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Summary of the Situation

In the aftermath of the Supreme Court’s 2014 decision in Fifth Third Bancorp et al. v. Dudenhoeffer, the stock drop lawsuits that are getting the most traction with courts generally involve claims that plan fiduciaries were aware of inside information on the basis of which they could have reasonably concluded that the company stock’s market price was “artificially inflated.” In this article discuss the Department of Labor’s theory of the issue – what an ERISA fiduciary can (and, by implication, should or must) do when she possesses such inside information – as outlined in its amicus brief recently filed with the Supreme Court in Whitley v. BP.

Who is most impacted by this?

Sponsors of DC plans that include a company stock fund.

Key takeaways for clients

- **Background:** In Fifth Third, the Supreme Court rejected the “presumption of prudence” standard that had been applied by lower courts in stock drop cases. It replaced it with, for public companies, what might be called a “presumption that the market price is fair” standard. With respect to claim based on inside information, the Court held generally that:

  To state a claim for breach of the duty of prudence on the basis of inside information, a plaintiff must plausibly allege an alternative action that the defendant 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. [Emphasis added.]
Key takeaways for clients (cont’d)

- **Recent inside information-stock drop cases:** Several current stock drop cases, including *Harris v. Amgen* and *Whitley v. BP*, involve allegations that plan fiduciaries had inside information that the market price of company stock was “artificially inflated.” *Whitley* is currently before the Supreme Court on a defendants’ appeal of a lower court’s interpretation of this “more harm than good” standard.

  - *Whitley v. BP* is a “classic” stock drop claim: after the 2010 *Deepwater Horizon* explosion, BP’s stock lost significant value. Plaintiff-participants in the BP DC plans sued, alleging that the sponsor fiduciaries breached their ERISA duties of prudence and loyalty by not selling and by continuing to buy stock in the plans’ company stock fund.

  - In January 2015, responding to plaintiffs’ motion to amend the Whitley complaint to reflect the *Fifth Third* decision, the district court found that “Defendants [BP plan fiduciaries] knew, or should have known, that the market price of BP ADSs [American Depository Shares] was distorted due to non-public company information.” In light of that knowledge, the lower court found that plan fiduciaries could have done two things—(1) disclose the non-public information and (2) freeze, limit, or restrict company stock purchases—that would not have conflicted with the securities laws. And it found that it could not determine “that no prudent fiduciary would have concluded that removing the BP Stock Fund as an investment option, or fully disclosing the state and scope of BP’s safety reforms, would do more good than harm.”

  - Defendant fiduciaries then requested leave to appeal to the Supreme Court the question: “What plausible factual allegations are required to meet the ‘more harm than good to the fund’ pleading standard [of *Fifth Third*]?” and the Supreme Court granted that request. On March 11, 2016 DOL filed an amicus curiae brief in the case; at the same time the Securities and Exchange Commission filed a brief “intended to supplement” DOL’s brief.

  - As a critical element of its analysis in *Whitley*, DOL is assuming that there was an “ongoing fraud.” Not all inside information claims involve an “ongoing fraud,” and fiduciaries may be confronted with “grayer” situations than the one (assumed) in this case.

- **Actions consistent with the securities laws:** In this situation—where plan fiduciaries are aware of an ongoing securities fraud—what actions may plan fiduciaries take that are consistent with the securities laws? The SEC brief (supplementing DOL’s brief) provides the most succinct summary of DOL/SEC’s answer. Plan fiduciaries may:

  - *Disclose the fraud.* … Under the securities laws, an ESOP manager who made or was responsible for misstatements or omissions constituting the fraud has a duty to make a disclosure that renders the prior statements not misleading. … [A] manager who was not responsible for the fraud, but who knew about it, may nevertheless elect to disclose it if
possible. Any such disclosure must be public; an ESOP manager of a publicly traded issuer cannot disclose the fraud solely to ESOP participants because that would either cause a violation of the selective disclosure rules under Regulation FD of the Exchange Act or it would constitute an illegal tip under the securities laws’ insider trading prohibitions.

Suspend ESOP transactions. … ERISA may require the ESOP manager to refrain from effecting purchases of additional shares of overvalued employer stock. To avoid violating the securities laws, a plan manager in such circumstances must concurrently refrain from effecting sales of shares on behalf of plan participants in order to completely abstain from trading on the basis of inside information about the employer’s fraud.

Other alternatives. DoL’s amicus brief proposes other measures that, while not required by the securities laws or independently sufficient to meet obligations under the securities laws, would not be inconsistent with the securities laws. The DoL amicus brief’s view that an ESOP manager could urge the persons responsible for the fraud to disclose it does not conflict with the securities laws and could lead others to fulfill the disclosure duty they already owe under the securities laws. Such an approach would not satisfy any independent obligation that the ESOP manager might have under the securities laws to correct misstatements or omissions for which the manager was responsible. Similarly, the DoL amicus brief’s view that the ESOP could report the fraud to DoL and/or the SEC would not conflict with the securities laws.

- The “more harm than good” standard: Quoting Fifth Third:

Courts confronted with such claims should consider whether the complaint has plausibly alleged that a prudent fiduciary in the defendant’s position could not have concluded that stopping purchases 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.

- On the face of it, the Court seems to be implying that there may be cases where, because of the (greater) amount of stock already in the plan relative to the (lesser) amount of ongoing purchases, disclosure of inside information might “do more harm than good.” Because (again, by implication) there would be greater losses on the stock already held by the plan than on subsequent purchases. And, on the other hand, there may be other cases where it would not “do more harm than good,” because of the (lesser) amount of stock already in the fund relative to (greater) amount of ongoing purchases. Which is, when you think about it, kind of an odd standard.

- The lower court in Whitley “struggled” with the Supreme Court’s “more harm than good” standard, suggesting that Fifth Third “itself is inconsistent,” and concluding in the end (and with “consternation”) that it “cannot determine, on the basis of the
pleadings alone, that no prudent fiduciary would have concluded that removing the BP Stock Fund as an investment option, or fully disclosing the state and scope of BP’s safety reforms, would do more good than harm.” Thus, it’s not surprising that the Supreme Court took defendants’ appeal for clarification of the “more harm than good” standard.

- **DOL’s solution – disclosing ongoing fraud will never do more harm than good:** In its brief DOL takes that position that, where there is an ongoing fraud, inside information must be disclosed. DOL’s rationale is that fraud will, at some point, have to be disclosed by someone. Thus the “harm” to the plan cannot be avoided, and the sooner the fraud is exposed, the better.

- **Bottom line:** All of this is both confusing and intimidating, especially for plan fiduciaries who are not experts in the securities laws. Boiling it down, here is the bottom line:

  1. We are discussing a DOL brief (that is, an argument). The standards it articulates are not law (yet), but the brief does indicate what DOL thinks the law should be.
  2. At its narrowest, DOL’s position can be summarized as follows: where an ERISA fiduciary of a plan with a public company stock fund knows, based on inside information, that the stock’s market price is “artificially inflated” because of an “ongoing fraud,” the fiduciary can (and, by implication, should or must) (i) disclose the inside information and (ii) suspend plan buying and selling of the stock until the fraud is cured.
  3. The actions the DOL is calling for in these cases – disclosure and suspension of plan company stock transactions – are fairly drastic. They may bring the fiduciary into conflict with company management. And they involve the plan fiduciary in matters with respect to which he (typically) will not have any expertise (the “complex” rules under the securities laws with respect to the disclosure of material information) and others in management (e.g., company securities lawyers) will have expertise.
  4. That (all of 2 and 3) is, according to DOL, not relevant to its analysis: It is not anomalous that an ERISA fiduciary who is also a corporate insider may have broader obligations to disclose inside information in the face of an ongoing fraud than what the securities laws alone require. That is merely the “consequence of the corporation’s own decision to establish an ESOP and to install its own officers as plan fiduciaries.”
  5. Note that the disclosure must be to “the public” not just to participants. And note that the suspension must be of both purchases and sales. So that participants wanting to get out of the stock fund will be prevented from doing so. Indeed, if the fiduciary suspends company stock sales improperly (if he is wrong about his ERISA and securities law obligations), he may be sued by participants who were prevented from selling (or, for that matter, buying) during the suspension.
6. All of the foregoing may encourage sponsors and sponsor-fiduciaries to consider delegating (outsourcing) management of a company stock fund to an outside fiduciary. An outside fiduciary will (typically) not have access to compromising inside information and thus may not confront the challenges described in 3-5. The question will then become whether and in what circumstances a delegating fiduciary with inside information may have a duty to inform the outside fiduciary of that information.

*What’s next?*

We will continue to follow this issue.