BAILEY CAVALIERI LLC
ATTORNEYS AT LAW

One Columbus 10 West Broad Street, Suite 2100 Columbus, Ohio 43215-3422
telephone 614.221.3155 facsimile 614.221.0479
www.baileycavalieri.com

ERISA TAGALONG LITIGATION LOSS PREVENTION

Prepared by
Dan A. Bailey

ERISA "tagalong" or "stock drop" class action lawsuits are now being filed routinely as companion litigation to large securities class action lawsuits. These ERISA class actions generally contain the same factual allegations as set forth in the securities class action lawsuits (i.e., the defendants misrepresented or failed to disclose certain material information about the company or its financial performance or condition). However, instead of alleging violations of the securities laws, the ERISA class actions allege the defendants breached their fiduciary duties under ERISA. As a result of the breaches, the plan participants allegedly were allowed or induced to invest or maintain their plan assets in company stock at artificially high prices, or otherwise suffered loss because their plan assets were invested in overpriced or ill-advised securities.

This relatively new type of litigation has received mixed reactions from courts. Although a few of the lawsuits have been dismissed, most have survived the defendants' motion to dismiss for various reasons. In fact, in one recent case the court dismissed the securities class action but refused to dismiss the tagalong ERISA class action. As a result, the settlement value of these cases is becoming substantial. Like securities class actions, the defendants often prefer to settle rather than risk a potentially devastating judgment. Although often smaller than the settlement in the related securities class action (in part because of lower insurance limits under the fiduciary policies), settlements of ERISA tagalong lawsuits can be quite large. Examples of recent settlements include:

- Enron $85 million
- Global Crossing $79 million
- Lucent $69 million
- WorldCom $51 million
- Dynegy $30.8 million

The following summarizes a number of proactive loss prevention concepts which can reduce the likelihood that an ERISA tagalong claim will be filed and which can enhance the defendants' ability to successfully defend such a claim if filed.

1. Maximize Protection from Plan Terms. Plan documents should be reviewed annually to assure compliance with the most recent case law and regulatory developments. Most importantly, if the plan allows participant-directed investments, the plan should have an express provision which relieves fiduciaries of fiduciary responsibility for losses incurred as a result of a participant's investment instruction. Such a provision is authorized by Section 404(c) of ERISA. However, Department of Labor regulations impose numerous conditions that must be satisfied in order for a fiduciary to escape liability based on such a provision. Those regulations generally require that the plan provide (i) diversified investment options; (ii) opportunities to transfer assets in the plan account; (iii) sufficient information to allow participants to make sound investment decisions; and (iv) notice to participants of the Section 404(c) provision. Although these requirements may appear reasonably easy to satisfy, recent ERISA tagalong claims demonstrate that fiduciaries frequently have difficulty proving all of these requirements were met. For example, in the Enron ERISA tagalong litigation, the court found that Enron's plan failed to satisfy any of these four requirements.

Plaintiffs frequently raise two issues when arguing that the Section 404(c) protection does not apply to fiduciaries. First, plaintiffs allege that plan fiduciaries either misrepresented or failed to provide to plan participants material information about the true value of the company's stock. Because this is largely a fact issue, plaintiffs usually are able to defeat the defendants' motion to dismiss based on 404(c). Second, some plans restrict the sale of the employer's matching stock contribution until the participant reaches a certain age. Such a restriction likely eliminates the protection under Section 404(c), and therefore should be eliminated if possible.

In any event, the plan should clearly and expressly provide diversified investment options for plan participants, and participants should receive notice that the plan documents relieve fiduciaries of their responsibilities with respect to participant-directed investments pursuant to Section 404(c).

2. Offer Company Stock Pursuant to Plan Design. Even if Section 404(c) applies, the selection by plan fiduciaries of investment options for a participant-directed plan is a fiduciary act subject to ERISA fiduciary duties. Therefore, there is a fiduciary duty to monitor the prudence of continuing to offer company stock as an investment option in the plan. However, if the option to invest in company stock is expressly required by the plan documents, the plan fiduciaries arguably have no discretion over the decision to include company stock as an investment option and therefore arguably have no fiduciary duty with regard to whether company stock should remain an investment option for plan participants. Although this defense has received mixed results from the courts, such a plan provision is potentially quite beneficial to plan fiduciaries and therefore should be included in the plan documents if the company intends to permit plan accounts to own company stock.

3. Don't Blindly Follow Plan Provisions. Even if the plan requires company stock as investment option or otherwise expressly requires certain action, fiduciaries are not necessarily protected by following those plan requirements. As a general matter, fiduciaries are required to administer the plans as written and are not permitted to vary from plan design. However, if a plan provision or its enforcement is inconsistent with the provisions of ERISA, some courts have recently required the fiduciaries to ignore that provision of the plan and substitute their judgment for the decision of the plan sponsor. This duty to override the plan's terms most frequently arises where the plaintiff proves that the fiduciary could not have reasonably believed that continued adherence to the plan's terms was in keeping with the plan sponsor's expectations of how a prudent fiduciary would behave.

In light of this recent authority, fiduciaries should question whether, under the circumstances, a particular plan provision seems reasonable and should seek a legal opinion from qualified counsel regarding their fiduciary duty if there is concern about the provision. Assuming the fiduciaries disclose all relevant facts to qualified counsel and the legal advice appears on its face to be reasonable, fiduciaries should be able to avoid personal liability by acting in reliance upon the legal advice.

4. Independent Fiduciaries. One of the most problematic allegations in ERISA tagalong claims is that the plan fiduciaries had an inherent conflict of interest by serving as both a plan fiduciary and as an officer or director of the sponsor company. Because of this dual capacity, plaintiffs argue that the plan fiduciaries took actions primarily for the benefit of the company rather than plan participants, and that plan fiduciaries knew but failed to disclose material non-public information which injured plan participants.

   To avoid or at least minimize the effect of those allegations, companies should consider appointing independent fiduciaries to manage and monitor the plan's investment in company stock. These independent fiduciaries should have no actual or perceived relationship with the company or its directors and offices, and should have exclusive control over all investment-related decisions for the plan. Because liability exposure for plan administration is much less than liability exposure for plan investments, independent fiduciaries could be appointed solely with respect to plan investments, thereby allowing the plan sponsor and its officers to control various non-investment administrative tasks.

   Alternatively, company officials who typically do not have access to the company's non-public information could be designated investment fiduciaries, although such a practice invites arguments that the fiduciary in fact knew or should have discovered the non-public information by reason of his position with the company.

5. Avoid Inadvertent Fiduciary Status. The test for determining whether an individual or entity is a fiduciary under ERISA requires a "functional" analysis. A person who is not named as a fiduciary in the plan documents can still be liable as a fiduciary under ERISA if the person's actions were the functional equivalent of a fiduciary's actions. As a result, anyone who performs services or communicates on behalf of a plan is potentially liable for breach of ERISA fiduciary duties.

   Frequently, ERISA tagalong claims name as defendants not only the plan's named fiduciaries, but also other directors, officers and human resources personnel of the plan sponsor, as well as investment and administrative committee members. To avoid individuals being inadvertently subjected to ERISA fiduciary duties, the company and the plan should tightly control the number of people who become involved in plan matters, and the responsibilities for each such person should be well defined and understood. In addition, the plan sponsor should not be a named fiduciary, or if it is a named fiduciary, the board of directors should expressly delegate the company's fiduciary responsibility to an individual or group of individuals. Otherwise, the directors may be liable for improperly discharging the company's ERISA fiduciary duties.

6. Prompt and Accurate Communications. The federal securities laws require a company to disclose material information to investors only at certain designated times, such as when an SEC filing is due or when the company is purchasing or selling its own securities. In contrast, ERISA may require plan fiduciaries

(including company officers) to disclose material information regarding the company on a more current basis if the information could reasonably be viewed as important to plan participants in making plan investment decisions. These conflicting disclosure obligations under the securities laws and ERISA place company officers who are plan fiduciaries in a classic catch-22. If they disclose the non-public information to plan participants, they are likely violating the insider trading rules under the securities laws. If they do not disclose the information to plan participants, they may violate their ERISA fiduciary duties.

Some courts have concluded that plan fiduciaries can remove themselves from this catch-22 by (i) disclosing the non-public information to all investors and plan participants as soon as possible, (ii) eliminating company stock from the plan, or (iii) notifying the regulators of the specific dilemma. In addition, if the plan utilizes only independent fiduciaries and not company officers with respect to plan investments, those independent fiduciaries will likely not learn of the non-public information and therefore not be placed in this difficult catch-22.

In any event, all communications by plan fiduciaries to participants should be prompt, accurate, clear and consistent with disclosures to other company constituents. Clever "spin" or other vague or confusing communications should not be tolerated. Instead, the communications should be easy to understand and convey the whole truth. Even unsophisticated participants should be able to readily understand the disclosed information. Bad news should not be understated and good news should not be overstated.

7. Encourage Diversification of Investments. Consistent with sound investment concepts, company management and plan fiduciaries should encourage participants to diversify their investments and not include within their investment portfolio an unreasonably large percentage of company stock. An excessive concentration of an employee's investment portfolio in company stock can not only create unnecessary investment risk and engender tagalong claims, but may motivate employees to act inappropriately in order to artificially maintain or increase the company's stock price.

8. Eliminate Company Stock in Plan. There are clearly benefits to employees owning stock in the company, thereby aligning their interests with outside investors. However, as demonstrated by the recent waive of ERISA tagalong claims, such a practice creates inherent and potentially large litigation risks. As a result, some companies are eliminating company stock as an authorized investment option and as the employer's matching contribution under plans. This is unquestionably the safest strategy from a risk management perspective.