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Federal appeals court offers fiduciary-risk comfort to plans

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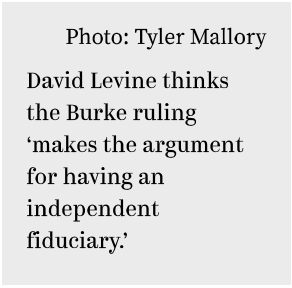

Photo: Tyler Mallory

David Levine thinks the Burke ruling 'makes the argument for having an independent fiduciary.'

The hiring of an independent fiduciary to manage company stock in a 401(k) plan offsets fiduciary risk, a recent court ruling found.

Defined contribution sponsors whose 401(k) plan menus include company stock have learned that a 2014 U.S. Supreme Court decision can be a vaccine against stock-drop lawsuits, setting a high bar for plaintiffs to overcome defendants' motions to dismiss the case.

But like all vaccines, the court's decision in Fifth Third Bancorp et al vs. Dudenhoeffer et al. isn't 100% effective, even though the unanimous ruling described a series of guidelines for lower courts to determine if a stock-drop lawsuit could proceed to trial.

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And that's why a recent federal appeals court decision provides the ERISA equivalent of a booster shot for sponsors' defenses.

The 7th U.S. Circuit Court of Appeals ruled on Aug. 1 that a sponsor doesn't have fiduciary liability in a stock-drop case if the sponsor hired an independent third party to manage the company-stock fund within a 401(k) plan.

"If I were an independent fiduciary looking for a marketing pitch, this is it," said David Levine, a Washington-based principal at Groom Law Group, referring to the ruling in the case of Burke et al. vs. The Boeing Company et al.

"It makes the argument for having an independent fiduciary," said Mr. Levine, who represents sponsors in ERISA cases. "This is a clear, well-written decision — a master class in laying it all out."

The appeals court upheld a ruling by a U.S. District Court judge in Chicago, who dismissed in November 2020 the stock-drop lawsuit filed by four participants in the $73.9 billion Boeing Co. Voluntary Investment Plan.

They sued in March 2019, saying plan fiduciaries failed to protect their company-stock investments, which were weakened due to a pair of crashes of the Boeing 737 MAX airplane and to allegations that the company didn't publicly disclose design problems with the aircraft.

"We agree with the district court that the delegation of investment decisions to an independent fiduciary means that neither Boeing nor the other defendants acted in an ERISA fiduciary capacity in connection with the continued investments in Boeing stock," the appeals court judges wrote. The independent fiduciary, Newport Trust Co., was not a defendant.

A Boeing contract "clearly delegated to Newport the decisions that are usually the focus of ESOP (employee stock ownership plan) stock-drop cases — the decisions to allow the plan and employees to continue to hold employer stock, and the decision to allow employees to continue making new investments in employer stock," the appeals court judges wrote.

"In making those decisions, Newport was not a Boeing insider," they added. "It was making decisions like any outside investor … on the basis of public information about the company and its prospects."

Although the 7th Circuit only covers federal courts in Illinois, Wisconsin and Indiana, ERISA attorneys and DC consultants said the decision sent a message to sponsors as well as to potential plaintiffs.

"This almost reads like a law review article," said Stephen Rosenberg, a Boston-based partner for the Wagner Law Group, who represents sponsors in ERISA cases.

The appeals court's ruling plus the Supreme Court's Dudenhoeffer decision build an even tougher defense against stock-drop lawsuits, improving the odds that a complaint will be dismissed, he said. "After you get past the dismissal stage, you can spend a fortune in discovery — or you settle," said Mr. Rosenberg, referring to the data-gathering and data-sharing process that is necessary if a judge rejects a motion to dismiss.

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Serves a 'valuable' purpose

The Supreme Court's ruling in the Dudenhoeffer case told lower federal courts that they must determine that a plaintiff's proposed remedy in a stock-drop lawsuit doesn't violate SEC rules governing insider information and doesn't create a bigger problem than the one plaintiffs seek to address.

Courts should "consider whether the complaint has plausibly alleged that a prudent fiduciary in the defendant's position could not have concluded that stopping purchases — which the market might take as a sign that insider fiduciaries viewed the employer's stock as a bad investment — or publicly disclosing negative information would do more harm than good to the fund by causing a drop in the stock price and a concomitant drop in the value of the stock already held by the fund," the Supreme Court said.

However, the use of independent fiduciaries wasn't part of the Supreme Court's opinion.

"Independent fiduciaries like Newport can serve a valuable and legitimate purpose in managing the tension between ERISA and federal securities laws," the Chicago appeals court judges wrote.

If corporate insiders who manage company-stock investments in a 401(k) plan "are willing to give up control to avoid potential conflicts between duties under ERISA and their duties under corporation and federal securities laws, we see no legal obstacles," they wrote.

The Dudenhoeffer decision has played a big role in stock-drop lawsuit dismissals. Since the beginning of 2021, for example, federal appeals courts have upheld dismissals in high-profile lawsuits including those against Johnson & Johnson, Edison International Inc. and General Electric Co.

Last year, International Business Machines Corp. agreed to pay $4.75 million to settle a stock-drop lawsuit that was initially filed in 2015.

The Dudenhoeffer decision also led to fewer stock-drop lawsuits, according to Cornerstone Research, an economic and financial consulting firm, Washington.

None was filed during the first half of 2021, according to the firm's latest data. Two were filed 2020, three in 2019 and none in 2018. The annual number of cases filed had been in single

digits from 2013 through 2017. Peak filings were 34 in 2002 and 37 in 2008.

Cornerstone's data excludes private company ESOP lawsuits and lawsuits related to public spinoff companies that hold both their own company stock and publicly traded stock of their parent.

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Not an automatic choice

Despite the Boeing ruling and a handful of other federal appeals court rulings supporting the role of independent fiduciaries in managing company stock, hiring a third party hasn't been an automatic choice for sponsors.

"I can't understand why more companies don't do it other than inertia or not wanting to give up control," Mr. Rosenberg said.

In its latest annual survey of DC plans, Callan LLC found that 24% of respondents said they outsourced oversight of company stock last year and 23% said they would do so this year. The survey, published in February, featured responses from 101 sponsors including clients and non-clients. The number of respondents varies each year.

The survey contained 11 choices — multiple answers were allowed — to the question asking what steps have sponsors taken or will take regarding company stock.

The biggest responses for action last year were regular reviews of company stock in investment meetings (60%) and participant communications to improve diversification out of company stock (60%). These strategies also ranked highest —58% and 50%, respectively — in sponsors' plans for 2022.

Other answers related to fiduciary liability issues were providing clear guidelines for evaluation and monitoring in the investment policy statement (20% last year; 19% for 2022) and removing insiders from the investment committee (16% last year; 15% for 2022).

In recent years, the percentage of plans offering company stock has remained essentially steady — between 37% and 39% for the seven years ended in 2021 except for 51% in 2017, which Callan considers an anomaly.

In each of the years that the Callan survey asked about hiring independent fiduciaries for company-stock programs, the percentages have ranged from a low of 12.5% in 2011 to a high of 37.5% in 2019.

DC consultants and ERISA attorneys say they stop short of advocating to clients the hiring of independent fiduciaries, but they tell them about the options for reducing the risk of a lawsuit.

"I don't push them in one direction or another," said Mr. Levine of Groom Law Group. "I explain the Boeing decision."

Consultant Alec Dike said the extra cost of an independent fiduciary and corporate executives' concerns about loss of control are the main reasons why companies say they prefer to manage a company stock fund in-house.

"I would try to understand why they don't want to hire an independent fiduciary," said Mr. Dike, a Chicago-based senior director for Willis Towers Watson PLC, who called the recent appeals court ruling a "groundbreaking case" and a "wake-up call" for sponsors.

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Internal safeguards

If sponsors choose to manage company stock internally, then they should make sure insiders don't participate in an investment committee's management of a company stock fund.

That will help build a legal wall between their corporate duties and their ERISA duties, reducing the risk that they would provide non-public information in the stock-plan management, he said.

C-suite executives and high-ranking officials such as treasurers and head of total rewards should stay away from a 401(k) plan's company-stock management, he said.

Callan DC consultant Jana Steele said clients' attitudes and financial capabilities are too varied to prescribe a one-size-fits-all approach to managing a company-stock program.

For those wanting to keep it in-house, Callan recommends keeping anyone with "internal knowledge of company performance" away from managing a stock program, said Ms. Steele,

a Chicago-based senior vice president.

She acknowledged that the cost of hiring an independent third-party and how to pay for it may dissuade some corporate executives. However, she described as "not a viable concern" the perception by some executives that "an independent fiduciary will act in a rash fashion."

The various federal court cases endorsing an independent fiduciary should give "comfort" to plan sponsors, said Ms. Steele, adding that it's her impression more sponsors are issuing requests for information about independent fiduciaries.

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