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Dudenhoeffer and the Duty to Monitor

Mark E. Bokert and Alan Hahn

Plan fiduciaries of 401(k) plans are charged with monitoring the performance of their plan investment funds to ensure they continue to be prudent investments. Most plan fiduciaries understand this responsibility and monitor their plan investments on a quarterly basis, such as by comparing the performance of their investments to relevant benchmarks and peer groups. If a 401(k) plan contains a company stock fund, however, the fiduciary obligation to monitor the company stock fund is less than clear. This is particularly true since the U.S. Supreme Court's decision in *Dudenhoeffer*,[1] which abolished the "presumption of prudence" that many plan fiduciaries of company stock funds enjoyed, yet made it arguably more difficult for plan fiduciaries to be successfully sued for allowing participants to invest in allegedly "overvalued" company stock. In light of *Dudenhoeffer* and the cases that came after it, plan fiduciaries, with assistance from their ERISA counsel, should consider the extent to which their company stock fund should be monitored.

Background

Under the Employee Retirement Income Security of Act of 1974, as amended (ERISA), a plan fiduciary must act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."[2] This is a very high standard of conduct and requires plan fiduciaries to act like prudent experts. To satisfy this duty, when confronted with a decision, plan fiduciaries must (i) gather relevant information, (ii) analyze the information, (iii) seek expert advice, such as from investment advisors and ERISA counsel, and (iv) make a well-reasoned decision

Mark E. Bokert is a partner and co-chairs the Benefits & Compensation Practice Group of Davis & Gilbert LLP. His practice encompasses nearly all aspects of executive compensation and employee benefits, including matters related to equity plans, deferred compensation plans, phantom equity plans, qualified retirement plans, and welfare plans. Mr. Bokert may be contacted at *mbokert@dglaw.com*. Alan Hahn is a partner and co-chairs the Benefits & Compensation Practice Group of Davis & Gilbert LLP. His practice is devoted to advising clients of all sizes, including in the design and implementation of a wide variety of creative, unique, and tax-effective employee benefit plans and programs. Mr. Hahn may be contacted at *ahahn@dglaw.com*.

based on the gathered information. Importantly, this duty also requires plan fiduciaries to consider the "circumstances then prevailing." In other words, as the world becomes more complex and facts change, a plan fiduciary is required to revisit and reconsider earlier decisions.

Another important fiduciary duty under ERISA requires fiduciaries to act for the exclusive purpose of providing retirement benefits to plan participants and to discharge their duties solely in the interest of plan participants. ERISA describes these duties as follows: "A fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and: (A) for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries."[3] Thus, a plan fiduciary, when confronted with a decision, must always place the interests of the plan participants ahead of everything else (e.g., their own interests or the plan sponsor's interests). This fiduciary duty is sometimes referred to as the "duty of loyalty."

Yet another important fiduciary duty under ERISA is the duty to diversify. Pursuant to that duty, a fiduciary must "diversify the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so." However, an exception to this general rule allows 401(k) plans to offer a non-diversified company stock fund. A company stock fund is, essentially, an investment fund which contains almost exclusively stock of the plan sponsor.

In the past, courts have struggled to reconcile ERISA's duty of prudence and loyalty with its express sanctioning of company stock funds. Eventually, many courts adopted the *Moench* presumption, named after the holding in *Moench v. Robertson*.[4] Under this presumption, plan fiduciaries were presumed to have acted prudently in offering a company stock fund under a 401(k) plan, unless the plan sponsor was in a dire financial situation.

Dudenhoeffer

The Supreme Court's decision in *Dudenhoeffer* effectively abolished the *Moench* presumption. The Court held that, under ERISA, plan fiduciaries are not entitled to a presumption of prudence regarding their decision to continue offering a company stock fund. This was initially seen as a win for plaintiff attorneys who, generally speaking, are eager to file lawsuits anytime a company's stock drops significantly in value. However, the remainder of the *Dudenhoeffer* decision does not make it so easy for plaintiffs to file a successful lawsuit. In fact, an argument can be made that it made it more difficult.

After abolishing the *Moench* presumption, the Supreme Court in *Dudenhoeffer* examined the two principal theories that plaintiffs espouse when challenging an ERISA fiduciary's decision to continue offering a company stock fund despite allegedly having knowledge that the stock price would drop in value. The Court then established pleading standards (i.e., facts that need to be alleged in a complaint) for these theories to move forward to trial. To provide context, such "stock drop" lawsuits generally involve a stock trading at a high level and then the price drops precipitously. In such situations, plaintiffs who file a lawsuit generally allege that the plan fiduciaries should have known that the stock was overvalued (i.e., that the price of the stock was too high relative to its actual value) and should have done something before the price drop, such as freezing or selling off the company stock fund, to prevent plan participants from incurring losses.

The first theory generally espoused by plaintiffs in stock drop lawsuits is that plan fiduciaries should have known, based on "public information" (i.e., news reports, SEC filings, analyst reports), that their company stock was overvalued. With regard to this theory, the Supreme Court held that "where a stock is publicly traded, allegations that a fiduciary should have recognized from publicly available information alone that the market was over- or undervaluing the stock are implausible as a general rule, at least in the absence of special circumstances."[5] The Court reasoned that the stock markets are presumed to work efficiently and to provide the best estimate of the value of the stocks traded on them. The end result of the Supreme Court's holding is that if a plaintiff brings a lawsuit alleging that plan fiduciaries should have known that their company stock was overvalued based on public information, the lawsuit will be dismissed unless they can plead specific facts which show "special circumstances." Unfortunately, the Supreme Court did not discuss what it meant by "special circumstances."

The second theory is that the plan fiduciaries should have known, based on "inside information" (i.e., non-public information), that their stock was overvalued. With regard to this theory, the Supreme Court said that plaintiffs must "plausibly allege an alternative action that the ERISA fiduciary could have taken that would have been consistent with the securities laws and that a prudent fiduciary in the same circumstances would not have viewed as more likely to harm the fund than to help it."[6] In other words, if a plaintiff brings a lawsuit alleging that plan fiduciaries should have known that their company stock was overvalued based on inside information and should have done something to prevent losses, the lawsuit will be dismissed unless the plaintiffs can offer an alternative course of action that the plan fiduciaries should have taken and plead specific facts showing that (i) such alternative course was consistent with securities laws and (ii) no prudent fiduciary in the same circumstances could conclude that such alternative course would harm the plan more significantly than if the fiduciary did nothing.

Post-Dudenhoeffer *Cases*

Dudenhoeffer was decided in 2014. In the years since, plaintiffs have had great difficulty meeting *Dudenhoeffer's* pleading standards and, as a result, most stock drop cases against plan fiduciaries have been dismissed. The cases discussed below are illustrative.

In *Coburn v. Evercore Trust Co., N.A.*,[7] the plaintiff alleged that plan fiduciaries breached their fiduciary duties by failing to prevent plan participants from buying or holding stock of J.C. Penney Corporation in their retirement plan after the stock price precipitously declined over a two-year period. The district court had dismissed the plaintiff's claims because she failed to plead specific facts showing "special circumstances" as required by *Dudenhoeffer*, but the decision was appealed to the U.S. Court of Appeals for the D.C. Circuit. The plaintiff had claimed that the plan fiduciaries should have known that the stock was an imprudent investment based on publicly available information. The plaintiff further argued that *Dudenhoeffer's* "special circumstances" requirement did not apply because the plan fiduciaries did not overvalue the stock, rather they simply failed to comprehend the riskiness of the stock as a continuing investment. The circuit court, however, disagreed with plaintiff's assertion that risk is attenuated from stock price, stating that because an efficient stock market reflects all publicly available information, the plaintiff must plead "special circumstances." As the plaintiff failed to plead special circumstances, the circuit court concluded that the plaintiff's "claim falls far short"[8] and upheld the district court's dismissal of the case.[9]

In re Pilgrim's Pride Stock Investment Plan Litigation[10] was a case involving plan fiduciaries continuing to hold investments in company stock despite their knowledge of material inside information that alledgely showed the stock was overvalued. In *Pilgrim*, plaintiffs suggested several courses of action that the plan fiduciaries could have undertaken prior to the collapse of the stock price. First, they claimed that the plan fiduciaries could have publicly disclosed all of the material inside information that allegedly caused the stock price to be significantly inflated. In rejecting this assertion, the court stated that "[p]ublicizing all of the negative insider information alleged by Plaintiffs would guarantee the collapse of the company stock"[11] and that it is "simply implausible to say that a reasonable fiduciary could not have concluded that accelerating a stock collapse would cause more harm than good." [12] Second, the plaintiffs alleged that the plan fiduciaries could have converted the company stock to cash or transferred the company stock into other plan investments. The court rejected this allegation as well, indicating that if the plan fiduciaries cashed out or transferred to other investments, it would have signaled to the public to sell, thus, potentially causing a precipitous decline in the stock's price. Plaintiffs' suggestions that the plan fiduciaries appoint an independent fiduciary to oversee the company stock or seek guidance from the U.S. Department of Labor were also rejected. Accordingly, the case was dismissed.

The Duty to Monitor

As a result of ERISA's fiduciary duties, plan fiduciaries are required to monitor their plan's investment funds. Most plan fiduciaries understand this requirement and monitor their investment funds on a quarterly basis. Monitoring typically includes reviewing the fund's performance versus a relevant benchmark and/or peer group and evaluating the fund based on its alpha, beta, tracking error, style, expense ratio versus benchmark, and numerous other quantitative and qualitative data. If plan fiduciaries offer a company stock fund within their plan, they need to determine, in light of *Dudenhoeffer* and its progeny, the extent to which the company stock fund should be monitored.

It can be argued that many traditional monitoring methods, such as comparing performance to a benchmark, are pointless both pre- and post-*Dudenhoeffer*, as a plan fiduciary is not likely required to divest its plan of company stock even if the company stock consistently underperforms its benchmark. This is the opposite of what usually would be required if any other plan investment consistently underperformed its benchmark. On the other hand, evaluating the company stock fund based on quantitative and qualitative data, such as performance versus benchmark, may prove useful to a fiduciary in understanding the role of the company stock fund within the plan's broader investment portfolio. Also, courts may view favorably the monitoring of a company stock fund as evidence of a fiduciary's overall compliance with its fiduciary responsibilities.

Post-*Dudenhoeffer*, it is clear that plan fiduciaries that become aware of publicly available information, indicating that the price of the company stock may drop, need not react to such information absent "special circumstances." Unfortunately, it is not clear what "special circumstances" are because the Supreme Court declined to clarify that phrase and subsequent cases have provided little guidance. In a broad sense, if the market price of the company stock is somehow unreliable, then "special circumstances" will likely exist. Accordingly, plan fiduciaries may wish to monitor any indicators that potentially relate to the market price's reliability. An example is the stock's trading volume, since the prices of thinly traded stock may be considered less indicative of the stock's true value. Plan fiduciaries will also want to engage the assistance of their ERISA counsel to monitor new ERISA "stock drop" cases so they can be aware of new developments in this area of law.

With regard to preventing a lawsuit alleging that plan fiduciaries possessed inside information indicating that their company stock was overvalued, a plan sponsor may wish to preclude personnel with access to inside information from serving as a plan fiduciary or, alternatively, appoint an independent fiduciary to oversee the company stock fund, as such independent fiduciary would also likely not have access to inside information.

Conclusion

ERISA requires plan fiduciaries to monitor the investment funds offered by their plans. Typically, this means evaluating such funds on the basis of established quantitative and qualitative criteria. Company stock funds do not necessarily lend themselves to the established methods of monitoring. In light of *Dudenhoeffer* and cases that came later, plan fiduciaries should determine the extent to which its company stock fund should be monitored. At the very least, plan fiduciaries should pay close attention to new "stock drop" cases so they can react to any new developments in this area of law.

Notes

1. 134 S. Ct. 2459 (2014).
2. ERISA §404(a)(1)(B).
3. ERISA §404(a)(1).
4. 62 F.3d 553 (3d Cir. 1995).
5. 134 S. Ct. 2459, 2471.
6. *Id.* at 2472.
7. No. 16-7029 (D.C. Cir. December 30, 2016).
8. *Id.* at 3.
9. *But see* Gedek v. Perez, 66 F. Supp. 3d 368, 370-71 (W.D.N.Y. 2014).
10. No. 2:08-cv-472, slip op. at 1 (E.D. Texas August 19, 2016).
11. *Id.* at 5.
12. *Id.* at 6.