DIRECTORS' AND OFFICERS' LIABILITY

ERISA ENTERS THE SPOTLIGHT

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Directors of public companies and their advisers have long understood that announcement of adverse corporate news, followed by a meaningful stock price decline, may trigger a federal shareholder class action alleging securities fraud. Increasingly, the securities fraud lawsuit has a companion -- a purported class action on behalf of participants in the company's 401(k) plan, seeking recovery under the Employee Retirement Income Security Act ("ERISA") for decreases in the value of company stock purchased at open market prices through the plan. These cases are attractive to plaintiffs because ERISA claims are not subject to the heightened pleading requirements of a federal securities fraud claim, and usually involve less competition for lead counsel status. The surge in stock drop ERISA purported class actions continued in recent weeks with suits against Merck after its voluntary withdrawal of Vioxx, and various members of the insurance industry in the wake of bid rigging allegations. By reviewing the nature of the claims and defenses commonly asserted, this column hopes to serve as a ball of thread for those entering the ERISA labyrinth.

ERISA's Regulatory Scheme

ERISA exclusively governs the rights of 401(k) plan participants and the duties of employers who sponsor retirement plans. ERISA's regulatory scheme contains fiduciary standards to ensure that plan fiduciaries "discharge [their] duties . . . solely in the interest of [plan] participants."[1] Defendants may be liable as fiduciaries only "to the extent" they exercise discretionary authority over the management of the plan or exercise authority (not necessarily discretionary) over the management or disposition of its assets, or render investment advice for a fee.[2] Thus even the plan administrator is a fiduciary only to the extent that it acts as administrator of a plan.[3] Borrowing from the law of trusts, ERISA imposes four duties on ERISA fiduciaries: duties of care, loyalty, prudence, and prudent diversification of plan assets, *i.e.*, "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."[4]

Most 401(k) plans provide for individual accounts and offer a range of investment alternatives, and permit a participant or beneficiary to exercise control over how their 401(k)

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retirement savings are invested. Moreover, most participant-directed plans afford participants the option to invest account plan assets in the employer's own publicly traded stock, usually through an investment fund consisting solely of company common stock. When a pension benefit plan permits participants to exercise control over the assets in their individual retirement account, ERISA § 404(c) insulates the employer from liability for investment losses resulting from such participant's exercise of control.[5] "However, courts have generally held that whether a plan permits participants sufficient control over investment decisions to qualify for protection under ERISA 404(c) is a fact-based question not ripe for decision upon a motion to dismiss."[6]

In addition to the fiduciary duties it imposes, ERISA provides specific disclosure rules governing the information that must be provided to participants and beneficiaries (and certain government agencies). The Summary Plan Description ("SPD") is the central ERISA disclosure requirement.[7] The plan administrator must provide an SPD to persons within ninety days of their becoming a participant, and the description must be written in a manner "calculated to be understood by the average plan participant" and must be "sufficiently comprehensive to apprise the plan's participants and beneficiaries of their rights and obligations under the plan."[8] ERISA also mandates that administrators provide a summary description of any material plan modification within 210 days after the end of the plan year in which the change was adopted.

Stock Drop Cases

Although plaintiffs may seek to include additional defendants that had some affiliation with the company, the most frequently named defendants in stock drop cases are the plan Sponsor (usually the company), the Named Fiduciary of the plan and plan Administrator (usually an Employee Benefits Plan Committee but sometimes the company), any plan investment management committee, the Board of Directors, and the trustee of the trust that held the assets of the plan. The trustee invests funds as directed by the Named Investment Fiduciary, an Investment Manager or a plan participant or beneficiary, as the case may be; the Board of Directors ordinarily has the sole authority to appoint and remove the trustee. Certain Human Resources or Employee Benefits personnel involved in the administration of the Plan also have been named.

Having enjoyed years of unprecedented investment returns on their retirement funds, plan participants who have seen their retirement funds wither along with the market value of the company stock often seek relief under ERISA. The complaint typically alleges that defendants violated ERISA sections 502(a)(2) and (3) by breaching (i) their duty of prudence by continuing to offer company stock as a plan investment option and by failing to take appropriate action when they knew or should have known that the plan's investment in company stock was imprudent; (ii) their ERISA fiduciary duty to monitor the fiduciary performance of certain plan fiduciaries usually appointed by the Board, and by failing to provide such plan fiduciaries with accurate information; (iii) their fiduciary duties by failing to provide plan participants with complete and accurate information regarding the company's soundness and the prudence of investing retirement contributions in the stock, including in

ERISA-mandated SPDs; and (iv) their duty of loyalty to discharge their duties under the plan solely in the participants' interests. Plaintiffs usually purport to bring the action on behalf of the plan and a class consisting of all plan participants for whose individual accounts the plan purchased shares of the company stock fund during a defined period.

Critical to defending these claims is enforcing the rule that fiduciary status under ERISA is not an all-or-nothing proposition. Consistent with ERISA's "to the extent" requirement for fiduciary liability, ERISA recognizes that fiduciaries may wear "two hats": one for the performance of fiduciary functions, and another for separate business decisions that do not constitute management or administration of the plan. The statutory phrase "to the extent" indicates that a person is a fiduciary only with respect to those aspects of the plan over which it actually exercises authority. The threshold question is not whether an entity's actions adversely affected a plan participant's interest, but whether that entity was acting as a fiduciary (that is, performing a fiduciary function) when taking the challenged action.[9] Accordingly, directors of a company will be fiduciaries only to the extent that they exercise discretionary authority over the management of the plan or exercise authority (again, not necessarily discretionary) over the management or disposition of its assets.[10] The Department of Labor has expressly adopted this position, opining that "[m]embers of the board of directors of an employer which maintains an employee benefit plan will be fiduciaries only to the extent that they have responsibility for" the discretionary management of the plan or exercise authority respecting management or disposition of its assets.[11]

Director and officer defendants have successfully invoked this "two hats doctrine" to obtain dismissal of claims. In *In re WorldCom, Inc. ERISA Litig.*[12], seeking recovery for WorldCom employees who invested in WorldCom stock through a 401(k) savings plan, the court dismissed all claims against WorldCom's directors because the complaint did not adequately allege that the directors acted as ERISA fiduciaries. The court rejected the argument that directors "exercised fiduciary authority [by] signing or authoring the Section 10(a) prospectus included in the SEC Form S-8 registration statements for WorldCom" because the SPD is part of the prospectus and the SPD in turn incorporated by reference various SEC filings alleged to contain misleading statements. Noting that ERISA liability must be based on actions taken or duties breached in the performance of ERISA obligations, the court concluded that a director's preparation or signing of filings required by the federal securities laws does not create fiduciary status, "and consequently, [directors] do not violate ERISA if the filings contain misrepresentations." This is an important rule, as usually almost all documents identified in an ERISA complaint as containing misleading statements were prepared and disseminated to all investors pursuant to duties arising under the securities laws, not ERISA.

The court also rejected the theory that fiduciary liability may be imposed on directors by virtue of the board's right to appoint and to remove the Plan Administrator and Investment Fiduciary, because the theory "would make any supervisor of an ERISA fiduciary also an ERISA fiduciary." The court dismissed claims against corporate officers other than the CEO, because plaintiffs' claims against them were predicated solely on the insufficient allegation that

the plan authorized WorldCom to appoint "any" officer as a fiduciary, and that the plan should be interpreted to appoint all of WorldCom's officers as fiduciaries by default where WorldCom did not appoint any other person to be the plan Administrator or Investment Fiduciary. In short, "neither the Plan nor ERISA impose fiduciary responsibilities on any person without assigning to them the duty to perform ERISA fiduciary functions." Judge Siragusa adopted *WorldCom*'s reasoning in reaffirming his dismissal of fiduciary claims against directors in *Crowley ex rel. Corning, Inc. Investment Plan v. Corning, Inc.*[13] Similarly, in *In re McKesson HBOC, Inc., ERISA Litig.*,[14] the court dismissed claims against directors alleging breaches of fiduciary regarding the prudence of a plan's investment in company stock where "[t]he Board [wa]s not identified as a fiduciary, nor [wa]s it provided any discretionary authority with regard to investment decisions," and the court in *In re Williams Cos. ERISA Litig.*,[15] dismissed (a) disclosure claims where the plan did not grant the board power to control investment options or to communicate Plan information, and (b) duty to monitor claims where the plan only granted power to appoint members of the benefits committee.

In *In re Sprint Corp. ERISA Litig.*,[16] a Kansas district court this year dismissed with prejudice imprudent investment and disclosure claims against director defendants because the plan made clear that the directors were not responsible for making investment decisions or communicating with plan participants. Citing a Labor Department interpretive bulletin, however, and decisions holding "that an appointing fiduciary has an ongoing duty to monitor its fiduciary appointees," the *Sprint* court sustained claims against the directors for failure to monitor various plan committees and trustees, saying that "the director defendants had a fiduciary duty to monitor their appointed fiduciaries (*i.e.*, the committees and the trustee) to make sure those appointees were performing their duties in compliance with the terms of the plans and ERISA."

Other decisions from district courts this year in *Hill v. BellSouth Corp.*,[17] *In re Sears, Roebuck & Co. ERISA Litig.*,[18] *In re Electronic Data Sys. Corp. ERISA Litig.*,[19] and *Howell v. Motorola, Inc.*[20] have sustained claims that directors failed to monitor the performance of an investment committee. These rulings that a director's duty to appoint may carry with it a duty to monitor in all cases are questionable expansions of case law holding that a duty to monitor exists only when appointed committee members have a conflict of interest, or some other circumstance puts the appointing fiduciary on notice of possible misfeasance by their appointees.[21] This observation has particular force when, as is often the case, the governing plan specifically delegates responsibility for selection of investment options to the investment committee, rather than to the board.

D&Os should consider seeking dismissal of ERISA claims on additional grounds. First, there is authority that recognizing such ERISA claims would improperly interfere with the comprehensive regulatory scheme established under the federal securities, which subject public companies to periodic disclosure requirements and liability for misrepresentations in defined circumstances. An attempt to plead what is, in effect, a securities fraud action through ERISA puts plan administrators in an "untenable position" of having to choose between "unacceptable

(and in some cases illegal) courses of action" such as "obtain[ing] 'inside' information and then mak[ing] stock purchase and retention decisions based on this 'inside' information."[22] Further, because ERISA claims for monetary relief can only be brought derivatively on behalf of the plan, courts may require plaintiffs to comply with the pre-suit demand and other requirements for derivative suits set forth in Federal Rule of Civil Procedure 23.1.[23] And because the only form of relief that participants can seek in their individual capacities is equitable relief under ERISA § 502(a)(3) (which does not authorize a participant to seek compensatory damages resulting from a breach of fiduciary duty), defendants can argue that plaintiffs lack standing to assert class claims on behalf of individual plan participants.[24] Damages claims must be asserted on behalf of the plan itself under § 502(a)(2).

Defendants also should seek dismissal of claims with respect to the offer (and non-removal) of company stock as an investment option on the ground that D&Os were not fiduciaries with respect to the offer of company stock; under the express terms of most governing plan documents, the option to invest in company stock is a design feature of the 401(k) plan that arose from trust-settlor decisions by the Sponsor in a non-fiduciary capacity. In such circumstances, D&Os as a matter of law had no discretion or control over the plan's investment options. Such trust-settlor decisions are not actionable under ERISA.[25] Even where plan fiduciaries have discretion to remove company stock as an investment option, the "decision" to continue offering employer stock as an investment option -- to allow participants in their sole discretion to invest in a tax-advantaged manner in their employer's stock -- is entitled to a presumption of reasonableness. Courts have made clear that, in the case of plans intended to allow employee investment in employer securities, the decision to allow continued investment in company stock can be challenged only in the most exceptional circumstances, *i.e.*, where (i) the fiduciary "is not absolutely required to invest in employer securities," (ii) "such investments no longer serve the purpose of the trust, or the settlor's intent," and (iii) there are facts alleged to show that the company was on the brink of collapse or that the decision to continue investing in employer securities is, for some other reason, an abuse of discretion.[26]

1 29 U.S.C. § 1104(a)(1).

2 29 U.S.C. § 1002(21)(A); *see In re Enron Corp. Sec., Deriv. & ERISA Litig.*, 284 F. Supp.2d 511, 544 (S.D. Tex. 2003) (exercise of authority over management or disposition of assets sufficient to confer fiduciary status; discretion not required).

3 *Pegram v. Herdrich*, 530 U.S. 211, 225-26 (2000).

4 29 U.S.C. § 1104(a)(1)(C).

5 29 U.S.C. §1104(c)(1).

6 *In re Unisys Sav. Plan Litig.*, 74 F.3d 420, 446 (3d Cir. 1996).

[7] 29 U.S.C. §§ 1022(a), 1024(b)(1); 29 C.F.R. § 2520.104-4(b)(1).

[8] 29 C.F.R. § 2520.102-2.

[9] *In re Dynegy, Inc. Erisa Litig.*, 309 F. Supp.2d 861, 875 (S.D. Tex. 2004).

[10] *Martinez v. Schlumberger, Ltd.*, 338 F.3d 407, 412-13 (5th Cir. 2003); *Coleman v. Nationwide Life Ins. Co.*, 969 F.2d 54, 61 (4th Cir. 1992); *In re Enron Corp. Sec., Deriv. & ERISA Litig.*, 284 F. Supp.2d 511, 543-44 (S.D. Tex. 2003).

[11] 29 C.F.R. § 2509.75-8, at D-4.

[12] 263 F. Supp. 2d 745 (S.D.N.Y. June 17, 2003).

[13] 2004 WL 763873 (W.D.N.Y. Jan. 14, 2004).

[14] 2002 WL 31431588, at *6-7 (N.D. Cal. Sept. 30, 2002).

[15] 271 F. Supp.2d 1328 (N.D. Okla. July 14, 2003).

[16] 2004 WL 1179371 (D. Kan. May 27, 2004).

[17] 313 F. Supp.2d 1361 (N.D. Ga. 2004).

[18] 2004 WL 407007, at *8 (N.D. Ill. 2004).

[19] 305 F. Supp.2d 658, 671 (E.D. Tex. 2004).

[20] 337 F. Supp.2d 1079, 1099 (N.D. Ill. 2004).

[21] *See, e.g., Coyne & Delany Company v. Selman*, 98 F.3d 1457, 1466, n.10 (4th Cir. 1996).

[22] *Hull v. Policy Mgmt. Sys. Corp.*, 2001 WL 1836286, at *9 (D.S.C. Feb. 9, 2001); *see also In re McKesson HBOC, Inc., ERISA Litig.*, 2002 WL 31431588, at *6-7 (N.D. Cal. Sept. 30, 2002).

[23] *See, e.g., Diduck v. Kaszycki & Sons Contractors, Inc.*, 974 F.2d 270, 287 (2d Cir. 1992); *Hartline v. Sheet Metal Workers' Nat'l Pension Fund*, 134 F. Supp. 2d 1, 21 (D.D.C. 2000).

[24] *Mertens v. Hewitt Assocs.*, 508 U.S. 248, 255 (1993); *Crosby v. Bowater Inc.*, 382 F.3d 587, 594 (6th Cir. 2004) ("a claim for benefits is not cognizable under § 502(a)(3) of ERISA unless it is a claim for 'equitable relief'").

[25] *See Crowley v. Corning Inc.*, 2004 U.S. Dist. LEXIS 758, at *19-22 (W.D.N.Y. Jan. 14, 2004)

[26] *Moench v. Robertson*, 62 F.3d 553, 571 (3d Cir. 1995); *see also Kuper v. Iovenko*, 66 F.3d 1447, 1457-9 (3d Cir. 1995).