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The ERISA Litigation Newsletter

June 2008

Editor's Overview

In light of the importance of 401(k) plans to retirement security, we begin this month's newsletter with two articles discussing challenges to the prudence of investments offered by 401(k) plans. The article on *Kirschbaum v. Reliant Energy* suggests that claims challenging investments in employer stock funds may be difficult to establish even when they include allegations of fraud. Although no one is expecting "stock drop" suits to go away (see the filing frenzy in *Bear Stearns*), *Reliant Energy* builds on a growing body of law from the U.S. Court of Appeals suggesting that there will be substantial defenses to these claims. By illustrating and relying on the favored status under ERISA of employer stock as an investment option, however, these cases also may be opening the door to prudent investment claims regarding non-employer stock investments, an issue discussed in the second article. The second article also briefly touches upon practices fiduciaries should consider to lessen these risks.

The next article addresses an issue of practical importance in advising and running ERISA plans: When are communications related to claims review protected from disclosure under the attorney-client privilege or the work product doctrine? The decision in *Tatum v. RJ Reynolds* illustrates some of the difficult issues that the courts have confronted.

The final article addresses the risks faced by a company's senior executives when a company fails to fund its ERISA pension plan. Financial distress is a fact of economic life, long reflected in the bankruptcy code and its provisions permitting the reduction or forgiveness of debt. *U.S. v. Jackson* reminds us that criminal liability can be, nonetheless, a substantial risk for failing to fund an ERISA pension plan. This go-to-jail risk seems surprisingly harsh, particularly since civil liability under ERISA is itself unclear to begin with, depending heavily on the plan language and the fortuity of the Circuit in which suit is brought.

Kirschbaum v. Reliant Energy: Fifth Circuit Adds to Growing Body of Law Imposing Substantial Hurdles to Fraud-Based Employer Stock Drop Claims

By Robert Rachal

In *Kirschbaum v. Reliant Energy, Inc.*, 2008 WL 1838324 (5th Cir. Apr. 25, 2008), the Fifth Circuit addressed a fiduciary stock drop claim arising out of the energy trading scandals occurring between 1999 and 2001. During this period certain employees of Reliant Energy had engaged in round trip trades, i.e., trades with no economic substance that were designed to inflate revenue. In May 2002, Reliant disclosed to the market that these trades had inflated revenue by about 10% over this period, and that the senior executives implicated in this trading had resigned. Reliant stock dropped 40% after these disclosures.

Reliant's 401(k) plan mandated the offering of Reliant stock as a plan investment option. A class of plan participants sued, claiming that various ERISA fiduciaries breached their duties because Reliant Energy stock was an imprudent investment, and by distributing misleading financial statements to participants. The Fifth Circuit affirmed summary judgment dismissing these claims. On the prudent investment claim, the court held that ERISA bars any claim that the plan became too heavily invested in Reliant stock. The claim was based on the notion the concentration became too risky as Reliant's business changed from a power utility to an energy trading operation. The court reasoned that this was simply a variant of a failure to diversify claim, which is precluded by ERISA § 404(a)(2). As the court explained, "[d]espite the risks inherent in concentrating plan assets in any one security," ERISA § 404(a)(2) statutorily exempts qualifying employer securities from any duty to diversify to avoid the risk of large loss.

The court next addressed the claim that, in light of the hidden business problems facing Reliant, the fiduciaries had a duty to override plan terms and preclude investment in Reliant stock. The court rejected plaintiffs' argument that the presumption of prudence for investments in qualifying employer securities, recognized in *Moench v. Robertson*, 62 F.3d 553, 571-72 (3d Cir. 1995), does not apply when the claim is that the stock was artificially inflated. The court reasoned there was no principled basis for distinguishing between "artificial inflation" of a stock price versus other sorts of negative inside information. The court then applied *Moench* to conclude plaintiffs failed to establish a claim:

> In contrast to the company-wide failure evidenced in *Moench,* here Kirschbaum has alleged round-trip trading by a few employees and an initial drop in REI's stock value of approximately forty percent. There is no indication that REI's viability as a going concern was ever threatened, nor that REI's stock was in danger of becoming essentially worthless. This is a far cry from the downward spiral in *Moench*, and much less grave than facts other courts routinely conclude are insufficient to rebut the *Moench* presumption. [Citing cases concluding that stock drops of 75% to 80% were insufficient to overcome *Moench*.]

The court also noted that *Moench* should be construed in light of the fact that fiduciaries cannot be put in the untenable position of having to predict the future performance of company stock, while the federal securities laws would prohibit fiduciaries from trading based on inside information.

On the misrepresentation claim, the court concluded that plaintiffs failed to identify any misrepresentation made in an ERISA fiduciary capacity. The court noted that the Form S-8 registration statements and 10(a) prospectus (which are required to incorporate key SEC filings) are distributed to participants in a corporate capacity as required by the federal securities laws, not in an ERISA fiduciary capacity. The court also distinguished the *Dynegy* case wherein the 10(a) prospectus was considered a possible ERISA fiduciary communication because it was allegedly used as the summary plan description.

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Reliant Energy builds on recent Circuit Court decisions that have suggested claims of fraud will not make out a fiduciary breach claim unless the fraud challenges the company's survival. For example, in *Edgar v. Avaya, Inc.*, 503 F.3d 340 (3d Cir. 2007), the Third Circuit recently dismissed a claim that fiduciaries knew or should have known the stock was inflated prior to an earnings warning that resulted in a 25% one-day drop in the stock price, reasoning that this was not the type of "dire circumstance" that would overcome *Moench's* presumption of prudence. Similarly, in *Pugh v. Tribune Co.*,2008 WL 867739 (7th Cir. Apr. 2, 2008), discussed in **last month's Newsletter**, the Seventh Circuit concluded fiduciaries may reasonably rely on the company's investigation and reporting of fraud absent some reason to believe the corporate reporting process was broken. Although ERISA fiduciary suits continue to be filed when a company with an employer stock fund in its 401(k) plan suffers a substantial setback, these cases suggest that there will be substantial defenses to these claims.

401(k) Plans and Prudent Investments: Are the Employer Stock Cases Laying the Groundwork for Claims beyond Employer Stock Funds?

By Robert Rachal

As discussed in this month's article on *Reliant Energy*, the U.S. Courts of Appeals are providing grounds for substantial defenses to the claim investments in employer stock funds are imprudent. However, in so doing, the Circuit Courts have emphasized the favored status of employer stock under ERISA, and have created *dicta* that, collectively, provide potential grounds for challenging risky investments in other investment options.

First, is the premise set forth in *DiFelice v. U.S. Airways*, 497 F.3d 410 (4th Cir. 2007), to the effect that modern portfolio theory (which requires evaluating the prudence of individual investment options in relation to the portfolio of applicable investment options) does not control analysis of the prudence of investment options offered in participant-directed 401(k) plans. According to the Fourth Circuit:

> The relevant "portfolio" that must be prudent is *each* available Fund considered on its own, including the Company Fund, not the full menu of Plan funds. This is so because a fiduciary cannot free himself from his duty to act as a prudent man simply by arguing that other funds, which individuals may *or may not* elect to combine with a company stock fund, could theoretically, in combination, create a prudent portfolio.

Second, is the premise that certain types of investments are inherently risky, with the courts in *Reliant Energy* and *Summers v. State Street (United Airlines)*, 453 F.3d 404 (7th Cir. 2006), suggesting that, but for the statutory exemption provided by ERISA § 404(a)(2), employer stock funds risk violating the duty to diversify to avoid the risk of large loss. According to the Seventh Circuit:

> Because the value of any single stock or bond is tied to the fortunes of one company, holding a single kind of stock or bond is very risky. By contrast, people who hold a diverse portfolio of stocks and bonds face less risk because they have only a small stake in each company. [Citation omitted.] That is why ERISA fiduciaries have a duty of diversification as part of their overall duty of prudence-unless as in this case they are directed pursuant to an ESOP to invest everything in stock of the participants' employer.

It would make little sense for courts to develop rules that preclude 401(k) plans from being able to offer high-risk/high return investment options; e.g., international stock funds have been the source of outsized investment returns for many 401(k) participants over the past few years. If the "stand alone" and "inherently risky/duty to diversify" premises discussed above were combined and applied literally, however, that is precisely what would happen. It is thus no surprise that suits have been brought challenging the prudence of non-employer stock investments for stock acquired in spin-offs (e.g., Southern Company, General Motors, Williams Companies), and for bond funds that suffered losses related to the sub-prime crisis (State Street, Regions Bank).

We believe that there are substantial defenses to these claims, including that this *dicta* should not be taken out of context. For example, the Department of Labor, the *Restatement (Third) of Trusts*, and several courts have recognized that modern portfolio theory *does* apply under ERISA to evaluate the prudence of investments; this theory also is embodied in the ERISA § 404(c) defense, which provides an independent defense to these claims. In light of the current litigation environment, where applicable, fiduciaries should also consider documenting why the plan is offering high risk/high return investment options, and educating participants on how these options are meant to work within, and to be only a part of, a participant's diversified portfolio of investments.

Are You Sure Your Communication Is Privileged? Application of the Fiduciary Exception In ERISA Litigation

by Russell L. Hirschhorn

Courts have long recognized the importance of the attorney-client privilege. Its purpose is to encourage full and frank communication between attorneys and their clients. The privilege, however, is not absolute; a "fiduciary exception" to the attorney-client privilege has become well established. Rooted in English common law, and applied in various disciplines, courts routinely have applied the fiduciary exception in the appropriate circumstances in ERISA litigation. Although the fiduciary exception is well accepted, how it applies in practice is not so uniformly settled, as illustrated by *Tatum v. R.J. Reynolds Tobacco Co.*, 247 F.R.D. 488 (M.D.N.C. 2008). *Tatum* arose out of an employee's challenge to the elimination of two stocks as investment options in his employer's 401(k) plan. In 2001, plaintiff met with the manager of benefits compliance and stated that he had retained a lawyer and was considering a class action lawsuit. Plaintiff was told to submit a claim for benefits, which he did, claiming that the plan fiduciaries breached their fiduciary duties in connection with the divestiture of the stock. After plaintiff's benefits claim was denied and the appeals process exhausted, plaintiff filed suit. During the course of discovery, defendants objected to a number of interrogatories and document requests on the grounds that the information requested was protected by the attorney-client privilege and/or the work product doctrine.

The court observed that although the Fourth Circuit has not yet considered the applicability of the fiduciary exception to ERISA litigation, it has applied the fiduciary exception in other disciplines. The court accordingly agreed with two other district courts within the Fourth Circuit and concluded that the fiduciary exception to the attorney-client privilege applied to ERISA litigation. In so holding, the court determined that: (i) communications concerning settlor functions of plan amendment remain privileged even if those communications occur during the claim review procedure; (ii) draft communications to participants about the plan must be produced; (iii) advice given by counsel as to litigation issues, even if given during the claims review process, are privileged; and (iv) documents concerning the claims review procedure related to the legal claim are subject to attorney work-product protection.

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The *Tatum* decision highlights one of the more controversial issues that arise in these cases: whether the fiduciary exception should apply to communications between counsel and plan fiduciaries concerning claims for benefits by a participant. In the past, some courts have concluded that even these communications are subject to the fiduciary exception, provided they occur prior to the decision to deny benefits. These courts reason that there is no adversity between the plan and the beneficiary until a claim for benefits is denied. *See*, *e.g.*, *Asuncion v. Metro. Life Ins. Co.*, 493 F. Supp. 2d 716 (S.D.N.Y. 2007); *Geissal v. Moore Medical Corp.*, 192 F.R.D. 620 (E.D. Mo. 2000).

These holdings have been somewhat surprising because, when beneficiaries assert claims for benefits, they may be arguably adverse to the plan even prior to the decision to the decision to deny benefits. The *Tatum* court appears to agree insofar as it rejected plaintiffs' argument that all communications between counsel and the plan during the administrative claims are subject to the fiduciary exception. The court reasoned the fiduciary exception is grounded in the identity of interests, and that "grounding vanishes where the fiduciary is faced with a threat of litigation and seeks legal advice for its own protection against plan beneficiaries, regardless of whether that threat of litigation occurs before, during, or after the administrative claim process." Under this approach, it is thus necessary, regardless of when the communication occurred, to examine both the context and the content of every communication to determine whether the fiduciary exception applies.

***United States v. Jackson*: Imposing Criminal liability for Failure to Fund a Company's Pension Plan**

By Robert Rachal

Companies too often face financial distress. Chapters 7 and 11 of the Bankruptcy Code are premised on this, including the need to work out or forgive payments to various company creditors. The Fourth Circuit's decision in *United States v. Jackson*, 2008 WL 1903485 (4th Cir. May 1, 2008) reminds us, however, that there can be at least one class of creditor for whom you can go to jail for failure to payup: an ERISA plan.

Jackson involved the common situation in where a business deteriorated, it worked itself deeper into debt and fell behind on various payments. The CEO and CFO eventually were indicted on bank and wire fraud offenses, and on the claim that they stole assets from an ERISA plan in violation of section 664 of the federal criminal code, 18 U.S.C. § 664. During the period of financial distress, the CEO and CFO set up a secret bank account to which they diverted certain funds received by the corporation for their own use. The pertinent ERISA issue on appeal was whether the CEO and CFO's failure to make the employer's funding contributions to a pension plan violated section 664. The Fourth Circuit held that it did, reasoning that the unpaid contributions were "plan assets":

> When Burruss established its ERISA pension plans, it bound itself to the terms thereof. Both Plans mandated annual contributions based upon hours worked, and wages and salaries paid. Burruss could properly extricate itself from those ERISA obligations only by proper termination of the Plans.

The court also noted that section 664 applies to "any person," not just to ERISA fiduciaries. In this case, the court ruled that the defendants were ERISA fiduciaries because they exercised control over whether to pay the unfunded contributions.

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Although there are sound policy reasons to encourage the paying of unfunded employer contributions, the rule in *Jackson* seems harsh, particularly in light of the conflicting state of the law on the capacity in which "control" is exercised over unfunded plan contributions. For example, in several recent decisions (*see In re Luna,* 496 F.3d 1192 (10th Cir. 2005); *Holdeman v. Devine,* 474 F.3d 770 (10th Cir. 2007)), the Tenth Circuit concluded that the decision allocating corporate funds is, by definition, *not* a fiduciary function, even if a debt is owed to the plan for unpaid contributions, and even if some of those funds are diverted for the personal benefit of the corporate actor. The Tenth Circuit reasoned that the power over those funds arises from the corporate role. In contrast, in the Fourth Circuit this same act can constitute criminal embezzlement from an ERISA plan. Also, although it was not apparently at issue in *Jackson*, it is not clear what it means to "embezzle or convert" from an ERISA plan when the funds at issue reside in corporate accounts. For example, does any corporate use qualify, and thus "conversion" occurs when the funds are moved from one corporate account to another? Or must there be some use on behalf of the corporate actor and, if so, are there any quantum (does paying salary violate) or traceability requirements?

Rulings, Filings and Settlements of Interest

- In *Trujillo v. PacifiCorp*, 2008 U.S. App. LEXIS 9807 (10th Cir. May 7, 2008), the court held that plaintiffs (a husband and wife) provided sufficient evidence on which to go to trial on the issue of whether the decision to terminate their employment was based on discriminatory intent to violate the ADA, and that the evidence also supported an inference that their discharge was motivated by an intent to interfere

with their ERISA benefits. Among other things, the evidence showed that healthcare expenses were a budget line item for each employee, and that at the time of their termination, the company had denominated the claim of the employees' son as a "high dollar" claim and was tracking it closely.

- The Solicitor General recommended that the U.S. Supreme Court deny *certiorari* in *AT&T Pension Benefit Plan v. Call*, No. 06-1398, a decision from the Seventh Circuit concluding that a pension plan amendment affecting the calculation of lump-sum payments improperly reduced early retirees' accrued benefits. The Solicitor argued that the case only involved a dispute about the proper interpretation of the plan, not ERISA, and that it does not present an important legal issue that warrants the Court's review.

On May 23, the Solicitor General asked the U.S. Supreme Court to grant *certiorari* in *Amschwand v. Spherion Corp.*, Docket No. 07-84, a case that once again addresses the types of "equitable remedies" that are available under ERISA. **Click here** for a link to the April Newsletter, which discusses the Fifth Circuit's opinion.

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