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SEC and DOL See Eye to Eye in Stock-Drop Case

The SEC endorses DOL guidelines governing the proper behavior for fiduciaries who manage company stock funds in defined contribution plans and who learn that employer stock is materially overvalued due to an undisclosed alleged fraud.

Background

BP Corporation North America, Inc., a subsidiary of BP p.l.c. (BP or "the company"), sponsors several defined contribution retirement savings plans for its employees. One of the investment options available in these plans is the BP Stock Fund, which consists mainly of employer stock.

On April 20, 2010, a deadly explosion occurred on Deepwater Horizon, a BP oil rig, in the Gulf of Mexico. After the disaster, the company's stock price declined substantially. As a result of the decline in the stock price, the savings plans sustained major losses.

Participants in the savings plans filed suit on June 24, 2010, alleging a breach of fiduciary duties by failing to provide material information before and after the stock price plunged. They claimed company executives provided inaccurate information about safety improvements, the risk of future accidents and the magnitude of the oil spill after the explosion and, as a result, participants who invested in employer stock suffered when the stock price plunged. In addition, they asserted that plan fiduciaries could have acted to protect participants by halting further purchases of company stock and/or publicly disclosing information about the company's safety practices.

Moench "Presumption of Prudence"

In *Moench vs Robertson*, the 3rd Circuit Court of Appeals held that fiduciaries of plans that require or encourage investment in employer stock are entitled to a presumption that they acted prudently. This presumption can only be overcome by a showing that the fiduciaries abused their discretion when they chose to continue to invest in or hold employer stock. The 3rd Circuit's ruling was adopted by many other circuits — with none refusing to apply it, though controversy remained over the procedural point in time to apply it.

Presumption of Prudence Eliminated, New Standard Imposed

In keeping with the *Moench* "presumption of prudence" for fiduciaries of ESOPs, in March 2012 the district court granted the company's motion to dismiss, reasoning that the participants had not alleged sufficient facts to overcome the "presumption of prudence" then applicable to the plans' investment in employer stock. The participants appealed to the 5th Circuit Court of Appeals.

Settlement in *Dudenhoeffer* Case

On March 17, 2016, Fifth Third Bancorp agreed to a $6 million settlement in the lawsuit by employees who claimed the company's risky subprime lending caused them to lose millions in retirement savings held in employer stock. Fifth Third also agreed that the company stock fund would not be available to new plan participants as an investment and that matching contributions would be paid in cash, rather than Fifth Third stock, for the next eight years. According to the court filings, this settlement will benefit thousands of participants in the Fifth Third plan.

In June 2014, the U.S. Supreme Court rejected the presumption of prudence in its decision in *Fifth Third Bancorp vs. Dudenhoeffer*. This game-changing decision prescribed how employees can hold employers liable for employer stock investment activities in their plans. See our June 25, 2014 *FYI Alert*.

The Court explained that to state a claim under ERISA based on a fiduciary's failure to act on nonpublic information about employer stock, participants must plausibly allege an alternative action the employer could have taken that would have been consistent with the securities laws and objectives, and that a prudent fiduciary could not have concluded would do more harm than good to the fund.

In light of *Dudenhoeffer*, in July 2014 the 5th Circuit vacated the district court's ruling in the BP case and sent it back to the district court, allowing the participants to amend their complaint. In March 2015, the district court allowed the employers to file an appeal to address the Supreme Court's "more harm than good" standard. As part of this appeal, the participants submitted additional information and the SEC and DOL filed amicus briefs.

Amicus Briefs Filed

Though several amicus briefs have been filed in this case, most notable for employers that offer company stock in their ERISA plans are those filed in support of the participants by both the SEC and DOL on March 11, 2016. These are of particular interest in that they reflect the government's position in the matter and inform other employers of possible approaches to handling events that arise for their own shares.

An amicus brief is a brief filed by a person who is not a party to the lawsuit but has a strong interest or views on the matter.

The DOL's brief suggests alternative actions fiduciaries can take if they are aware that the employer's publicly traded securities are overvalued due to material false statements or misleading omissions constituting fraud; the SEC's brief addresses how those alternative actions can be taken in a manner that does not conflict with securities laws. The agency briefs assume the alleged allegations about the facts to be true. Taken together, DOL and SEC advise plan fiduciaries in similar situations to:

- Urge others to disclose. The plan fiduciary can urge persons responsible for disclosure to correct any securities laws violations.
- Suspend all purchases and sales. ERISA may require fiduciaries to stop purchasing overvalued employer stock, but the fiduciary must also stop selling stock to avoid violating securities laws by trading on insider information. The suspension of trading must be disclosed in an 8-K form — including the reason for the suspension. Although the blackout's length will vary depending on the circumstances of each case, it must stay

in place until indications of possible fraud are dispelled by investigation or otherwise, a corrective disclosure is issued, the employer stock's artificial inflation dissipates, or the fraud no longer causes harm to the plan.

- Disclose the fraud. Securities laws require a plan fiduciary "who made or was responsible for misstatements or omissions constituting fraud" to make a public disclosure "that renders the prior statements not misleading." Other fiduciaries who have knowledge of an undisclosed fraud but do not have a disclosure duty under the securities laws can, consistent with the securities laws, disclose the fraud if possible. Any disclosure must be public; a plan executive cannot disclose the fraud only to the participants in the company stock fund. As a last resort, report the fraud to the DOL or SEC.

More Good than Harm

The DOL's brief further addresses why the alternative actions would satisfy *Dudenhoeffer's* "more good than harm" standard. Public disclosure of inside information would cause market forces to correct the stock price downward, with the result that the plan would not be purchasing stock at an inflated price. This would do more good than harm to the fund. It would be unreasonable and imprudent to continue purchasing stock on the assumption that the problem would never be uncovered. Eventually the drop in value would have occurred anyway. Refusing to buy more stock would have stopped any further harm. And once fiduciaries stopped buying stock, they would have been obligated under securities law to stop selling shares as well. The participants alleged that earlier disclosure of the safety problems at BP would have caused far less harm to the plans than continuing to conceal the fraud.

The Amicus Briefs – A Reversal of Good Fortune?

Both the *Moench* and *Dudenhoeffer* cases were seen to be rulings that favored plan fiduciaries; fiduciaries were given the benefit of the doubt in the face of a drop in the value of employer stock. The amicus briefs by the SEC and DOL in the BP case indicate an attempt to swing the pendulum the other way. Fiduciaries will need to be proactive in the face of undisclosed fraud or knowledge of a potential risk to the company if the courts adopt their view. While it is always a good thing to end fraud as soon as possible, the imposition of additional requirements and liabilities on plan fiduciaries may have a chilling effect on plan sponsors offering employer stock as a fund option.

The SEC and DOL comments in this case may encourage participants to file more "stock-drop" lawsuits, could influence sponsors to consider the elimination of their company stock funds due to expanded litigation risk, and could increase the reluctance of company officials to serve as fiduciaries for defined contribution plans. Alternatively, plan sponsors may turn to hiring an independent fiduciary. Hiring an independent fiduciary doesn't absolve a company of all responsibility, however, third-party managers aren't exposed to inside information about a potential fraud.

In Closing

Under stock-drop lawsuits, plaintiffs typically allege that a defined contribution plan or Employee Stock Ownership Plan sponsor should be held liable for investment losses when the employer's stock price declines or performs below expectations. Pressure on defined contribution plan fiduciaries is expected to rise as a result of the recent legal filings by the DOL and SEC in which they appear to expand the responsibilities of plan fiduciaries when it comes to managing company stock funds.

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