Publications

Courts Focus on DC Plan Investments in Employer Stock

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SERVICES

Since the passage of ERISA, litigation over plan investments in employer stock has been by far the biggest category of litigation over plan investments. Not surprisingly, the number of such cases goes up in direct response to declines in the stock market.

This year, a large number of new employer stock cases have been filed by classes of plaintiffs and the DOL. These cases present a variety of relatively novel theories of liability and damages that, if successful, could prove troublesome for plan sponsors and service providers. They include:

- fiduciary duty to disclose information not specifically required by ERISA and which no participant has requested;
- fiduciary duty to make plan investment decisions based on non-public or "inside" information;
- fiduciary duty to override plan design decisions relating to the form of the employer match and diversification of the employer stock account;
- the scope of the relief available to plan fiduciaries under section 404(c);
- fiduciary duty to exercise on behalf of participants rights they may possess under securities laws; and
- the measure of losses on investments in participant-directed individual account plan.

Although prior case law in this area is supportive of plan investments in employer stock, the newly filed cases bear watching and could have a dramatic impact on the risks associated with such investments. We review the recent litigation activity, including decisions in a couple of earlier cases, below.

The lead article in the November 27 Wall Street Journal — prompted by the precipitous fall of Enron — has added fuel to the fire and caught the attention of members of Congress. According to press reports, Senator Barbara Boxer (D-CA) recently expressed her strong concerns in the ERISA area. This is not surprising since Senator Boxer spearheaded a 1997 amendment to ERISA to restrict mandatory investments of participants' 401(k) money in employer stock. This recent activity may provide an impetus for Congress to consider proposals to impose more significant limits in this area.

Recent Court Filings

- Reinhart v. Lucent Technologies, No. 01-3491 (D.N.J.) — The plaintiff class purportedly consists of participants in three participant-directed defined contribution plans maintained by Lucent. The defendants include Lucent and members of its board of directors and plan committees. The complaint asserts that the defendants were aware of problems at Lucent and that made Lucent stock an inappropriate investment for the plans. In this regard, the complaint specifically refers to allegations — stated in a separate securities fraud action filed in state court — which in substance, claimed that corporate officials issued unsupportable revenue estimates that inflated the price of Lucent stock. The complaint alleges that the defendants breached their fiduciary duties by providing participants with misleading information, failing to provide participants with accurate information, failing to adequately investigate the merits of investment in Lucent stock, and acting under a conflict of interest by continuing to offer Lucent stock to participants. Plaintiffs allege that the defendants are not entitled to the protection of ERISA section 404(c) because the failure to provide participants with accurate information deprived them of the required control over their investments. Plaintiffs seek plan-wide relief under ERISA sections 502(a)(2) and 409, measured by the difference between the amounts invested in Lucent stock and the amounts the participants would have earned had they invested in the most "profitable" option available under the plan.
- Kolar v. Rite Aid Corp., No. 01-CV-1229 (E.D.Pa.) — The plaintiff class purportedly consists of participants in a participant-directed defined contribution plan sponsored by Rite Aid. The defendants include the plan sponsor, the in-house trustees of the plan, the plan's unaffiliated recordkeeper and certain affiliates. The complaint alleges that the defendants knew, or should have known, that certain officials of the company engaged in a scheme to manipulate the price of Rite Aidstock and knew, or should have known, that unregistered shares of Rite Aid stock were sold to plan participants in violation of federal securities laws. As with the Lucent case, the allegations track the allegations of a pending securities fraud class action which had been settled as to certain defendants, including Rite Aid. The complaint asserts that the defendants breached their fiduciary duties by providing participants with inaccurate and misleading information and by failing to provide accurate information. It further alleges that the fiduciaries breached their duties by selecting and maintaining Rite Aid stock as an investment option under the plan, by participating in or permitting the sale of unregistered securities, and by failing to exercise the rights of participants under the securities laws to rescind the purchases of unregistered stock. The complaint seeks relief on behalf of the plan under section 502(a)(2) and section 409 of ERISA and, alternatively, individual equitable relief under section 502(a)(3) of ERISA in an amount in excess of $100,000,000.
- In re Stone & Webster, Incorporated, No. 00-02142 (RR) (D. Del.) and Stein v. Smith, No.01-CV-10500 (D.Mass.) — The Stone & Webster ("S&W"), Inc. leveraged ESOP, savings plan and retirement plan each held substantial investments in the stock of S&W. Following the bankruptcy of S&W, the DOL filed claims in bankruptcy on behalf of the three plans. While the DOL claims are stated in very general terms and subject to revision, it appears that the DOL will assert that (1) the ESOP fiduciaries had a duty to allocate S&W stock held in the suspense account notwithstanding the fact that it secured the unrepaid ESOP loan; (2) the savings plan fiduciaries should have ceased making the employer match in S&W stock at some time before the bankruptcy; and (3) the pension plan fiduciaries should not have made investments in S&W stock in the year before the bankruptcy filing.
- A class action against fiduciaries of the S&W savings plan and the ESOP also has been filed. Stein v. Smith, No. 01-CV-10500 (D.Mass.). It tracks allegations in a separate securities fraud class action alleging that corporate officials manipulated the price of the stock.
- Kemper v. Enron Corp.; Tittle v. Enron Corp.; and Rinard v. Enron Corp., (S.D. Texas) — Three separate class actions have been filed on behalf of participants in the Enron Corporation Savings Plan. The defendants include the company and the individual members of the plan committee. The complaints allege that plan fiduciaries breached their fiduciary duties by (1) maintaining company stock as an investment option under the plan after it had become inappropriate to do so, (2) providing misleading information to participants regarding the financial condition of the company, (3) failing to provide participants with prospectus disclosure required by the securities laws, (4) making matching contributions in employer stock, (5) imposing a "black-out period" which prevented participants from disposing of company stock during a recent period of sharp decline in the stock price, and (6) failing to give notice of the "black-out." The complaint relies heavily on allegations that plan fiduciaries knew that the company was in serious financial trouble. The complaint seeks restoration of losses to the plan as well as other equitable relief.

Recent Decisions

Two recently decided cases provide considerable support for the defense of employer stock investments. LAndréegraff v. Columbia/HCA, No. 3-98-0090 (M.D. Tenn. May 24, 2000) and Hull v. Policy Management Systems Corp., No. 3:00-778-17 (D.S.C. Feb. 9, 2001). The Columbia/HCA case involved a stock bonus plan that invested substantially in Columbia/HCA stock. The plan was intended to invest primarily in employer securities. Following a highly publicized raid and criminal investigation by governmental authorities, the price of Columbia/HCA stock declined sharply. Suit was brought on behalf of a class of plan participants against Columbia/HCA and members of the plan committee charging that the fiduciaries breached their duties under ERISA by buying, and by failing to sell, the Columbia/HCA stock.

The court addressed the tension between ERISA's exacting standards for plan fiduciaries and the clear intent of Congress to encourage employee ownership through ESOPs and other employee benefit plans, and followed the course set by the Third Circuit in Moench v. Robertson, 62 F.3d 553 (3d Cir. 1995) and the Sixth Circuit in Kuper v. Iovenko, 66 F.3d 1447, 1459 (6th Cir. 1995). Those cases held that there is a presumption of prudence attached to investments in employer securities in plans such as ESOPs.

The court here conducted a two-pronged analysis. First, did the fiduciaries conduct an adequate investigation of the merits of Columbia/HCA stock? The court applied a rigorous standard and found the process used by the fiduciaries did not measure up. It then went on to look at the "substantial prudence" of the investment, that is — would a fiduciary who conducted a proper investigation have acted differently? It found that a prudent fiduciary would not have acted differently. On this basis, the court held for the defendant fiduciaries.

The Columbia/HCA case is encouraging for several reasons. First, it follows the Moench analysis, which gives some effect to the clear intent of Congress to encourage employee investment in employer stock through benefit plan. Second, it adopts the substantial prudence rule. Finally, it extends the presumption of prudence to a stock bonus plan that was not an ESOP.

The Hull case involved a 401(k) plan in which employer "matching" contributions were invested in company stock. The price of that stock dropped sharply after certain negative information was released to the general public. That price drop triggered a securities fraud action against the company and certain insiders. The securities fraud, in turn, formed the template for the ERISA action brought against the company, certain of the companyÄ¢¢□Û_Â¢□Û_¢s insiders, and the individuals who served on the committee responsible for plan investment decisions. The ERISA plaintiffs argued that the company, company insiders, and individual committee members knew or should have known that the stock was overvalued during a time when the plan was either purchasing or holding stock. In support of that argument, the plaintiffs relied heavily on the allegations made in the parallel securities action, which essentially alleged fraud on the market by the company and its insiders. The plan committee members were not alleged to have participated in, or to have known of, the alleged fraud.

All of the ERISA defendants moved to dismiss on the grounds, among others, that the ERISA claims were nothing more than an ineffective attempt to recast the securities action as an ERISA action. The court, however, chose to dispose of the motion on somewhat different grounds — segregating the ERISA defendants into two groups.

The first group of ERISA defendants included the company and the company insiders who had been sued in the securities action. The court observed that this group of ERISA defendants did not function in a fiduciary capacity with respect to the planÄ¢¢□Û_Â¢□Û_¢s stock purchases. According to the court, only the committee members had a fiduciary role in the challenged stock purchases on behalf of the plan. As a result, the court held that this first group of ERISA defendants could have no liability under ERISA, even if the "fraud-on-the-market" theory of liability otherwise had factual merit.

The second group of ERISA defendants included the individuals who served on the plan committee responsible for the planÄ¢¢□Û_Â¢□Û_¢s stock purchases. The court observed that these individuals, while allegedly ERISA fiduciaries, were not alleged to have participated in the allegedly fraudulent conduct. As a result, the court held that these defendants would have no ERISA liability because they did not make any purchases of company stock at more than the prevailing market price. On this point, the court appears to have acknowledged that "innocent" plan fiduciaries may rely on market pricing, and have no duty to seek out "insider" information.

- Proposed IRS Employment Tax Guidance on Statutory Stock Options
- On November 14, the IRS issued proposed guidance on income tax withholding (FITW), social security (FICA) and federal unemployment (FUTA) taxes for incentive stock options (ISOs) and employee stock purchase plans (ESPPs) (collectively, statutory stock options). For over 30 years, the published IRS position was that the grant, exercise, or disposition of statutory stock options does not trigger income tax withholding or FICA/FUTA taxes. Early this year, however, the IRS announced that it intended to change its longstanding published position. In the interim, the IRS granted a 2-year moratorium (until 2003) on all employment taxes and withholding on statutory stock options (Qualified Plans 2001-2). The new IRS positions, as set forth in proposed regulations (66 Fed. Reg. 57023) and Notices 2001-72 and 2001-73 (to be published in the December 3 IRS Bulletin), are described below.

- These new rules do not become effective until subsequent IRS notices are issued with final Treasury regulations, but in no event earlier than January 1, 2003 (the end of the moratorium period). An employer may elect to apply the rules early (but we cannot imagine why any would). Comments are requested by February 14, 2002, and a public hearing is scheduled for March 7, 2002.

Imposition of FICA and FUTA Tax

1. As anticipated, the proposed regulations state that, upon exercise of a statutory stock option, an individual receives "wages" for FICA and FUTA tax purposes equal to the excess of the fair market value of the stock, determined at the time of exercise, over the amount paid for the stock by the individual. Even though an employee has no current taxable income upon the exercise of an ISO or an ESPP (sec. 421(a)), the IRS asserts that the absence of a similar statutory exemption in the FICA and FUTA rules requires that these employment taxes be imposed. In taking this position, IRS is also rejecting taxpayer arguments that a significant component of this "income" is capital, rather than compensatory, in nature. In essence, Treasury and IRS have taken the position that Congress must provide relief if that outcome is desired. As noted in Qualified Plans 2001-7, proposed legislative relief has been introduced in Congress, but action is not imminent.
2. Income Tax Withholding Relief
3. Notice 2001-72 provides continued relief from federal income tax withholding. Specifically, it states that no federal income tax withholding obligation will result from a sale or disposition of stock acquired through an ISO or ESPP. This is good news for employers because they can continue to deduct the compensation element recognized by the employee (or former employee) in a disqualifying disposition without the additional complexity of withholding taxes — which would be particularly difficult on sales by former employees with no income generally available for withholding.
4. The IRS notes in the Preamble to the proposed rules that the new guidance does not address the question of whether income from a disqualifying disposition is "wages" for purposes of the employer research credit (sec. 41), even though not subject to withholding for administrative purposes. That result was reached in a 1995 Tax Court decision (Sun Microsystems) in which IRS had previously acquiesced. Although the reasoning of Sun should still be applicable, the IRS chose not to address the matter at this point.
5. Notice 2001-72 also provides some relief from Form W-2 reporting. In general, the compensation element recognized by the employee on a disqualifying disposition of ISO or ESPP stock must be reported on Form W-2 if the total wage payments for the calendar year exceed $600. However, the guidance states that no Form W-2 is required if the employer has made "reasonable efforts" and cannot determine whether a payment of remuneration has been made. The guidance goes on to explain that an employer has not made reasonable efforts in any case in which it claims a deduction under section 83 for the compensation element, but fails to provide a Form W-2. (Section 83 and the regulations thereunder permit an employer to take a deduction if it can show that the employee reported the amount on his or her federal income tax return; reporting on Form W-2 has been a "safe harbor" supporting the employer's deduction.)
6. Administrative Relief for Paying FICA/FUTA Taxes

Notice 2001-73 provides "rules of administrative convenience," similar to the longstanding rules applicable to withholding taxes on non-cash fringe benefits. Specifically, FICA and FUTA "wages" resulting from an exercise of a statutory stock option:

- May be treated as paid on a pay period, quarterly, semi-annual, annual, or other basis, at the employer's election, but generally no later than December 31 of the year of exercise.
- An option actually exercised in December (or any shorter period ending on December 31) may be treated as paid in the first calendar quarter of the next year (i.e., through March 31).
- Employers must apply the chosen rule consistently to all employees eligible for the relevant ESPP or ISO plan. (Thus, for example, employers cannot delay counting such income until year-end only for employees who will exceed the FICA wage base ($80,400 for 2001).) Employers can still impose conditions on the chosen method if the conditions and the resulting method are applied consistently to all employees.
- No formal election or IRS notification is required, and different optional rules may be applied in different years. Employees are required to use the rule selected by their employer, who must notify them if a special rule applies.

The Notice also notes several other methods to pay the employee's share of FICA taxes, including employee pre-funding and employer advances. The proposed rules clarify that the use of these rules of convenience do not constitute "modifications" of the options.