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Minimizing the Risk of ERISA Litigation in a Turbulent Economic Climate

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As recent history has shown, ERISA claims seeking recovery of investment losses tend to proliferate during times of market volatility. The Coronavirus (COVID-19) pandemic presents a unique opportunity for plaintiffs to search for and bring fiduciary-breach claims based on the underperformance of company stock funds and other available investment options in 401(k) and 403(b) plans. The pandemic has had an extraordinarily disruptive impact on the economic markets since spreading globally and into the United States. Recent swings have seen historic losses in market prices, and although all investments are feeling the hit and some slightly rebounded after Congress passed the $2.2 trillion CARES Act, some will be more adversely affected than others. This is precisely the environment in which plaintiffs can make hindsight accusations against ERISA plan fiduciaries for offering allegedly imprudent investment options.

Based on past litigation experience, we find that there are some types of investments that are considerably more likely to be the target of claims under ERISA. We review these claims below, and also offer some thoughts on preventative measures that plan sponsors and fiduciaries can consider.

Company Stock Fund Claims

For decades, the ERISA plaintiffs' bar has attempted to hold employee stock ownership plan (ESOP) fiduciaries liable for breaching their fiduciary duties when the price of a company stock declines. The claims typically allege that the ESOP fiduciaries breached their fiduciary duties by allowing plan participants to continue to invest in company stock funds at a time when (i) such funds were artificially inflated as a result of some undisclosed event, or (ii) there were some "special circumstances" that made the company stock funds too risky to be a suitable investment option in a 401(k) plan.

ESOP fiduciaries may be particularly vulnerable to employer stock fund claims during this period of the COVID-19 pandemic in light of the risk of a substantial downward movement of the stock—one that is larger than the market generally. This risk would seem to be particularly pronounced in the industries most impacted by the stay-at-home orders, such as the retail, airline, and hospitality industries. The vulnerability to claims increases if the plan fiduciaries include corporate officials with knowledge of nonpublic information that could severely affect the stock price, such as whether their company plans to implement a significant reduction-in-force or file for bankruptcy protection. The failure to protect plan participants against the anticipated drop in the price of the stock once these plans become public could give rise to a subsequent ERISA lawsuit. While there would certainly be available defenses to such claims, plan fiduciaries who are looking to avoid them altogether may wish to consider at this time implementing changes to the fiduciary decision making structure that would remove senior executives who may be privy to nonpublic information, including the possible retention of an independent fiduciary to be responsible for the ESOP.

Other Investment Vehicles That May Become Litigation Targets

The plaintiffs' bar also has brought suits challenging other investment offerings in 401(k) and 403(b) plans. Certain types of funds have proven to be particularly vulnerable to challenge, and we can expect that to be even more so the case in this volatile environment.

- *Stable Value Funds*. Stable value funds are typically offered as plan investment options to participants seeking capital preservation. Plaintiffs have brought a variety of claims challenging the offering of these funds, including claims alleging that a stable value fund was not sufficiently diversified and, as a result, underperformed other available stable value funds. In these volatile times, plan fiduciaries would be well advised to conduct a review of their capital preservation options, including their stable value funds, to determine whether they are in fact serving the objective of capital preservation, and whether more conservative options, like money market funds, should be offered as well. As with all fiduciary conduct, the review and the rationale for any resulting decisions should be well documented.
- *Alternative Investments.* Some plans offer as investment options alternative investments, such as hedge funds and private equity investments. In many cases, these investments are offered because they can function as a hedge against

declining prices in the domestic equity market. Nevertheless, plaintiffs have challenged their use whenever they underperform and have contended that they are imprudent because of their high fees, volatility, or exotic nature. We can expect the same to occur if it should turn out that, during this period of market volatility, alternative investments underperform other investment alternatives. In anticipation of such claims, plan fiduciaries should pay particular attention to developing a clear record of the rationale for maintaining these investments, and that this rationale is clearly reflected in participant communications.

- *Actively Managed Funds*. Some plans continue to offer actively managed funds in lieu of index funds. Index funds are generally less expensive than actively managed funds and frequently have performed better during the steady gains of the S&P 500 during the last decade. Depending on their investment philosophy or market sectors, actively managed funds may outperform index funds in these volatile times. But those that do not may be the target of the ERISA plaintiffs' bar. If they are not already doing so, plan fiduciaries may wish to consider supplementing actively managed products with index fund alternatives in the same market sectors.
- *Proprietary Funds.* Plans in the financial sector (and less frequently in other sectors) sometimes offer proprietary (or affiliated) investment options. These funds have been particularly vulnerable to claims when they underperform, net of fees, since participants will argue that the funds were offered in order to enrich the corporate plan sponsor. This will be particularly the case if a proprietary fund underperforms in this economic climate, when relative losses could prove to be very large. Plan fiduciaries may want to consider supplementing their plan offerings with nonproprietary options as a means to reduce the risk of such challenges.

Proskauer's Perspective

It would be truly unfortunate if companies that are already struggling to survive in the face of COVID-19 have to confront costly ERISA litigation over the retirement plans they sponsor. There is no sure way to avoid such litigation. But, at a time when plan sponsors and fiduciaries may be distracted by more emergent issues, it is important to keep in mind that ERISA fiduciary breach claims are best defended by a clear record of an objective decision-making process. Whether or not a regularly scheduled meeting is coming up, plan sponsors and fiduciaries may wish to schedule one soon for the purpose of thoroughly reviewing their investment offerings and the decision-making process, and with an eye toward the potential risks outlined above.

Plan participant communications also should be reviewed to make certain that they fully inform participants of the rewards and risks presented by their investment options in a volatile market. These reviews should be done in coordination with, and with the assistance of, competent service providers who are asked to fully review the alternatives available in these challenging times. Any changes made to the plan as a result of these reviews, and the reasons why, should be clearly communicated to plan participants.

In sum, the best defense to anticipated litigation in this volatile market is a proactive approach that enhances the fiduciary decision-making process.

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