

Two New Stock Drop Decisions – Friendly Skies for ERISA Fiduciaries?

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June 30, 2006

This week, courts issued rulings in two separate employer securities cases. The first decision, issued on June 26, involved the stock of US Airways held in a US Airways 401(k) plan. The second, issued on June 28, involved the stock of United Airlines held in an Employee Stock Ownership Plan ("ESOP") sponsored by United. Although favorable to the defendants, the decisions don't necessarily settle the debate over plan holdings of employer securities, and they may raise as many questions as they answer.

On June 26, 2006, the United States District Court for the Eastern District of Virginia decided one of a only a handful of stock drop lawsuits that has made it to trial. In *DiFelice v. US Airways, Inc.*, No. 04-889 (E.D. Va. June 26, 2006) the court held that US Airways did not breach its fiduciary duties under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), by allowing the stock of its parent company, US Airways Group Inc., to remain as a plan investment option in the US Airways 401(k) plan during the period from October 1, 2001 to June 27, 2002.

The US Airways plan was a defined contribution, individual account plan in which participants could direct the investment of the assets in their account among 13 investment options, one of which was comprised of US Airways stock. During the class period, less than 5% of the plan's assets were invested in the company stock fund. During this same time, US Airways experienced financial difficulties resulting from high operating costs and a competitive marketplace that were exacerbated by the terrorist attacks of September 11, 2001.

Under the plan, US Airways was the fiduciary with discretionary authority to select the plan's investment options. US Airways delegated this responsibility to the plan's Pension Investment Committee. The plan did not require a company stock option, and US Airways was free to terminate the company stock fund at any time. The Pension Investment Committee met regularly and obtained advice from outside counsel on continuing the plan's company stock option. Based on this advice, and its review of information about the company and its prospects, the committee concluded that it was prudent to retain company stock as a plan investment option. These findings were reported to the US Airways Board of Directors. The court found that, even though bankruptcy was a risk at all times during the class period, it was never imminent. On June 27, 2002, the Board appointed an independent fiduciary to monitor the company stock fund.

The central question addressed by the court was whether it was prudent for US Airways to retain the company stock option during the class period given the company's financial difficulties. The court rejected the plaintiff's contention that retaining the

company stock option was imprudent because during the class period, it was highly likely that the company would go bankrupt. The court's main reason for rejecting plaintiff's theory was its belief that a prudent fiduciary is one who judges an investment in the context of "its contribution to the risk and return characteristics of a portfolio of investments." Citing modern portfolio theory and the Department of Labor's regulations on prudent investing, the court found that highly risky investments can, in fact, contribute to the diversity of an investment portfolio, thereby reducing the portfolio's overall risk (and boosting return). The court concluded that under ERISA, the prudence of retaining company stock, an admittedly risky investment alternative must be judged "in light of its contribution to the entire portfolio, and not in light of its individual risk."

To judge the "contribution" of US Airways stock under this standard, the court reviewed whether plan participants had the necessary tools to build a diversified portfolio, and found that they did. Specifically, the court found that the 13 investment options under the plan covered the spectrum from low to high risk. Moreover, the court found that US Airways' communications to plan participants about the importance of diversification and the risks of investing in company stock, further enabled participants to construct a diverse portfolio given the available investment options, including company stock.

Although the court's analysis of US Airways' conduct is primarily premised on the role of diversification and participant communications, it also noted in support of its decision the fact that ERISA generally exempts company stock from diversification requirements and places fewer limitations on the holding of company stock in an individual account plan than it does in other types of plans. Bases on this, the court explained that it would be inconsistent with Congressional intent to hold a plan fiduciary imprudent for including company stock in an individual account plan unless the company was no longer viable and the risks of the stock were not fully disclosed to participants.

The court did not, however, include company viability in its concluding roadmap for investment fiduciaries. Rather, the court held that an investment fiduciary for a 401(k) plan with a company stock fund will not be imprudent in continuing to offer company stock so long as (a) the plan offers a range of investment options across the risk/return spectrum, (b) the fiduciary provides participants with accurate information about the particular risk/return characteristics of the company stock, and (c) participants have the "unfettered ability" to diversify out of the plan's investment options, including company stock.

In a footnote, the court distinguished the standard of prudence for retaining company stock as an investment in 401(k) plan from the standard of prudence applicable to ESOPs. Recognizing the "presumption of prudence" applied by some courts in ESOP cases, the court emphasized that, "[u]nlike ESOPs, the prudence of continuing to offer company stock as an investment option in a 401(k) plan will depend largely on the other investment options offered to participants and the participants' ability to diversify their account assets among those investment options."

In a case issued on June 28, 2006, two days after *DiFelice*, the United States Court of Appeals for the Seventh Circuit, in an opinion written by Judge Posner, addressed the issue of whether State Street Bank & Trust Company, as directed trustee of the United Airlines ESOP, acted imprudently in failing to cause the ESOP to sell its United stock. *Summers v. State St. Bank & Trust Co.*, Nos. 05-4005 and 05-4317, 2006 WL 1751888 (7th Cir. June 28, 2006).

The court first found that even as a directed trustee, State Street retained a fiduciary duty not to comply with an imprudent direction to retain the ESOP's holdings in United stock. The court did not, however, accept plaintiff's argument that State Street should have acted on publicly available information to sell the stock. According to the court, all publicly available information about the company was reflected in the stock price, and "it would be *hubris*" for State Street to believe it could predict the company's future better than the market and "preposterous" for the plan's investment fiduciaries to challenge the market's valuation. This assessment of the market's ability to accurately price the stock is the basis of the court's ruling that State Street was not imprudent for failing to cause the sale of United stock from the ESOP.

Although not necessary for its actual holding, in the opinion the court suggests an alternative standard by which to judge the actions of ESOP fiduciaries. The standard suggested by the court is really a variation on the "presumption of prudence" standard articulated in *Moench v. Robertson*, (and cited in both *DiFelice* and *Summers*). The *Moench* court presumed that it is prudent for a plan designed to hold company stock to invest in such stock, but found that the presumption can be overcome by establishing that continued investment in the employer stock would impair the purposes of the trust. The standard suggested by the *Summers* court varies in two ways from the *Moench* standard. First, rather than expressing the circumstances that could impair the trust's original purposes in terms of the condition of the company as an on-going entity, the court expressed the unforeseen circumstances in terms of the risk of owning the stock. This appears to be more a matter of perspective, or economic theory, than a real distinction.

The second distinction, however, is more interesting. Because the *Summers* court assumed that the ESOP holdings were the primary, if not the sole, retirement asset of the ESOP participants, the court felt compelled to recognize a duty to diversify the ESOP's assets to protect participants from the risks associated with holding a single stock. The court recognized that the goal of an ESOP – to invest in a single security – and the goal of protecting ESOP participants from the risks of non-diversification cannot be reconciled. Because of its underlying assumption, the court could not allow the ESOP goal to trump completely the goal of diversification. Instead, it suggested a compromise: where ESOP participants do not have substantial other wealth (i.e., are not otherwise holders of diverse portfolios), an ESOP fiduciary should begin diversifying out of company stock "at the point at which an increase in the riskiness of the assets, had it been foreseen, would have induced the creators of the ESOP either to have not created it at all or to have required at least partial diversification." What is distinct about the court's proposed compromise, is not the expression of risk of the *stock* (which is its first variation on the *Moench* standard). Rather, the striking component of the proposed

standard is the premise that action may be required because participant investments are not otherwise diversified. Recognizing the unworkability of this standard in a litigation context, the court went on to question the policy behind the laws governing ESOPs.

These two cases deserve to be studied further to determine the effect the decisions are likely to have on the rest of the stock drop cases now working their way through the courts, and on the actions of plan investment fiduciaries and directed trustees. Initially, however, the cases raise some interesting questions, including (but by no means limited to) the following:

- From a litigation liability standpoint, is it better to hold company stock in an ESOP or as a component of a 401(k) plan?
- What legal standard would apply to judge the prudence of retaining employer stock in an ESOP feature of a 401(k) plan?
- If prudent investment selection keys off of participants' abilities to build a diverse portfolio, is there really a difference between monitoring a single plan investment option and monitoring the range of plan options as a whole? Put another way, so long as a 401(k) plan contains diverse enough investment options to allow a participant to build a diversified portfolio, is there any single option that would be imprudent to select or maintain?
- Should 401(k) plan fiduciaries require participant investment education?
- Must (or may) fiduciaries consider the level of participant investment diversification across (or even outside of) a company's retirement plans?