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Management Alert

Seventh Circuit Severely Weakens ERISA "Stock Drop" And "401(K) Fees" Cases

On January 21, 2011, the Seventh Circuit Court of Appeals issued two important decisions for all employers who offer defined contribution retirement plans (commonly known as 401(k) plans). These two decisions, which arise from four cases, severely undermine plaintiffs' ability to challenge fiduciary decisions related to 401(k) plans on a class-wide basis.

In *Howell v. Motorola, Inc.* (Case No. 07-3837) and *Lingis v. Dorazil* (Case No. 09-2796) ("Stock Drop Cases"), the Court concluded that the Employee Retirement Income Security Act ("ERISA") 29 U.S.C. § 1104(c) "safe harbor" shielded fiduciaries from claims that the defendants failed to disclose sufficient information about an allegedly bad business transaction and that certain defendants failed to monitor the conduct of fiduciaries they had appointed. The Court also determined that the fiduciaries did not violate ERISA's duty of prudence by including the Motorola Stock Fund as an investment option in the 401(k) plan, because Motorola stock never performed so poorly as to make it an imprudent investment option. The Court also ruled that one plaintiff's release agreement, signed as part of a reduction in force, barred his breach of fiduciary duty claims, despite a carve-out for claims for "benefits" under the company's plans.

In *Spano v. The Boeing Co.* (Case No. 09-3001) and *Beesley v. International Paper Co.* (Case No. 09-3018) ("401(k) Fees Cases"), the Court vacated largely identical orders certifying classes of participants challenging the appropriateness of certain 401(k) plan fees and the prudence of plan investment options. The Court found that the certified classes violated the adequacy and typicality requirements of Federal Rule of Civil Procedure 23(a).

The Background

A. The Stock Drop Cases

In the Stock Drop Cases, the plaintiffs alleged that defendants breached their fiduciary duties to the Motorola 401(k) plan by allowing participants to invest in a Motorola Stock Fund following an allegedly bad business transaction (disclosure of which the Court assumed had caused Motorola's stock price to drop), failed to disclose allegedly material information regarding the transaction, and failed to appoint and appropriately monitor competent fiduciaries. The Northern District of Illinois granted summary judgment as to the first class representative, Howell, because he signed a release of his ERISA claims. Three new plaintiffs eventually intervened and the district court ultimately granted summary judgment, as to the *Lingis* case, for all defendants. The plaintiffs' appeals were consolidated before the Seventh Circuit.

B. The 401(k) Fees Cases

In two separate actions, the participants in the Boeing Co. and International Paper Co. 401(k) plans alleged that the defendants caused the plans to pay excessive fees and expenses, to offer imprudent investment options, and to conceal material information from participants. The Southern District of Illinois certified the cases as class actions, defining the respective classes to encompass virtually all participants who ever had or might in the future participate in the plans. Both sets of defendants' petitions for leave to appeal the class certification rulings were granted and the cases were consolidated with the Stock Drop Cases for argument and decision.

The Court's Holdings

A. The Court Upholds Summary Judgment For Defendants In The Stock Drop Cases.

The Court initially addressed the *Howell* appeal. As part of a severance program, Howell signed a release waiving all claims he may have had against Motorola, including claims under ERISA. The defendants argued that this release barred Howell's breach of fiduciary duty claims. Howell argued that this claim was not released because it was a claim for benefits under the plan and because ERISA prohibits fiduciaries from abdicating their fiduciary responsibilities. The Seventh Circuit rejected both claims, finding that the exception in the release for "benefits" claims only applied to any "specific benefits that had already vested in Howell's 401(k) plan by the time that he signed the release." (Slip op. at 18). Howell's claim in this lawsuit, however, was that "his account would have been worth even more had the defendants not breached a fiduciary duty" and this claim was encompassed within the release. *Id.* The Court also found that nothing in ERISA prohibits a fiduciary from obtaining a release of potential claims that had already accrued.

Turning to the *Lingis* appeal and the question of whether the defendants breached their fiduciary duties, the Court first examined whether the ERISA 404(c) safe harbor shielded defendants from liability. As the Court stated, "[t]he purpose of the 404(c) safe harbor is to relieve the fiduciary of responsibility for choices made by someone beyond its control." (Slip op. at 33). Initially, the Court concluded that the selection of plan investment options is not subject to 404(c) protection because it is a decision not within participants' control. Even though the Section 404(c) safe harbor did not apply to plaintiff's imprudent selection claim, the Court rejected plaintiffs' theory on the merits. The Court stressed that the Motorola Stock Fund was one option amongst many that participants could have selected and that the plan repeatedly warned participants of the risks of investing in an undiversified investment option. Acknowledging further that Motorola was never on verge of collapse, the Court pointed out that fluctuations in the Stock Fund's price were well within the range described in the Plan documents. Ultimately, the Court held that "Motorola was a fundamentally sound company" and the plaintiffs offered nothing to support their imprudence theory that the stock was "so risky or worthless" to justify immediately pulling the Motorola Stock Fund from the Plan's investment options. (Slip op. at 38).

The Court found that Section 404(c) was a defense to plaintiffs' nondisclosure and monitoring claims. The Court rejected plaintiffs' arguments that the safe harbor did not apply because the plan had provided insufficient information, concluding instead that the Plan provided detailed disclosures about the risk associated with investments and the defendants never intentionally misled participants. According to the Court, "there is no support for the view that Plan fiduciaries were required to provide all information about Motorola's business decisions in real time to Plan participants." (Slip op. at 44). The Court

concluded that the 404(c) safe harbor applied to the failure to monitor claim with equal force. And even if the 404(c) safe harbor did not apply to the failure to monitor claim, the Court rejected the plaintiffs' suggested standard for monitoring, which seemingly would require "every appointing Board member to review all business decisions of Plan administrators." (Slip op. at 47).

B. The Court Vacates The Class Certifications Of The 401(k) Fees Cases

Reviewing the district court's class certification decisions under a lenient abuse of discretion standard, the Seventh Circuit concluded that the classes certified were far too broad and failed to meet the requirements of Rule 23(a).

Turning first to the *Spano* class, the Court initially noted that neither party disputed that the certified class met the numerosity element of Rule 23(a)(1). The Court then found that the class also met the commonality element of Rule 23(a)(2). Rejecting the defendants' arguments that the varying investment options available to participants defeated commonality, the Court found that the plaintiffs' allegations of imprudent selection of investment options and across-the-board excess fees were sufficient to show commonality. Analyzing the Rule 23(a)(3) typicality requirement, however, the Court initially characterized the class definition as "breathtaking in its scope" because it encompassed "[a]nyone, in the history of Time, who was ever a participant in the Boeing Plan, or who in the future may become a participant in the Boeing Plan." (Slip op. at 25). The Court pointed out that there was no evidence that the named plaintiffs even participated in the allegedly imprudent funds. The Court then stated that "at a minimum" plaintiffs challenging investment decisions in a defined contribution plan should be able to show that the class representatives participated in the same fund(s) as the class members. (Slip. Op. at 26).

Similarly, in analyzing the Rule 23(a)(4) adequacy requirement, the Court pointed out that many of the class members may have had no complaint with the funds at issue, depending on when they entered and left the funds. The Court found that the broad class failed to adequately protect the interests of all class members, given the potential for conflicts between those members who profited from the investments and those who did not.

Turning to Rule 23(b), the Court questioned the lower court's certification under Rule 23(b)(1)(B). Noting that "[a] claim of imprudent management, for example, is not common if the alleged conduct harmed some participants and helped others, which appears to be the case" (slip op. at 29), the Court found that the class as certified could not meet the requirements of Rule 23(b)(1)(B), which require that "adjudication of one person's claim" to dispose of a fellow class member's claim or "would impair or impede their [class member's] ability to protect their interests." *Id*. The Court also pointed out that the *Spano* class would fare no better under Rule 23(b)(1)(A), because there is no evidence that inconsistent decisions could have a negative impact on the competing class members.

The Court's analysis of the *Beesley* class was similar. The Court concluded that the plaintiffs failed to show how their claims were typical or that the class representatives were adequate, given that there was no evidence as to the type of alleged misrepresentation or the participation in the alleged imprudent funds or the harm of allegedly excessive fees on the class representatives, let alone all of the class members. The Court therefore remanded the cases for further proceedings, noting that the lower court must carefully consider the "boundaries" the Court drew in this opinion and narrowly define the classes, if any, that meet these requirements.

What Do These Cases Mean For Employers?

The Court's opinion in the Stock Drop Cases reaffirms the importance of compliance with ERISA § 404(c). This safe harbor provision can provide 401(k) plan sponsors with protection if their fiduciary decisions are later challenged, although the Court does not apply the safe harbor to initial fund selection. The Court's ruling on Howell's release is also significant because it enhances the value of a well-drafted severance agreement. Moreover, the Court's ultimate holding on the imprudent investment claim sets a high bar for plaintiffs. Essentially, the Court has said that to recover, a plaintiff in a stock drop case must show that the employer's stock has to be on the verge of collapse and that only worthless or extremely risky stocks will be deemed imprudent.

The Court's class certification rulings call into question the future viability of 401(k) plan class actions by mandating that classes share a genuine common interest. The opinion certainly suggests that a class that encompasses all participants in a 401(k) plan is too broad, given the wide-variety of investment practices and dates of entry and exit from the plan.

Seyfarth represented Motorola and the other defendants in the Stock Drop Cases described above. Please feel free to contact Ian Morrison or John Murray if you have further questions about the decision.

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