The Power of the Pen and the Decline of ERISA “Stock Drop” Class Actions

James P. Baker and Emily L. Garcia-Yow

Andalfe the Grey is not the only person who uses magic words. Lawyers ornament contracts with “boilerplate” phrases in the hope that the magic of shopworn phrases will ward off misfortune (lawsuits or, even worse, scary malpractice claims). The world of employee benefits is no different. Like other lawyers, we, too, have magic words. In the world of ERISA litigation, a 1989 US Supreme Court decision in Firestone Tire & Rubber Co. v. Bruch encouraged plan administrators to embed magic words within the terms of employee benefit plans so as to allow their decisions not to be...
second-guessed by a reviewing court. The Supreme Court explained that when an ERISA plan document gave the plan administrator the power to interpret the plan and to determine eligibility for benefits, a court reviewing an administrator’s denial was to defer to that decision unless the decision itself was arbitrary and capricious.\(^1\)

Once a company is hit with a class action lawsuit alleging violations under the Securities Exchange Act of 1934 due to a recent decline in that company’s stock price, it is likely that an ERISA class action will soon follow. These ERISA copycat class actions, commonly referred to as “stock drop” lawsuits, typically allege an ERISA Section 502(a)(2) statutory violation under the theory that fiduciaries—such as the company, members of the board of directors, or senior company officers—breached their ERISA fiduciary duty by continuing to invest in company stock when they knew or should have known it was no longer prudent to do so. A series of Circuit Courts of Appeals decisions indicate that although plan fiduciaries cannot immunize themselves entirely from ERISA stock drop class action fiduciary breach claims, they can take steps to ensure that their decisions about retaining company stock as a retirement plan investment vehicle are subject to \textit{Firestone’s} arbitrary and capricious standard of review.

Recent court decisions indicate that the key to unlocking the doors to the arbitrary and capricious standard of review (presumption of prudence) for the fiduciary decision to retain company stock in a retirement plan requires the retirement plan document to contain magic words.\(^2\)

The Circuit Courts of Appeals have generally followed the Ninth Circuit’s observation that “mere stock fluctuations, even those that trend downwards significantly, are insufficient to rebut the \textit{Moench} presumption” that the decision to retain company stock in a retirement plan is prudent.\(^3\) So price gyrations alone do not state a claim. The developing law from the Circuit Courts of Appeals decisions is that a fiduciary has a duty to sell employer stock only when the fiduciary knows the employer faces imminent financial collapse or when the employer is experiencing a serious deterioration of its financial circumstances or other extreme circumstances.\(^4\) In \textit{Moench v. Robertson},\(^5\) the Third Circuit established what is now referred to as the “\textit{Moench} presumption.” The court held that “[a]n ESOP fiduciary who invests the assets in employer stock is entitled to a presumption that it acted consistently with ERISA by virtue of that decision. However, the plaintiff may overcome that presumption by establishing that the fiduciary abused its discretion by investing in employer securities.”\(^6\) Fifteen years later, in \textit{Quan v. Computer Sciences Corp.},\(^7\) the Ninth Circuit adopted the “presumption of prudence” standard set forth in \textit{Moench}. The court held that “when plan terms require or encourage
[a] fiduciary to invest primarily in employer stock," that fiduciary is entitled to a presumption that he has been a prudent investor. 8

In *Moench*, a drop in the price of company stock from $18.25 to less than $0.25 per share (a 99 percent decline) was not, by itself, enough to overcome the presumption of prudence. 9 Similarly, in *Kuper v. Iovenko*, 10 an 80 percent decline in value from $50 per share to $10 per share was rejected by the Sixth Circuit as insufficient. 11

In affirming the dismissal of a complaint, the Ninth Circuit in the *Wright* court found that the defendant fiduciaries were not imprudent by failing to allow plan participants to sell company stock when its price increased from $23.44 per share to $33.89 per share and then declined by roughly 75 percent to $7.94 per share, 12 In *Edgar v. Avaya*, 13 the Third Circuit followed the *Wright* court’s rationale and dismissed the complaint, finding no fiduciary breach when the company’s stock price fell by 25 percent, from $10.69 to $8.01, in one day. 14 A temporary 40 percent decline in the price of Reliant Energy, Inc. (REI), stock was also found by the Fifth Circuit to be an insufficient factual predicate to support the plaintiffs’ imprudence claim. 15

The Fifth Circuit explained:

*Moench* concluded it might have been imprudent for the fiduciaries to continue investing in company stock that steadily lost ninety-eight percent of its value over two years, falling from $18.25 per share to $0.25 per share. It was also relevant that the fiduciaries were aware of the company’s impending collapse, and the employer ultimately filed for Chapter 11 bankruptcy protection. *Moench*, 62 F.3d at 557. In contrast to the company-wide failure evidenced in *Moench*, here Kirschbaum has alleged round-trip trading by a few employees and an initial drop in REI’s stock value of approximately forty percent. There is no indication that REI’s viability as a going concern was ever threatened, nor that REI’s stock was in danger of becoming essentially worthless. This is a far cry from the downward spiral in *Moench*, and much less grave than facts other courts routinely conclude are insufficient to rebut the *Moench* presumption. As the Ninth Circuit has explained, “[m]ere stock fluctuations, even those that trend downward significantly, are insufficient to establish the requisite imprudence to rebut the *Moench* presumption.” *Wright*, 360 F.3d at 1099.

Two recent cases demonstrate that whether the *Moench* presumption will apply depends on what the relevant plan says about company stock. The first case exemplifies what can happen when an ERISA-regulated plan fails to include language that “requires or encourages” investment in company stock. The second case shows how plan language was a powerful force in granting defendants’ motion to dismiss plaintiffs’ fiduciary breach claims.
Why the Words in the 401(k) Plan Really Matter: Harris v. Amgen

The plaintiffs in *Harris* were a class of participants in Amgen’s 401(k) plans. The *Harris* plaintiffs had all made 401(k) plan investments in the Amgen Common Stock Fund.

When a series of safety concerns were raised about an Amgen product and related marketing practices, the price of Amgen common stock plummeted. Plaintiffs sued, alleging breaches of fiduciary duty by Amgen, individuals on Amgen’s board of directors, and the 401(k) plans’ fiduciary committees. Plaintiffs alleged that the defendants breached their fiduciary duty of prudence by permitting 401(k) plan participants to continue to invest in Amgen stock when the fiduciaries knew or should have known that Amgen stock was being sold to the 401(k) plan at artificially inflated prices. Defendants moved to dismiss arguing that their decision to retain Amgen stock as a 401(k) plan investment was entitled to a presumption of prudence. The *Harris* plaintiffs’ allegation that the price of Amgen stock temporarily declined could not overcome that presumption. The district court agreed and dismissed the complaint. The *Harris* plaintiffs appealed and the Ninth Circuit reversed.

The question before the Ninth Circuit was whether the plan “required or encouraged” plan fiduciaries to invest in Amgen common stock. The relevant Amgen 401(k) plan language stated:

> All contributions to the Plan made pursuant to Articles 4 and 5 shall be paid to the Trust fund established under the Plan. All such contributions shall be invested as provided under the terms of the Trust Agreement, which may include provision for the separation of assets into separate Investment Funds, including a Company Stock Fund.

Defendants did not argue that Amgen’s language made Amgen stock a “required” 401(k) investment vehicle. They nonetheless argued that they were entitled to the Quan presumption of prudence because the plans “encouraged” Amgen’s fiduciaries to maintain a Company Stock Fund.

The Amgen fiduciaries set forth four arguments in support of their position. First, they argued that the 401(k) plans only refer to Amgen common stock as a permissible investment. The Ninth Circuit was not persuaded. The 401(k)’s language was not mandatory but permissive. It says the plan “may include” an Amgen Stock Fund. The Ninth Circuit cited the Second Circuit’s reasoning in *Taveras v. UBS AG*, as dispositive:

If the presumption of prudence was triggered in every instance where the EIAP plan document, as here, simply (1) named and defined the employer’s stock in the plan document’s terms, and
(2) allowed for the employer’s stock to be offered by the plan’s fiduciaries on a discretionary basis to plan participants, then we are hard pressed to imagine that there exists any EIAP that merely offered the option to participants to invest in their employer’s stock whose fiduciaries would not be entitled to the presumption of prudence.30

Defendants next pointed to plan language that regulated the purchase, transfer, and distribution of Amgen stock and provided voting rights to Amgen stockholders.31 The Ninth Circuit found this unpersuasive and noted some of the plan language cited by defendants cut against their own argument.32 For example, one provision defendants cited subjected a participant’s Amgen common stock holdings to a cap of 50 percent of their total holdings but no other funds had any such cap.33 The Ninth Circuit was also not persuaded by the defendants’ argument that Amgen’s 2008 Amendment stating Amgen stock would not be eliminated as an investment as a “too little and too late,” argument.34 The Harris complaint had been filed in 2007, a year before Amgen adopted the “no elimination” amendment.35 Finally, the Court rejected defendants’ argument that the plans “would have to have been amended in order to make Amgen stock unavailable to plan participants” finding that there was simply nothing in the plans that supported defendants’ contention.36

A simple statement in the plans that the Amgen Stock Fund was a permanent investment vehicle of the plan would have invoked the presumption of prudence. Because the Amgen 401(k) plan’s language about the Amgen Stock Fund was permissive, the defendants’ investment decisions about retaining Amgen Stock were found to be subject to de novo review.37

Good Retirement Plan Language = Good Litigation Results: In re: SunTrust Banks, Inc.38

The plaintiffs, participants in SunTrust Banks, Inc. 401(k) Savings Plan (the plan) who held company stock in their accounts, filed suit alleging the 401(k) plan’s fiduciaries were imprudent for retaining Company Stock as a 401(k) plan investment when SunTrust’s stock price suddenly dropped.39 Plaintiffs made the typical claim that the plan suffered hundreds of millions of dollars in losses because the plan’s fiduciaries maintained the plan’s investment in company stock when they knew or should have known that the investment was imprudent.40 According to plaintiffs, SunTrust became wrapped up in subprime lending despite warnings from experts that there were risks associated with these relaxed lending practices.41 The nub of plaintiffs’ complaint was that because of SunTrust’s involvement in the
subprime market, company stock was an overly risky and inherently imprudent investment option for the 401(k) Savings Plan.\textsuperscript{42}

The defendants moved to dismiss, which motion the district court promptly denied.\textsuperscript{43} Thereafter, in a case involving similar “stock drop” allegations, \textit{Lanfear v. Home Depot, Inc.},\textsuperscript{44} the Eleventh Circuit came to the opposite conclusion.\textsuperscript{45} The Eleventh Circuit ruled that the Home Depot ESOP’s language requiring Home Depot stock to be a permanent investment vehicle entitled the ESOP fiduciaries to a presumption of prudence.\textsuperscript{46} In light of \textit{Lanfear}, the \textit{SunTrust} court granted the defendants’ second motion to dismiss:

> [a]lthough a fiduciary is generally required to invest according to the terms of the plan, when circumstances arise such that continuing to do so would defeat or substantially impair the purpose of the plan, a prudent fiduciary should deviate from those terms to the extent necessary. Because the purpose of a plan is set by its settlors (those who created it), that is the same thing as saying that \textit{a fiduciary abuses his discretion by acting in compliance with the directions of the plan only when the fiduciary could not have reasonably believed that the settlors would have intended for him to do so under the circumstances}.\textsuperscript{47}

Because \textit{Lanfear} had not been decided at the time plaintiffs filed their complaint in \textit{Sun Trust}, the court did not initially afford the Sun Trust fiduciaries with a presumption of prudence.\textsuperscript{48}

In granting Sun Trust’s second motion to dismiss, the court found that the settlor “fully understood and approved of the fact that the ESOP component of the 401(k) plan was a high-risk investment for plan participants.”\textsuperscript{49} The district court cited to numerous examples of plan documents that demonstrate the settlor’s intent.\textsuperscript{50}

For example, the plan’s policy statement provided:

> Ordinarily, the Committee should assume that retaining Employer Stock as a Plan investment within the Employer Stock Fund is reasonable and prudent. Ordinary stock price fluctuations and declines in the value of Employer Stock are to be expected and those conditions alone are generally not sufficient for an ESOP fiduciary to consider suspending or ceasing Employer Stock investments within the Employer Stock Fund.

> If the Committee becomes aware of extraordinary circumstances that indicate that continuing to provide an Employer Stock as an investment alternative would be an abuse of discretion (e.g., if the Committee were to become aware that the Company’s dire financial situation would likely cause it to cease being a viable going concern), then the Committee should seek outside counsel’s assistance and advice as to carrying out its fiduciary duties with respect to Plan participants and beneficiaries.\textsuperscript{51}
And the summary plan description described the employer stock fund in no uncertain terms:

The 401(k) Plan includes the [Employer] Stock Fund, which is an employee stock ownership plan (“ESOP”). This Fund provides another way for you to be a SunTrust stockholder, sharing in the financial rewards that your efforts help produce for the company. Keep in mind, however, that investing in a single stock of one company is a high risk investment. Consider diversifying your account to avoid large losses.52

In light of this plan language, the district court concluded that “[t]he settlor understood the dangers inherent in the Employer Stock Fund and was willing to allow the fully-informed plan participants to take that risk if they chose to do so.”53 The Sun Trust plaintiffs’ claims were dismissed.

Harris and SunTrust teach us that an ounce of prevention is worth a pound of cure. Good 401(k) plan language stating that company stock is a permanent investment vehicle and will only be divested in the event of imminent financial collapse are the magic words plan fiduciaries must use to unlock the doors to the presumption of prudence.

Conclusion

The magic, is of course, only as good as the magician. Sometimes magic words don’t work. Ask Voldemort. Because the Supreme Court has not yet weighed in on the Moench presumption, uncertainty continues to haunt the sugar plum dreams of ERISA fiduciaries.

Notes

2. ERISA § 404(a), 29 U.S.C. § 1104(a), sets forth the standard of care that applies to fiduciaries.
4. 360 F.3d at 1098.
5. Moench v. Robertson, 62 F.3d 553 (3rd Cir. 1995)
6. Id. at 572.
7. Quan v. Computer Sciences Corp., 623 F.3d 870 (9th Cir. 2010)
8. Id. at 881.
9. 62 F.3d at 557.
10. 66 F.3d 1451 (6th Cir. 1995).
12. 360 F.3d at 1095–1096, 1099.
13. 503 F.3d 340 (3d Cir. 2007).
14. 503 F.3d at 348–349.
17. *Id.* at *3.
18. *Id.*
19. *Id.* at *17.
20. *Id.* at *19.
21. *Id.* at *22.
22. *Id.* at *20.
23. *Id.* at *25.
24. *Id.* at *26.
25. *Id.* at *27.
26. *Id.*
27. *Id.*
28. *Id.*
30. *Id.* at 1054.
31. *Id.* at **28-29.
32. *Id.* at *29.
33. *Id.*
34. *Id.* at *30.
35. *Id.*
36. *Id.*
37. *Id.* at *31.
40. *Id.*
41. *Id.* at *9.
42. *Id.*
43. *Id.*
45. *Id.* at 12.

46. Lanfear, 679 F.3d at 1279.

47. *Id.* at *13, citing Lanfear, 679 F.3d at 1280 (emphasis supplied unless otherwise indicated).

48. *Id.* at **14–15.

49. *Id.* at *19.

50. *Id.* at **18–23.

51. *Id.* at **18–19.

52. *Id.* at *20.

53. *Id.* at **22–23.