the first transaction, the company self-funded it by contributing $288,000 in cash to the ESOP; the second transaction was a leveraged one in which the ESOP borrowed $1 million to fund the share purchase. Although the stated intent was for the ESOP to acquire 100 percent of the company, at the end of these two transactions the ESOP owned 34 percent of the company, whereas Cunningham held the balance of 66 percent.[210]

Prior to formation of the ESOP, the company retained an investment banking firm to value the company's stock. The investment banking firm issued a report valuing the stock at $200 a share based on the assumption that the purchase would be for 100 percent of the company's stock and that the company's revenues would grow at a substantial rate for the indefinite future. The ESOP trustees used this valuation to justify the ESOP's acquisitions of a minority interest from Cunningham 13 and 20 months after the date of the report.[211] The DOL filed suit, alleging that the ESOP fiduciaries committed a prohibited transaction by purchasing stock on behalf of the ESOP for more than "adequate consideration" in violation of Section 406 of ERISA and breached their duty of prudence under Section 404 of ERISA by failing to prudently and independently conduct an investigation as to the fair market value of the shares prior to purchase.[212]

In evaluating whether the shares were purchased for fair market value, the court in *Cunningham* held that ERISA's statutory language and general fiduciary case law required the ESOP fiduciaries to "prove that adequate consideration was paid by showing that they arrived at their determination of fair market value by way of a prudent investigation in the circumstances then prevailing."[213] This investigation would be evaluated in light of the prudence rule set forth in ERISA.[214] The court held that relying on an investment banking report that was created 13 and 20 months prior to the ESOP's purchases did not amount to a prudent investigation.[215] Among other things, this valuation failed to

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[205]*See, e.g.*, Fernandez v. K-M Indus. Holding Co., 585 F. Supp. 2d 1177, 45 EB Cases (BNA) 1680 (N.D. Cal. 2008) (successor trustee may be liable for failing to sue prior trustee who purchased stock at inflated price).

[206]The plaintiff must, of course, have standing to bring the claim. *Cf.* Crawford v. Lamantia, 34 F.3d 28, 32–33, 19 EB Cases (BNA) 1027 (1st Cir. 1994) (participant who cashed out his ESOP holdings no longer had standing; he was unable to show how alleged breach affected benefits he would have received).

[207]*See generally* Norman P. Goldberg & Charles R. Smith, *ESOP Fiduciaries: Decisions and Valuations, in* ERISA FIDUCIARY LAW, ch. 11 (Susan P. Serota, Frederick A. Brodie et al. eds., 2d ed. 2006 & Supp. 2009).

[208]*Cf.* Armstrong v. Amsted, Indus., Inc., 2004 U.S. Dist. LEXIS 14776, at *32–36, 33 EB Cases (BNA) 1385 (N.D. Ill. July 30, 2004) (applying Lockheed Corp. v. Spink, 517 U.S. 882, 20 EB Cases (BNA) 1257 (1996), to conclude that §406 does not apply to valuing repurchase of stock from participants because this is payment of benefits, which is not "transaction" within ambit of §406).

[209]716 F.2d 1455, 1466 & n.22, 4 EB Cases (BNA) 2329 (5th Cir. 1983).

[210]Donovan v. Cunningham, 716 F.2d 1455, 1459–60, 1472, 4 EB Cases (BNA) 2329 (5th Cir. 1983).

[211]*Id.* at 1468–69.

[212]*Id.* at 1460.

[213]*Id.* at 1467–68.

[214]*Id.* at 1467.

[215]*Id.* at 1469–73. The Fifth Circuit did note, however, that "[t]o use an independent appraisal properly, ERISA fiduciaries need not become experts in the valuation of closely-held stock—they are entitled to rely on the expertise of others.

take into account that subsequent revenue and income growth was substantially below projections, that the ESOP did not acquire control of the company, and that the ESOP transaction itself affected the value of the company by increasing compensation costs and by imposing a $1 million obligation on the company to pay off the ESOP loan.[216]

Pursuant to the Fifth Circuit's recommendation in *Cunningham*, the DOL promulgated a proposed regulation in 1988 defining "adequate consideration."[217] (The regulation was never made final.) The DOL stated that the purpose of the regulation was to "provide a framework within which fiduciaries can fulfill their statutory duties."[218] The proposed regulation requires fiduciaries to meet a two-part test for determining whether "adequate consideration" is met: (1) the "value assigned to an asset must reflect its fair market value as determined pursuant to proposed [part (b)(2)]"; and (2) the "value assigned to an asset must be the product of determination made by the fiduciary in good faith as defined in proposed [part (b)(3)]."[219] The DOL then defined fair market value as

> [t]he price at which an asset would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, and both parties are able, as well as willing, to trade and are well-informed about the asset and the market for that asset.[220]

In determining this fair market value, the proposed regulation requires the valuation report to contain

(A) A summary of the qualifications to evaluate assets of the type being valued of the person or persons making the valuation;

(B) A statement of the asset's value, a statement of the methods used in determining that value, and the reasons for the valuation in light of those methods;

(C) A full description of the asset being valued;

(D) The factors taken into account in making the valuation, including any restrictions, understandings, agreements or obligations limiting the use or disposition of the property;

(E) The purpose for which the valuation was made;

(F) The relevance or significance accorded to the valuation methodologies taken into account;

(G) The effective date of the valuation; and

(H) In cases where a valuation report has been prepared, the signature of the person making the valuation and the date the report was signed.[221]

When the valuation is of stock of a nonpublicly traded company (such as in the closely held ESOP context), the valuation report must *also* contain:

However, as the source of the information upon which expert opinions are based, the fiduciaries are responsible for ensuring that that information is complete and up-to-date." *Id*. at 1474.

[216] *Id*. at 1469–73; *cf*. Norman P. Goldberg & Charles R. Smith, *ESOP Fiduciaries: Decisions and Valuations*, *in* ERISA FIDUCIARY LAW ch. 11, at III.A. (Susan P. Serota & Frederick A. Brodie et al. eds., 2d ed. 2006 & Supp. 2009) (discussing rationales for valuing ESOP's acquisition without taking into account impact of ESOP financing).

[217] Prop. 29 C.F.R. §2510.3-18(b), 53 Fed. Reg. 17,632 (May 17, 1988). Although never made final, the DOL's proposed regulation has provided a framework for analyzing whether an ESOP's stock was acquired or sold for "adequate consideration." *Cf*., *e.g*., Montgomery v. Aetna Plywood, Inc., 39 F. Supp. 2d 915, 919 (N.D. Ill. 1998); Norman P. Goldberg & Charles R. Smith, *ESOP Fiduciaries: Decisions and Valuations, in* ERISA FIDUCIARY LAW ch. 11, at III.A. (Susan P. Serota, Frederick A. Brodie et al. eds., 2d ed. 2006 & Supp. 2009).

[218] 53 Fed. Reg. at 17,633.

[219] *Id*.

[220] 53 Fed. Reg. at 17,634. The proposed regulation provided that whether a fiduciary is "well informed" will be a factual determination based on the facts and circumstances of a particular case, including any special knowledge the fiduciary has that could affect the value of the asset at issue. *Id*. n.1.

[221] *Id*. at 17,637–38.

(A) The nature of the business and the history of the enterprise from its inception;

(B) The economic outlook in general, and the condition and outlook of the specific industry in particular;

(C) The book value of the securities and the financial condition of the business;

(D) The earning capacity of the company;

(E) The dividend-paying capacity of the company;

(F) Whether or not the enterprise has goodwill or other intangible value;

(G) The market price of securities of corporations engaged in the same or a similar line of business, which are actively traded in a free and open market, either on an exchange or over-the-counter;

(H) The marketability, or lack thereof, of the securities. Where the plan is the purchaser of securities that are subject to "put" rights and such rights are taken into account in reducing the discount for lack of marketability, such assessment shall include consideration of the extent to which such rights are enforceable, as well as the company's ability to meet its obligations with respect to the "put" rights (taking into account the company's financial strength and liquidity);

(I) Whether or not the seller would be able to obtain a control premium from an unrelated third party with regard to the block of securities being valued, provided that in cases where a control premium is taken into account: (1) Actual control (both in form and in substance) is passed to the purchaser with the sale, or will be passed to the purchaser within a reasonable time pursuant to a binding agreement in effect at the time of the sale, and (2) It is reasonable to assume that the purchaser's control will not be dissipated within a short period of time subsequent to acquisition.[222]

In discussing the second, "good faith" prong of the test, the DOL's proposed regulation provides that the good faith requirement should be evaluated under an objective standard of conduct.[223] In addition, the proposed regulation sets forth two criteria a fiduciary must satisfy to meet the good faith requirement: the fiduciary must (1) "apply sound business principles of evaluation and … conduct a prudent investigation of the circumstances prevailing at the time of the evaluation,"[224] and (2) "be independent of all parties to the transaction (other than the plan) or … rely on the report of an appraiser who is independent of all the parties to the transaction (other than the plan)."[225]

The DOL's proposed regulation and the often conflicted nature of ESOP transactions (which may entail the purchase of shares from fiduciaries or from those who control the fiduciaries) may necessitate an independent valuation report. However, the courts are clear that this "independent appraisal 'is not a magic wand that fiduciaries may simply wave over a transaction to ensure that their responsibilities are fulfilled.'"[226] Rather, the Ninth Circuit, in *Howard v. Shay*,[227] stated that, to rely on such a report, the fiduciary must: "(1) investigate the expert's qualifications, (2) provide complete and accurate information, and (3) make certain the reliance on the expert's advice is reasonably justified under the circumstances."[228] In *Howard*, the ESOP sold its stock to the chairman of the company, who was also an ESOP fiduciary. The ESOP trustees retained Arthur Young, Inc., to conduct the valuation. Arthur Young arrived at the sales price by taking the appraised value of the underlying real estate assets and discounting those values by 60 percent because of only partial ownership of one subsidiary company, another 40 to 50 percent because the ESOP only had minority ownership of the holding

[222] *Id*. at 17,638.
[223] *Id*. at 17,634.
[224] The DOL adapted the Fifth Circuit's language in *Donovan v. Cunningham*, 716 F.2d 1455, 1468, 4 EB Cases (BNA) 2329 (5th Cir. 1983).
[225] 53 Fed. Reg. at 17,634–35. Thereafter, the DOL set forth proposed guidelines for courts to evaluate the independence of either the fiduciary or the appraiser. *Id*. at 17,635, 17,637.
[226] Howard v. Shay, 100 F.3d 1484, 1489–90, 20 EB Cases (BNA) 2097 (9th Cir. 1996) (quoting Donovan v. Cunningham, 716 F.2d 1455, 1474, 4 EB Cases (BNA) 2329 (5th Cir. 1983)).
[227] 100 F.3d 1484, 20 EB Cases (BNA) 2097 (9th Cir. 1996).
[228] *Id*. at 1489.

company, and another 50 percent for lack of liquidity. Thus, stock that had an asset value of $83 was appraised for sale to the chairman at $14.40 a share.[229]

The Ninth Circuit held that the ESOP trustees' acceptance of this valuation constituted a breach of their fiduciary duties under Section 404 and a prohibited transaction under Section 406. The court criticized the ESOP trustees for accepting the valuation price without negotiation and without attempting to test it through a second review or by shopping the stock to third-party buyers. The court also found that the discounts applied were greater than the norms, unsupported by empirical evidence, and not challenged or even questioned by the ESOP trustees.

After the DOL's proposed regulation was issued, the circuits split on whether a defendant must satisfy both the fair-value and the good-faith-investigation requirements. The majority view is that a fiduciary must meet both tests as stated in the Sixth Circuit's opinion in *Chao v. Hall Holding Co*.,[230] where the company established a leveraged ESOP to acquire approximately 10 percent of a subsidiary holding company's stock from the parent company's sole director and owner, Goldman. The ESOP trustees engaged an appraiser to value the operating company's—not the holding company's—stock, and the appraiser repeatedly stated that he was valuing 100 percent of that company, although his appraisal did not purport to value the ESOP's purchase of stock. To arrive at the value paid by the ESOP, the defendant human resource director simply took the midpoint of the appraiser's valuation range and multiplied it by the 9.9 percent of stock to be acquired by the ESOP.[231] The Sixth Circuit had little trouble concluding that the defendants breached their duties to conduct a good faith investigation into the fair value to be paid for the stock, holding that: (1) their reliance on the valuation report was flawed because that report valued the wrong company and did not purport to value the minority stake purchased in a leveraged transaction by the ESOP; and (2) the trustees were unaware of what was going on and did not negotiate the price to be paid for the stock.[232]

The defendants in *Hall Holding Co*. argued that, under the Eighth Circuit's ruling in *Herman v. Mercantile Bank*,[233] they nonetheless should be relieved of liability if they met only the "fair value" test—i.e., under *Mercantile Bank*, an ESOP fiduciary is insulated from liability for failure to conduct a good faith investigation if a hypothetical prudent fiduciary would have paid the same "fair value" price.[234] The Sixth Circuit rejected this argument, noting that the Eighth Circuit was the only court to use this relaxed test and that it believed such a test was contrary to the statutory definition of "adequate consideration" and to the Fifth Circuit's approach in *Donovan v. Cunningham*.[235] The Sixth Circuit also concluded that such a test was inappropriate for a Section 406 prohibited transaction claim, because Section 406 was meant to create per se rules and Section 406, unlike a violation of Section 404, does not require proof that the violation caused harm.[236]

The valuation issue is a major area of contention in the formation, management, and dissolution of closely held ESOPs.[237] Significant cases include:[238]

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[229]*Id*. at 1487.

[230]285 F.3d 415, 27 EB Cases (BNA) 2153 (6th Cir. 2002).

[231]*Hall Holding Co*., 285 F.3d at 420–22.

[232]*Id*. at 430–34.

[233]143 F.3d 419, 21 EB Cases (BNA) 1065 (8th Cir. 1998).

[234]*Mercantile Bank*, 143 F.3d at 421.

[235]*Hall Holding Co*., 285 F.3d at 436–37; *see also* Howard v. Shay, 100 F.3d 1484, 1489, 20 EB Cases (BNA) 2097 (9th Cir. 1996) (applying both fair value and good-faith-investigation tests to ESOP's sale of stock to company chairman).

[236]*Hall Holding Co*., 285 F.3d at 439.

[237]For some cases addressing valuation issues, see McCabe v. Capital Mercury Apparel, 752 F. Supp. 2d 396, 50 EB Cases (BNA) 1230 (S.D.N.Y. 2010) (dismissing fiduciary prudence and loyalty claims and holding usage of year-old valuation was sufficient for establishing fair market value where explicit terms of ESOP dictated valuation method); Keach v. United States Trust Co., 313 F. Supp. 2d 818, 32 EB Cases (BNA) 2398 (C.D. Ill. 2004) (court denied summary judgment on sale of company to ESOP, finding there were questions of fact surrounding whether CEO and Vice Chair sellers breached ERISA fiduciary duties by failing to disclose company's alleged financial problems to experts retained to conduct ESOP valuation); Roth v. Sawyer-Cleator Lumber Co., 16 F.3d 915, 17 EB Cases (BNA) 2556 (8th Cir. 1994) (court reversed summary judgment because question of fact remained whether ESOP trustees' decision to secure put options with security interests in company stock was objectively reasonable and prudent).

No Breach Found

- *Herman v. Mercantile Bank*:[239] The company filed for bankruptcy approximately five years after recapitalization. In the company's recapitalization, the ESOP sold and bought back its shares the next day at the same price; the ESOP's ownership went from 33 to 63 percent because recapitalization resulted in the company undertaking a large loan that was used in part to repurchase non-ESOP shares. The majority concluded that the price paid was within the range of what a hypothetical reasonable and prudent fiduciary would have paid; the dissent argued the substantial debt incurred was used primarily to benefit the non-ESOP seller and impaired the stock's value by placing the company at risk.
- *Foltz v. U.S. News & World Report*:[240] The court held that usage of minority valuation was proper (1) under relevant IRS regulations and (2) because the amount of stock repurchased from retirees was, in fact, a very small amount.
- *Henry v. Champlain Enterprises, Inc.*:[241], The Second Circuit focused on the result that the trustee had negotiated more favorable terms for the plan in the purchase of the stock. On remand from the Second Circuit, the district court concluded that the trustee was entitled to the Section 408(e) exemption, because the ESOP had paid fair market value.

Breach Found

- *Eyler v. Commissioner*:[242] The plaintiff, a majority shareholder and owner of the company, engaged in a prohibited transaction and was subject to excise taxes by the IRS for selling the ESOP his shares at an overvalued price; the valuation was based on a year-old analysis by an investment banking firm, which valued the stock with the idea that the company was going public and not in light of the company creating an ESOP.
- *Horn v. McQueen*:[243] The ESOP fiduciaries breached their fiduciary duties by allowing the ESOP to overpay for shares because the ESOP fiduciaries only conducted one valuation, which they took at face value, and failed to negotiate on behalf of the ESOP over the price of the company stock.
- *Reich v. Valley National Bank of Arizona*:[244] A trustee purchased company stock through a leveraged ESOP created to take the company private. The court held that the ESOP trustee breached duties of loyalty and prudence by failing to conduct a good faith independent investigation into whether it was prudent for the ESOP to purchase company stock when the

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[238] For an example of some of the unusual contexts and arguments that can arise in valuing ESOP stock, see Summers v. State St. Bank, 104 F.3d 105, 107–08, 20 EB Cases (BNA) 2317 (7th Cir. 1997) (as part of substantial wage concessions, ESOP was created giving union employees majority ownership of United Airlines, a public company; plaintiffs' claim that ESOP trustee should have valued wage and benefit concessions in approving deal was rejected because wage and benefits concessions were not plan assets, nor is a trustee to consider effects of deal on employees as employees); Neil v. Zell, 753 F. Supp. 2d 724, 50 EB Cases (BNA) 1294 (N.D. Ill. 2010) (holding defendants committed prohibited transaction where ESOP purchased unregistered shares); Swetic v. Community Nat'l Bank Corp, 2010 WL 2220248, 49 EB Cases (BNA) 2305 (M.D. Fla. June 2, 2010) (dismissing prudent investment claim in relation to privately held ESOP for failure to exhaust administrative remedies); Wilson v. Venture Fin. Grp., Inc., 2010 WL 2028088, 49 EB Cases (BNA) 1167 (W.D. Wash. May 18, 2010) (dismissing prudent investment claim for privately held ESOP because there was no market in which defendants could sell the stock in light of the fact that it was not publicly traded).

[239] 143 F.3d 419, 21 EB Cases (BNA) 1065 (8th Cir. 1998).

[240] 865 F.2d 364, 373–74, 10 EB Cases (BNA) 1689 (D.C. Cir. 1989).

[241] 445 F.3d 610, 37 EB Cases (BNA) 1941 (2d Cir. 2006), *on remand*, 2010 WL 2038841, 49 EB Cases (BNA) 1165 (N.D.N.Y. May 21, 2010).

[242] 88 F.3d 445, 20 EB Cases (BNA) 1552 (7th Cir. 1996).

[243] 215 F. Supp. 2d 867, 28 EB Cases (BNA) 1875 (W.D. Ky. 2002).

[244] 837 F. Supp. 1259, 17 EB Cases (BNA) 1257 (S.D.N.Y. 1993).

decision to go private was related to the company's poor financial condition.

- *Montgomery v. Aetna Plywood, Inc.*:[245] A director/trustee acquired control of a company through an ESOP's sale of stock. The court found a breach in the failure to pay the ESOP a control premium and the failure to factor in benefits to the purchaser of the acquiring stock.
- *Solis v. Webb (Parrot Cellular)*: [246]The DOL sued claiming that ERISA fiduciaries breached their duties in purchasing stock for an ESOP by paying more than adequate consideration for stock of company for which they served as officers and directors. The claim alleged that appraisal of stock's value had significant flaws and inaccuracies that would have been uncovered in thorough and objective review and that among flaws was failure to consider prior valuation or deferred compensation owed to executives. District court held allegations were sufficient to state a claim under ERISA that fiduciaries breached their duties.

B. Separating ESOP Administration From Company Management

This section focuses on cases resolving those where to draw the line between the administration of the ESOP and the management of a closely held company.. For an in-depth discussion of cases addressing whether a fiduciary should sell an ESOP's holding in company stock because of company financial misfortune, see Section V.B, above.

It is well established that a fiduciary can wear two hats, and that ERISA fiduciary duties do not attach to the individual's nonfiduciary role with respect to the company.[247] However, the line between the fiduciary and settlor roles can become blurred with respect to ESOPs when the individuals involved are major owners of closely held companies.

The default rule that settlor functions encompass creating, amending, and terminating the ESOP generally applies, although the unique characteristics of ESOPs as techniques of corporate finance and as means to acquire the company from insiders can blur these lines.[248] It is also fairly well settled that the normal operation of a business does not trigger ERISA's fiduciary duties.[249] However, when the company suffers major financial setbacks, it may not be clear whether a director or officer is acting in a corporate or fiduciary role.

In *Husvar v. Rapoport*,[250] the participants in an ESOP of a nonpublicly traded company filed suit alleging breach of corporate fiduciary duties that resulted in a loss in value for the company's stock., the plaintiffs sued when the corporate executives granted themselves substantial compensation and

[245]39 F. Supp. 2d 915 (N.D. Ill. 1998).

[246] 931 F. Supp. 2d 936 (N.D. Cal. 2012)

[247]*See, e.g.*, Lockheed Corp. v. Spink, 517 U.S. 882, 20 EB Cases (BNA) 1257 (1996); Akers v. Palmer, 71 F.3d 226, 230–31, 19 EB Cases (BNA) 2351 (6th Cir. 1995); Husvar v. Rapoport, 337 F.3d 603, 30 EB Cases (BNA) 2525 (6th Cir. 2003); Kuper v. Iovenko, 66 F.3d 1447, 1456, 19 EB Cases (BNA) 1969 (6th Cir. 1995).

[248]*See* Akers v. Palmer, 71 F.3d 226, 230–31, 19 EB Cases (BNA) 2351 (6th Cir. 1995) (creation and funding of ESOP are settlor acts); *Kuper*, 66 F.3d at 1456 (applying to trust-to-trust transfer of ESOP assets rule that "purely business decisions by an ERISA employer are not governed by [§404's] fiduciary standards"); *cf.* Eaves v. Penn, 587 F.2d 453, 457–59, 1 EB Cases (BNA) 1592 (10th Cir. 1978) (in conversion of plan assets into ESOP, court held that person who benefited from ESOP conversion by using it to take over company with no cash outlay and who was involved in recommending and designing ESOP was a fiduciary; court held fiduciary status attached because he received "indirect" compensation for his investment advice regarding disposition of preexisting plan assets through ESOP conversion); Dairy Fresh Corp. v. Poole, 108 F. Supp. 2d 1344, 1359–60 (S.D. Ala. 2000) (company owned by ESOP sought reformation of ESOP that would have reduced ESOP's ownership from 88% to 44%, thereby transferring majority ownership to company's directors; court held company as plan administrator breached its fiduciary duties of loyalty and prudence by seeking this reformation).

[249]*E.g.*, Martin v. Feilen, 965 F.2d 660, 666, 15 EB Cases (BNA) 1545 (8th Cir. 1992) (noting "virtually all of an employer's significant business decisions affect the *value* of its stock …. ERISA fiduciary duties only attach when an individual invests the ESOP's assets or administers the plan"); Peck v. Chopp, 2010 WL 2472757, 49 EB Cases (BNA) 2489 (W.D. Mich. June 14, 2010) (holding that defendants' decision to sell company and the process by which it executes the sale are business, not fiduciary, actions).

[250]337 F.3d 603, 30 EB Cases (BNA) 2525 (6th Cir. 2003).

bonuses even though the company was not doing well financially. The defendants tried to remove the case, contending that the plaintiffs were suing for violations of ERISA fiduciary duties.[251] The Sixth Circuit remanded the case becauase the plaintiffs were essentially alleging that the executives' decisions to award themselves salaries and bonuses breach their *corporate* fiduciary duties. The court reasoned that although mismanagement of a business would affect the value of the ESOP's investments, such mismanagement does not implicate the protections afforded by ERISA. The court distinguished between allegations regarding mismanagement of the ESOP fund versus those claiming that the company was mismanaged, holding that only the former stated claims for breach of ERISA fiduciary duties.[252]

The same conduct and common nucleus of operative facts can expose the defendant to two potential sources of liability.[253] For example, in *Eckelkamp v. Beste*,[254] the participants in an extraordinarily successful ESOP sued the company's officers and owners for alleged excessive compensation. Participants in the ESOP with at least one year of service had an average ESOP account balance of $350,000; they earned an average of 125 percent in cash compensation as compared to those in comparable industries; and the company itself was wildly successful, earning an average annual 20 percent rate of return on its ESOP stock between 1985 and 2000.[255] The Eighth Circuit held that the plaintiffs failed to establish the ERISA claim for breach of fiduciary duties because the compensation methodology of the plaintiffs' expert was fundamentally flawed, i.e., it failed to factor in that *all* employees at the company were paid above market and that much of the executives' compensation was tied to bonuses earned because of the company's substantial, sustained business growth and financial success.[256]

Defendants do not win all ESOP cases pursuing corporate mismanagement claims under ERISA however. In a case that now stands as a precursor for the *Enron* and *WorldCom* ERISA lawsuits[257]—*Canale v. Yegen*[258]—the plaintiffs used a derivative suit/need-to-act theory to impose ERISA fiduciary duties on corporate officers regarding corporate fraud and mismanagement.[259] The defendants' actions in light of their knowledge of their own misconduct and of its deleterious effect on the ESOP's holdings violated their ERISA fiduciary duties.:.

The *Canale* court also concluded that the defendants' knowledge of their fraud triggered a duty under ERISA to bring a derivative lawsuit on behalf of the ESOP as a shareholder, even if that lawsuit would have required them to sue themselves in their corporate capacities.[260] In *Community Bancshares v. Patterson*,[261] a district court followed the rationale enunciated in *Canale* and held that an ESOP fiduciary breached his fiduciary duty by not informing other ESOP fiduciaries of his fraud while

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[251] *Husvar*, 337 F.3d at 605–06.

[252] *Id*. at 608–09.

[253] For some other examples of this dynamic, compare *Ervast v. Flexible Products Co*., 346 F.3d 1007, 1014–17, 31 EB Cases (BNA) 1321 (11th Cir. 2003) (concluding no complete ERISA preemption applied to claim company should have disclosed impending merger before plaintiff tendered his ESOP shares), with, e.g., *Sweeney v. Kroger Co*., 773 F. Supp. 1266, 1269, 14 EB Cases (BNA) 2057 (E.D. Mo. 1991) (treating as ERISA fiduciary claim contention that employer should have informed participants who cashed out their plan stock that group had expressed interest in buying company).

[254] 315 F.3d 863, 29 EB Cases (BNA) 1993 (8th Cir. 2002).

[255] *Eckelkamp*, 315 F.3d at 866.

[256] *Id*. at 868.

[257] *In re* Enron Corp. Secs., Derivative & "ERISA" Litig. (Tittle v. Enron Corp.), 284 F. Supp. 2d 511, 31 EB Cases (BNA) 2281 (S.D. Tex. 2003); *In re* WorldCom, Inc. ERISA Litig., 263 F. Supp. 2d 745, 30 EB Cases (BNA) 2035 (S.D.N.Y. 2003).

[258] 782 F. Supp. 963, 14 EB Cases (BNA) 2653 (D.N.J. 1992).

[259] The theory that fiduciaries breach their ERISA fiduciary duties by not bringing lawsuits or by otherwise failing to act when they allegedly know of corporate fraud has been applied to 401(k) plan investments in publicly traded companies. *See In re Enron Corp*., 284 F. Supp. 2d at 565–67 (applying same to allegations of massive fraud regarding Enron).

[260] *Id*. at 968 n.3.

[261] 547 F. Supp. 2d 1230, 44 EB Cases (BNA) 1241 (N.D. Ala. 2008).

serving as an ESOP fiduciary and CEO of the company.[262]

In *Martin v. Feilen*[263] the DOL challenged an accountant's and a director and owner's involvement in numerous complicated corporate transactions related to the Feilen Meat Company, which was partially owned by an ESOP. The DOL argued that the defendants' self-interest in the transactions itself constituted breaches of their fiduciary duties, and that any transaction that affected the value of the stock owned by the ESOP implicated fiduciary duties because of that impact. The Eighth Circuit in *Feilen* concluded that Congress specifically permitted the conflict, holding that "the ESOP fiduciary is not prohibited from being on both sides of a transaction involving the ESOP's assets, but he must serve both masters (or at least the ESOP) with the utmost care and fairness."[264] The Eight Circuit held that court also rejected the DOL's arguments regarding the scope of ERISA fiduciary duties related to an ESOP, reasoning that "[v]irtually all of an employer's significant business decisions affect the *value* of its stock. … However "ERISA's fiduciary duties under [Section 404] attach only to transactions that involve investing the ESOP's assets or administering the plan."[265] The court concluded that ERISA fiduciary duties applied and were breached (1) when the defendants manipulated the price of and issuance of dividends from the company's stock in relation to the ESOP's sale of the stock, and (2) when the fiduciaries failed to bring a derivative lawsuit on behalf of the ESOP challenging their misappropriation of a corporate opportunity.[266]

In *Johnson v. Couturier*,[267] the participants in the Noll Manufacturing Corp. ESOP brought suit against the former president and two other directors, who served as ESOP trustees, for breaching their fiduciary duties under ERISA by awarding $34.8 million (approximately two-thirds of the company's value) to the former president, Couturier, in a buyout compensation package.[268] Under various indemnification agreements, the defendants sought advancement of their defense costs from the company that was wholly owned by the ESOP.[269]

The plaintiffs challenged the defendants' request for payment of their defense costs. The Ninth Circuit rejected the defendants' contention that determining Couturier's compensation was a business decision not subject to ERISA.[270] The court observed that although corporate pay decisions were typically not subject to ERISA scrutiny, where, as here, an ESOP fiduciary also serves as a corporate director or officer, imposing ERISA fiduciary duties on business decisions involving self-dealing with ERISA fiduciaries was needed to protect the ESOP.[271] As to the enjoinment of the payment of defense costs, the court stated that the plaintiffs were likely to succeed in proving that the defendants had breached their fiduciary duties by approving Couturier's buyout package of $34.8 million (approximately 65% of the company's total assets as of June 2004).[272] Tthe court noted that the DOL regulation permits indemnification of fiduciaries by the company but not the plan,[273] and held that since assets were being held in escrow to distribute to participants, payment of any defense costs from these assets would be "tantamount" to the plan paying these costs. Accordingly, the court held that

[262] *Patterson*, 547 F. Supp. 2d 1230. *But see* Blankenship v. Chamberlain, 2009 WL 1421201, at *2–3 (E.D. Mo. May 20, 2009) (dismissing plaintiffs' breach of fiduciary duty claims because plaintiffs failed to allege that Chamberlain was acting in a fiduciary capacity when he made the allegedly injurious decisions).

[263] 965 F.2d 660, 15 EB Cases (BNA) 1545 (8th Cir. 1992).

[265] *Id*. at 666 (emphasis added).

[266] *Id*. at 666–67.

[267] 572 F.3d 1067, 47 EB Cases (BNA) 1449 (9th Cir. 2009).

[268] *Johnson*, 572 F.3d at 1072–75.

[269] *Id*.

[270] *Id*. at 1076–77.

[271] *Id*.

[273] *See* 29 C.F.R. §2509.74-4 (DOL regulation on fiduciary indemnification permitting employer, but not the plan, to satisfy any liability incurred by a fiduciary for a fiduciary breach).

ERISA preempted state contract law that would permit the advancement of these costs.[274] When the company is an on-going concern, however, courts permit the company, even if it is ESOP-owned, to provide indemnification to ESOP fiduciaries.[275]

In *Armstrong v. LaSalle Bank National Ass'n*[276] illustrates how major corporate events involving no allegations of fraud or self-dealing can nonetheless create potential duties to act on the part of ESOP fiduciaries. In *Armstrong*, a large closely held company owned by an ESOP acquired another large company, which required Amsted Industries to incur $1 billion in debt. During this same period, the rise in the value of the company's stock resulted in substantial distribution requests, as employees cashed out their ESOP holdings by leaving the company in record numbers. In response, the company amended the ESOP to reduce the company's repurchase obligations by requiring those who did not meet certain criteria to wait five years before their ESOP stock could be cashed out.[277]

The Seventh Circuit, conceding that Congress explicitly exempted ESOP fiduciaries from the duty to diversify, held that exemption justified a heightened standard of prudence.[278] The court held that a trustee's valuation of the ESOP stock is entitled to "abuse of discretion review" when the trustee is balancing the interests of current ESOP participants against those participants who want to leave.[279] The court chided the trustee for failing to take into account the potential liquidity problems that the company would face if there were a run in redemptions following the acquisition of another company.[280] The court suggested that the trustee could have lessened the risk by lowering the redemption price.

C. Control of the Closely Held Company and of the ESOP

Closely held companies owned by ESOPs rarely qualify as models of corporate governance in a post–Sarbanes-Oxley Act world. The typical structure is that the company's directors appoint the ESOP fiduciaries, who may be either themselves or the officers of the company, who then vote the ESOP's shares to reappoint the directors. For all ESOPs, the fiduciaries are charged with fiduciary duties to vote the shares prudently, although this duty may be somewhat lessened by "mirror voting" provisions, which provide that the unallocated shares of the ESOP shall be voted in the same proportion as those voted by the holders of allocated shares.[281] For closely held ESOPs, however, unless the ESOP plan provides otherwise or the ESOP shares were acquired through a loan qualifying for certain tax benefits, even those participants who have shares allocated to their account cannot vote those shares in director elections or other routine corporate matters. They can only vote in "major

[274]*Johnson*, 572 F.3d at 1078–82; *see also* Fernandez v. K-M Indus. Holding Co., 646 F. Supp. 2d 1150, 48 EB Cases (BNA) 1301 (N.D. Cal. 2009) (denying cross claim for indemnification).

[275] *See, e.g.*, Harris v. GreatBanc Trust Co., 2013 WL 1136558 (C.D. Cal. Mar. 15, 2013).

[276]446 F.3d 728, 37 EB Cases (BNA) 2256 (7th Cir. 2006).

[277]*Armstrong*, 446 F.3d at 730–31.

[278]*Id*.

[279]*Id*. at 733.

[280]*Id*. at 733–34.

[281]In *Herman v. NationsBank Trust Co*., 126 F.3d 1354, 21 EB Cases (BNA) 2061 (11th Cir. 1997), the DOL sued Polaroid's ESOP trustee, alleging that the trustee breached its fiduciary duty of prudence by failing to exercise its independent judgment with respect to competing tender offers to purchase the ESOP's shares. Polaroid created the ESOP to defeat hostile takeovers. In creating the ESOP, the plan provided for pass-through voting and mirror voting, wherein the unallocated shares in the ESOP would be voted in proportion to the voting of those shares that are allocated. *Id*. at 1357–58. Between 1988 and 1989, two competing tender offers were made with respect to the purchase of Polaroid shares, one from Shamrock and one from Polaroid. The ESOP trustee mailed out a description of the offers, along with instructions as to voting the allocated shares held in the ESOP. *Id*. at 1358. In the end, the ESOP trustee tendered the ESOP shares in accordance with the plan documents and the instructions from the plan participants, the majority of whom elected to tender their shares to Polaroid. *Id*. at 1359. The Eleventh Circuit held that the ESOP's mirror voting provisions were facially valid under ERISA, but that a question of fact remained as to whether the ESOP trustee acted prudently in following those plan terms. *Id*. at 1368–69. For discussion of litigation relating to the use and voting of ESOP shares in the hostile takeover context, see ERISA FIDUCIARY LAW, ch. 1, at VIII.A (Susan P. Serota, Frederick A. Brodie et al. eds., 2d ed. 2006). For more on the topic of ESOPs generally, see ERISA FIDUCIARY LAW, ch. 11 (Serota & Brodie et al. eds., Supp. 2009).

corporate transactions," defined to include any corporate merger or consolidation, recapitalization, liquidation, dissolution, and the sale of all or substantially all assets of the business.[282]

Thus, the corporate governance structure in the closely held ESOP context is often very insular, with the directors having ultimate control over both the company and, through their appointment power, arguably the ESOP. ESOP participants have tried to use ERISA fiduciary duties as a means to upend who controls the ESOP, but to date they have had only limited success.[283] In *Grindstaff v. Green*,[284] the union and participants sued the company's directors and ESOP trustees, claiming that they breached ERISA fiduciary duties by continually reelecting the directors and by failing to amend the ESOP to provide for "pass through" voting rights so that the ESOP participants could vote for the directors.[285]

The Sixth Circuit concluded that these allegations failed to state a claim. The court noted that management entrenchment, as a result fo the ESOP trustees repeated reelection of incumbent directors, is the norm in the ESOP context, a matter of which Congress was fully aware when it authorized ESOP trustees to be able to act as and be appointed by corporate management. The court held that the voting of the ESOP shares in normal board elections did not constitute the management of plan assets, and thus was not subject to an ERISA fiduciary duty to act solely in the interest of the ESOP participants.

The Sixth Circuit distinguished two district court cases that suggested otherwise as involving special circumstances not present in the "normal, uncontested 'course of affairs' annual elections" of company directors.[286] The court also easily rejected the notion the fiduciaries had any duty to amend the plan to provide for "pass through" voting rights, noting that plan amendment is a settlor function and that this pass-through voting issue was part of the give and take in collective bargaining, which does not implicate ERISA fiduciary duties.[287]

[282]*See* ABA SECTION OF LABOR & EMPLOYMENT LAW, EMPLOYEE BENEFITS LAW, ch. 6, at I.A.3. (Jeffrey Lewis, et al. eds., 3d ed. 2012).

[283]Litigants have also attempted to use ERISA's fiduciary duties and ERISA's reporting and disclosure provisions to attempt to gain access to information regarding the management of the ESOP and of the company, again with limited success. *See* Brown v. American Life Holdings, Inc., 190 F.3d 856, 861–62, 23 EB Cases (BNA) 1985 (8th Cir. 1999) (holding ESOP fiduciaries did not breach their duties by failing to provide to ESOP participants various documents relating to committees, including documents concerning removal and appointment of ESOP committee members); Faircloth v. Lundy Packing Co., 91 F.3d 648, 655, 20 EB Cases (BNA) 2493 (4th Cir. 1996) (same; ESOP fiduciaries did not breach their duties to provide participants with documents relating to appraisal reports valuing ESOP stock and minutes of ESOP committee meetings, but were entitled to ESOP's funding and investment policies).

[284]133 F.3d 416, 21 EB Cases (BNA) 2249 (6th Cir. 1998).

[285]*Grindstaff*, 133 F.3d at 418–20.

[286]*Id*. at 421–25.

[287]*Id*. at 425.