Farewell to Company Stock, or Not?

In this PIMCO DC Dialogue, we speak with Jamie Fleckner about defined contribution litigation and the potential effect of the recent Supreme Court decision in *Fifth Third Bancorp v. Dudenhoeffer* on offering company stock to defined contribution plan participants. Jamie suggests that the risk to plan sponsors of offering company stock may be slightly higher given the Court’s rejection of the presumption of prudence. He explains that simply “hardwiring” company stock into a DC plan document and then following the document without more process will not be sufficient. Rather, the duty of prudence trumps the plan document; in other words, plan fiduciaries must continue to evaluate whether company stock is appropriate for their participants. Fleckner provides suggestions for plan sponsors who are obligated to retain company stock, as well as for those who decide to divest of the stock. Fleckner also comments on fee litigation and shares his view that index management does not appreciably decrease fiduciary risk, nor does active management necessarily increase risk. Finally, he shares his views on whether plan sponsors are protected when they take or fail to take a consultant’s advice.
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**DCD**: Can you speak to defined contribution litigation specifically?

**Fleckner**: Defined contribution is certainly one of the most significant and growing areas of ERISA litigation. With the trillions of dollars invested in DC plans, this growth should not be surprising. The prolific bank robber Willie Sutton once reputedly replied to a reporter’s inquiry as to why he robbed banks by saying, “because that’s where the money is.” That holds true for plaintiff lawyers, who are often paid a handsome percentage of DC settlements.

Plan sponsors may be sued for one of two reasons: they have actually made an error that exposed their participants, or second, they simply have large plans and perceived deep pockets, making them a target for class-action lawsuits. In the latter case, the plan sponsors are often smart, sophisticated people at large corporations who have worked to do everything right.

We’ve seen cases begin with plaintiff attorneys advertising on a wide array of media, including recently on LinkedIn. They reach out to people with LinkedIn profiles that indicate employment with a specific company. The employee or former employee gets a pop-up ad saying, essentially, “If you participated in this company’s 401(k) plan, click here.” Then they see “We think you should join this class-action lawsuit.” These lawyers are very opportunistic and often are the ones driving these cases. As long as our system allows for spurious class-action lawsuits, we need to help protect plan sponsors from becoming targets or to defend them in the event they do.

**DCD**: What types of DC lawsuits are you seeing?

**Fleckner**: There are two primary DC litigation areas: first, cases involving company stock, which often relate to a drop in the stock price – thus, referred to as “stock-drop” cases. Notably, *Fifth Third Bancorp v. Dudenhoeffer* is the first Supreme Court case to consider a DC stock-drop case. It’s also the first time the Supreme Court has considered the issue of investment prudence. Since the tech bubble in 2000, we have seen hundreds of stock-drop cases.

Over the last six or seven years, we’re seeing a second category of lawsuits involving fees. For instance, plaintiffs may allege a fund share class was inappropriate for a plan, revenue sharing was excessive, the plan overpaid for services, or fees were inequitably shared across participants.

**DCD**: What would you suggest plan sponsors do to help protect against lawsuits?

**Fleckner**: Plan sponsors should understand and fulfill their fiduciary duties. These include the duties of loyalty, prudence, diversification, and fidelity to plan documents. Loyalty focuses plan sponsors on doing what is in the best interest of participants, rather than on what may be of value to themselves or...
their company. We’ve seen this duty raised in cases that have alleged that the plan fiduciaries cared more about saving money for the company than they did about doing what was right for the participants.

The duty of prudence also is central to many lawsuits, including the recent Supreme Court case. Sponsors can help their chances in litigation if they can demonstrate they had a thoughtful process as they made decisions for the plan. The courts often focus on process, even though the outcome is important, too. It is key to document the decisions made and the process used.

There’s also the duty of diversification, intended to help reduce the risk of losses. Plan sponsors are guided by section 404(c) in offering at least three diversified investment choices within the plan. And, of course, there is the duty to follow plan documents.

ERISA litigation may go after the alleged failure to meet any of these fiduciary duties or to challenge technical violations of ERISA’s prohibited transaction rules. Unlike defined benefit plans, where the company bears the cost in the event of an error or misjudgment, in DC plans the participants bear the upside and downside risk. That’s a primary reason why we see few DB lawsuits and many DC cases. Also, since many of these fiduciary duties are left to interpretation or to the particular facts and circumstances of a given case, unfortunately this area exposes plan sponsors to litigation risk.

Lawsuits begin with discovery, which may require a plan sponsor to hand over all of their records, including emails. It’s a pretty invasive and burdensome process, and you see a lot of cases settled while in discovery, because sponsors may want to avoid those kinds of discovery burdens. As a practical matter, many plan sponsors will settle even if they have done nothing wrong.

**DCD:** Can you talk about the stock-drop lawsuits?

**Fleckner:** Company stock litigation started about a dozen or so years ago when the tech bubble burst. Enron was the poster child. As Enron crumbled, the company’s DC participants who were invested in Enron stock lost both their employment and much of their DC plan account values. At the time, companies were allowed to match employee contributions in company stock and then restrict the ability of participants to move out of the company stock. Losses in this case prompted a change in the law, which no longer allows restrictions in allocating away from company stock. Companies still can match in stock, but they cannot force participants to keep the match in this investment option. While this specific issue has been addressed, we continue to see company stock-drop cases where there is a significant decline in the value of the stock.
Claims in these cases often include allegedly imprudent selection and maintenance of a sponsor stock fund on a 401(k) lineup, improper monitoring of other fiduciaries and investment options, and concealment or misrepresentation of material facts. Again, the primary target for these suits has been the largest plans with the greatest amount of assets.

**DCD:** Can you tell us about the allegations in the *Fifth Third Bancorp v. Dudenhoeffer* Supreme Court case?

**Fleckner:** *Dudenhoeffer* involves the Fifth Third’s 401(k) plan that it made available for its own employees. It’s a pretty typical large employer 401(k) plan offering about 20 investment choices ranging from capital preservation to equity funds. The plan also offered an employee stock ownership plan (ESOP) within the 401(k) plan to allow participants to invest in the company stock. The plan documents “hardwired” the availability of company stock, meaning they mandated that the ESOP be one of the available 401(k) investments. By hardwiring the ESOP, plan fiduciaries were simply implementing the plan as written when they made the ESOP available.

When the last market crash hit in 2008 to 2009, Fifth Third as a financial services company had exposure to subprime markets, and its stock experienced a 74% decline between July 2007 and September 2009. This loss prompted a class-action lawsuit. Stock-drop cases are commonly brought as class actions because a broad base of participants assert that they are similarly situated by experiencing the same percentage loss. Alleged damages in the class-action suits can reach up into the hundreds of millions of dollars. By comparison, an individual participant’s loss is less likely to reach the courts.

Fifth Third, like other companies, made its matching contribution in Fifth Third stock. Now, while the stock was fully transferable, as folks in this business know, inertia sets in. When participants receive matching contributions in company stock, they oftentimes just leave it there. So, you get a lot of assets building up in the company stock fund.

The plaintiffs’ lawyers argued that Fifth Third and other fiduciary defendants acted imprudently by continuing to make contributions to, and allowing participants to invest in, company stock when many of the plan fiduciaries were insiders who allegedly were aware of the company practices that they claimed had caused the drop in value of the stock price. The complaint alleged that fiduciaries should have (1) halted purchases and divested the plan of Fifth Third stock and/or (2) disclosed to participants complete and accurate information about the risks associated with ongoing investments in Fifth Third stock, including the company’s exposure to subprime investments. Those were the primary allegations.

Stock-drop cases are commonly brought as class actions because a broad base of participants assert that they are similarly situated by experiencing the same percentage loss. Alleged damages in the class-action suits can reach up into the hundreds of millions of dollars.
DCD: How did the lower courts rule on the allegations?

Fleckner: The trial court dismissed all claims, applying what was known as a “presumption of prudence.” This presumption applied where a plan document mandated a company’s stock – when it is “hardwired” into the plan. In such a case, the courts would presume it was prudent to follow the plan document (and would correspondingly dismiss claims about continued holding of stock) unless there was a “precipitous decline” in stock price or the plan sponsor had knowledge of the employer’s “impending collapse.” In another stock-drop case, *Kirschbaum v. Reliant Energy, Inc.*, 526 F.3d 243 (5th Cir. 2008), the court explained that the presumption “was established [to] prevent a trustee from sitting on a ‘razor’s edge’ where he must choose between acting prudently and violating the goals of the plan.”

Over the years that this presumption of prudence had been used, the courts were basically saying, “Look – we can’t hold fiduciaries liable anytime the stock price goes down in company stock.” They recognized that, as an undiversified fund, company stock funds were acutely subject to these kinds of risks. And rather than allowing fiduciaries to be sued anytime the stock goes down, particularly where the holding of the stock was mandated by the plan document, the courts developed some protections. So, the courts had developed the presumption of prudence that basically said that if a plan document required the holding of company stock and the fiduciaries did that, then, unless a plaintiff made a special showing of a precipitous decline of the stock or the impending collapse of the company, the fiduciaries could not be liable for breaching ERISA’s duties.

Given the widespread adoption by lower courts of this presumption of prudence, plan sponsors who wanted to use company stock for their plans had increasingly “hardwired” company stock into their plan documents. However, when *Dudenhoeffer* reached the Supreme Court, the “presumption of prudence” was questioned and thrown out.

DCD: Tells us more about the Supreme Court decision regarding the presumption of prudence and the *Fifth Third v. Dudenhoeffer* decision.

Fleckner: The Supreme Court unanimously rejected the presumption of prudence that had been adopted by every intermediate court to have looked at the issue. Seven of the 13 intermediate appellate courts in this country had addressed this issue, and all said there should be a presumption of prudence. The Supreme Court disagreed with all of them and wrote that “[T]he duty of prudence trumps the instructions of a plan document….” With this pronouncement, they held that the case may continue for a “careful, context-sensitive scrutiny of [the] complaint’s allegations.”
The Supreme Court provided some guidance for future stock-drop suits and made sure to say that their decision was not intended to allow meritless claims to proceed. First they addressed public information, saying “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.” This may be helpful to plan sponsors who continue to offer company stock, because a plaintiff cannot maintain a suit if his or her only allegations are deemed to be implausible.

The Supreme Court also addressed inside information, commenting, “A plaintiff must plausibly allege an alternative action that the defendant could have taken that [i] would have been consistent with the securities laws and [ii] that a prudent fiduciary in the same circumstances would not have viewed as more likely to harm the fund than to help it.”

It’s hard to say how the Supreme Court’s broad pronouncements will play out in the lower courts. It’s up to the lower-court judges now to figure out how to apply the ruling.

**DCD:** How might plan sponsors be affected by the Supreme Court decision? What actions might plan sponsors take in reaction to this case?

**Fleckner:** It is difficult to say, but some plan sponsors might move away from offering company stock in their DC plans. It’s important to note, however, that the Supreme Court did not rule against holding company stock. The Court also did not necessarily make it easier for plaintiffs to sue over company stock or any other investment mandated by a plan document. Yet, I believe that from a litigation perspective, plan sponsors are neutrally to slightly less protected than in the past, at least in the short run when there is uncertainty about how the Dudenhoeffer decision will play out. Plan sponsors will no longer be able to simply hardwire company stock into the plan document and expect a stock drop suit to automatically be dismissed prior to discovery. It might ultimately be harder to have a suit thrown out at the initial phases of litigation.

Until the uncertainty plays itself out (if it ever does), I would expect plaintiffs’ lawyers to bring more stock-drop cases, especially when we see the stock market decline. When the stock market is rising, fewer people are likely to sue, as fewer people have suffered any harm.
The Plan Sponsor Council of America (PSCA) reports that as of year-end 2012, 18% of DC plans allow company stock as an investment option for both participant and company contributions. I don’t expect the percentage to drop to zero, but it could go down. However, all of the corporate pressures that led to offering company stock in the past still exist. Plus, there are a lot of C-suite executives who simply believe stock should be in their plans, which is why many sponsors do hardwire the stock in the first place.

For those companies that retain stock, you may see fewer matching in company stock (about 30% do so as of 2012) and more companies limiting the amount that can be invested in stock (30% of companies place such limits, per the PSCA survey).

**DCD:** How can plan sponsors who want to continue offering company stock minimize litigation risk?

**Fleckner:** In my opinion, the best litigation defense is having a documented, conscientious process for evaluating company stock. Process is an important defense for fiduciaries. Documentation should reflect the deliberation and process followed by the fiduciaries in making a decision about company stock. As we discussed before, courts often say that prudence in a large part is process. With the Supreme Court saying that prudence trumps the plan document, a plan sponsor would not have a complete defense to a stock-drop suit in saying that “I just followed what the plan said.”

Companies may also want to consider hiring an independent fiduciary to oversee the ongoing evaluation of the stock and its appropriateness for the plan. Unlike other investment options in the plan, company stock has no obvious benchmark. Hiring an independent fiduciary allows a disinterested professional to evaluate the stock, and it eliminates the concern with inside information. If a fiduciary who uses an independent fiduciary does end up in court, the fiduciary can say to the judge, “Look what we did to try to protect the participant and to make sure we didn’t place corporate interests ahead of participants’.” That alone has real value in one of these cases.

At the same time, courts have also said that a plan sponsor who has some fiduciary responsibility under a plan document cannot fully offload its responsibility by hiring an independent fiduciary. Such a sponsor probably still needs to evaluate, hire and monitor the independent fiduciary’s work. Also, the company, as opposed to the plan, often bears the cost of retaining an independent fiduciary. While you could have their fees passed on to the plan, companies typically cover the cost.
Before a stock fund is eliminated, it would be wise for the plan sponsor in a non-fiduciary capacity (a settlor function) to amend the plan document to prohibit the offering of non-diversified investments. Companies also may try to remove any company insiders from the plan fiduciary committee to reduce any perceived conflicts of interest. This has happened in some cases already, even before Dudenhoeffer. Plan sponsors will often bring in midlevel human resources professionals who do not have access to inside information. With that said, plans of many large companies may be holding hundreds of millions of dollars in employer stock, and billions of dollars of investments overall, and those sponsors might not be comfortable assigning decision-making to anyone but the highest-ranking corporate officers.

DCD: How can plan sponsors who decide to eliminate company stock from their plan do so with minimal litigation risk?

Fleckner: Once company stock is on the plan menu, removal can itself raise tricky issues. Removal requires special care. We have seen stock-drop cases alleging that the plan sponsor forced the participants to sell and forced them to lock in losses, claiming that the participants were robbed of a future increase in the stock’s price. Plaintiffs basically said, “Wait a second. You sold out at the bottom and you didn’t allow us to take advantage of the upside.”

Before a stock fund is eliminated, it would be wise for the plan sponsor in a non-fiduciary capacity (a settlor function) to amend the plan document to prohibit the offering of non-diversified investments. In addition, the plan fiduciaries should discuss and document prudent ways to divest of the stock; they should write down why they decided on a particular approach. It may be helpful for the committee to bring in a third party, such as a consultant, to present unbiased analysis of the alternative approaches.

Thinking through participant communication and operations is important. Plan fiduciaries should document their concern with the undiversified security risk and consider ways to help participants minimize the risk of selling out of the stock. For instance, they may want to allow participants to automatically sell small percentages of the stock over time (in essence, to dollar-cost-average out of the stock).

DCD: You mentioned a second area of lawsuits that relates to plan fees. Can you tell us more about the types of fee lawsuits you are seeing?

Fleckner: We have seen a range of suits in this area. There have been cases alleging that participants should have been placed in lower-priced share classes. Other suits concern revenue sharing and how that is used to help offset plan-related expenses. In one instance, we saw allegations that DC plan revenues were used to subsidize non-DC plan services. We have seen suits charging generally that the fees paid for recordkeeping or other services are excessive relative to the market. Another issue has been how fees have been paid by participants.
**DCD:** Are there suggestions that you would make to minimize the risk of fee litigation?

**Fleckner:** Again, I would suggest that plan sponsors have a process to review fees and document both the process and the work done. That gives the fiduciary something to point to if their plan is challenged. In defending a fiduciary in such a suit, we try to show that the fees are *reasonable* – not the *lowest* – for the value of the services delivered. With that said, there is often a challenge if the plan fiduciaries had not looked at the lowest investment cost given a plan’s scale. This doesn’t mean that every plan needs to have the lowest cost for an asset class, but rather, if there is a challenge, plaintiffs will make a point if the plan has not used the lowest cost for the investment manager selected. For instance, instead of an A share, there may be an R share or possibly a separately managed account structure that the plan qualifies to use and that offers a lower cost.

Plaintiffs also challenge recordkeeping costs and how those costs are covered by the plan, so plan sponsors should be mindful of those as well. Plaintiffs argue that some plans have moved away from any revenue sharing funds and use a per participant fee for administration. In addition, they argue that others share revenue directly to participants, so you do not have participants with large balances paying a significantly disproportionate percentage of the plan costs.

Given that there are a number of ways to handle administrative expenses, we believe fiduciaries are best protected if they have considered the issue and documented their reasons for choosing the arrangement that they view as best for their plan and participants. One way to potentially protect against this type of claim is if a plan sponsor pays the recordkeeping cost, which reduces the risk of conflict.

**DCD:** Are plan sponsors potentially safer if they use low-cost index management rather than actively managed investments? Are they less likely to be sued?

**Fleckner:** I do not believe that index management necessarily reduces fiduciary risk, nor that active management necessarily increases risk. The focus in the cases challenging investment management fees is usually on the fund itself, not necessarily on whether it is actively or passively managed.
The courts have made it clear that a plan sponsor should not simply rely on a consultant’s recommendation. The decision in Tibble v. Edison International, which is now before the Supreme Court on a different issue, followed a line of decisions that held that “independent expert advice is not a ‘whitewash.’”

Although some of the earlier fee cases contained an explicit challenge to the use of actively managed funds as not justifying the relative cost of active management as compared to indexed funds, we are not currently seeing active management challenged directly in the courts. In the Tussey v. ABB Inc. case, for example, the plaintiffs’ attorneys had initially claimed that the inclusion of active management was imprudent. They explicitly dropped that claim on the eve of the trial.

Fiduciary committees often have specific views about whether active management is worth the additional cost. Fiduciaries may well decide that active management is the best way to allow participants to maximize outcomes and minimize downside risk, or that participants should be given a choice between active and passive investing. Those all seem to me to be perfectly defensible decisions, and judges typically do not like to second-guess informed fiduciaries.

It all comes down to fiduciaries demonstrating that they care about their participants. Also, in defending against any litigation involving those choices, it is most helpful to have a written record of the consideration that the fiduciaries gave in arriving at their decision. That way, we can show the judge that, in fact, the fiduciaries were evaluating options and landed on the ones that they felt were most appropriate for their participants.

DCD: Is the sponsor protected by going with the consultant’s recommendation?

Fleckner: Not necessarily. The courts have made it clear that a plan sponsor should not simply rely on a consultant’s recommendation. The decision in Tibble v. Edison International, which is now before the Supreme Court on a different issue, followed a line of decisions that held that “independent expert advice is not a ‘whitewash.’” The court explained that a fiduciary who relies on an expert, like a consultant, should “make certain that reliance on the expert’s advice is reasonably justified under the circumstances.” The court cautioned that the sponsor “cannot reflexively and uncritically adopt investment recommendations.”
DCD: Are you saying that plan sponsors can take a different direction than recommended by their consultant and still meet their fiduciary duty?

Fleckner: Yes. Plan sponsors may fulfill their fiduciary responsibility even when taking a different approach than that suggested by their consultant. In fact, if the sponsor believes that the consultant’s recommendation is contrary to the interests of the plan and participants, or it believes that the consultant did not engage in a rigorous enough process, then the fiduciary may be obligated to reject the recommendation. As discussed with any fiduciary decision, the plan sponsor should document its rationale for taking action that differs from the consultant’s recommendation.

DCD: Thank you for your valuable insights.

Fleckner: My pleasure. Thank you.

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