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Hold It or Fold It: Keeping or Terminating the Employer Stock Fund After *Dudenhoeffer* and *Tatum*



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In this article, we propose a fiduciary process letting the Employee Retirement Income Security Act fiduciary decide whether it may prudently offer an employer stock fund in the 401(k) plan of a publicly traded company. On several key points, however, the law defining the fiduciary's duty of prudence is undeveloped, confused or conflicted. Our proposed process thus also supports an exit strategy: the fiduciary's prudent decision to terminate and liquidate the employer stock fund. The process supporting both decisions is based on the Supreme Court's 2014 opinion in *Fifth Third Bancorp v. Dudenhoeffer*, and its sturdy infrastructure of case law and financial market theory.¹ *Dudenhoeffer* and its legal and theoretical foundations support a robust process letting the fiduciary decide it may prudently hold the employer stock fund open to new investment, or prudently terminate it. This process supports either decision—but compels neither.

Introduction: The Fiduciary Dilemma

The fiduciary of an employer stock fund grasps the proverbial tiger by the tail: perilous to hold on; perilous

¹ *Fifth Third Bancorp v. Dudenhoeffer*, 134 S. Ct. 2459, 2014 BL 175777, 58 EBC 1405 (2014)(123 PBD, 6/26/14) .

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to let go. After the Court in *Dudenhoeffer* discarded the longstanding *Moench* presumption of prudence onto the ash heap of ERISA history by a nine-zero vote, the fiduciary must review the employer stock fund like any other. If the stock price collapses or merely underperforms, the fiduciary could be sued for having breached its duty of prudence. But if the fiduciary terminates and liquidates the fund, participants could sue when the stock price rebounds. ERISA's duty of prudent investing requires prudent conduct and a prudent process. Keep or close the fund, the fiduciary needs a robust process to show its decision is prudent.

The fiduciary's typical investment review process is woefully ill suited either to keeping or removing the employer stock fund. The fiduciary typically reviews a plan's fund offerings by comparing past performance against a benchmark or peer group. For a single stock fund, this invites trouble and risks an imprudent decision. The predictably random and idiosyncratic price movements of any single stock—its "specific risk" in finance jargon—mean periods of under-performance (and over-performance) against any benchmark are virtually inevitable. By keeping the fund open after a theoretically predictable period of bad performance, the fiduciary imprudently ignores its own process. But by terminating the fund, the fiduciary imprudently ignores the possibility of a later price rebound.

Moreover, this backward-facing review conflicts with *Dudenhoeffer*. Based on the efficient market hypothesis, *Dudenhoeffer* states the fiduciary may rely on the stock's market price as the best available estimate of its value, absent "special circumstance" making reliance on the market's valuation imprudent.² Under the *Dudenhoeffer* fair market price presumption, the fiduciary may conclude that—absent special circumstances making it imprudent to rely on the market price—it can't beat the market, it has no duty to try predicting whether the price will go up or down, and it may prudently buy, hold or sell the stock at the market price. *Dudenhoeffer* points to a better way of evaluating employer stock.

² *Dudenhoeffer* sets forth the facts plaintiffs must plausibly allege to survive a motion to dismiss for failure to state a claim the fiduciary acted imprudently. These pleading standards thus also define certain aspects of the substantive duty of fiduciary prudence.

A roadmap of this article follows here.

Section I outlines a process supporting the fiduciary's decision to hold the employer stock fund open to new investment. The starting point is a well-established and routine test proving the stock trades in an efficient market. This multi-part test is long accepted by the federal courts in securities law litigation as establishing the presumption the stock's market price accurately reflects all public information. This same securities case law is the express precedent for *Dudenhoeffer's* identical fair market price presumption. The fiduciary may repurpose this familiar test as an up-front process demonstrating the stock is fairly priced by an efficient market and therefore that no "special circumstances" make the stock's market price unreliable as the best estimate of its value.

Section I also explains how a *Dudenhoeffer*-based process can help the fiduciary address its two other sources of vulnerability: Whether the stock is overpriced based on inside information, and whether the stock is too "risky" to be in the plan.

Section I also shows, however, the fiduciary's duty of prudence is ill defined on key points. The law on all three sources of challenge to the prudence of the fiduciary's decision—public information, inside information, and risk—is on some points unsettled.

Section II accordingly reverses course and supports the fiduciary's opposite decision to remove the employer stock fund. Liquidating the fund too raises risks. The obvious one is the price then goes up and plaintiffs sue the fiduciary for imprudently failing to predict the price rebound. Moreover, changing direction and closing a fund long held open raises questions, creating additional risks for both the employer and fiduciary. Why close the fund? Why now? A good fiduciary process should answer these questions. Otherwise, the decision could be viewed by shareholders as management's tacit admission the company is in trouble, by participants as the fiduciary's admission it was imprudent not to close the fund sooner, and by plaintiffs' attorneys as the fiduciary's breach of its duty of loyalty if internal information reveals the decision was motivated in part by fears of liability. A process based on *Dudenhoeffer* and its underlying financial market theory addresses all these risks. It lets the fiduciary establish the termination is prudent and solely in participants' interests—even if the stock price later goes up. And it lets both fiduciary and company explain the termination truthfully, credibly and without the risk of signaling that management has lost faith in the stock, that the fiduciary was imprudent not to close it earlier, or that the fiduciary terminated the fund for inappropriate and disloyal reasons.

Section III outlines possible strategies to supplement the fiduciary's protection under ERISA Section 404(c).

Section IV is an Executive Summary of the fiduciary processes set forth in the preceding three sections.

I. Holding the Fund Open: A Fiduciary Process

After *Dudenhoeffer*, the fiduciary of a 401(k) plan offering an employer stock fund needs a process to support its decision to keep the fund open to new investment. If the stock price drops, plaintiffs will claim the fiduciary imprudently failed to anticipate the drop because of the fiduciary's imprudent failure to consider

(1) public information; (2) inside information; or (3) risk. A strong process can help show the fiduciary's decision was prudent on all three counts.

(1) Public Information. (a) Pitfalls of the Typical Investment Review. The typical fiduciary review of a plan's investment funds relies on benchmarking and other public information. This review is backward looking. A fund that has persistently underperformed its benchmark or peer group may be put on a watch list and ultimately terminated and liquidated. The fiduciary regularly reviews and drops other fund offerings this way—why not the employer stock fund?

Yet financial market theory predicts over time any single stock will randomly underperform any peer or benchmark for some period (and also outperform it).³ By sticking to its regular process, the fiduciary inevitably faces a dilemma when the stock predictably skids or languishes relative to its benchmark: imprudently ignore its own process and be sued for past losses; or imprudently ignore the likelihood of a price rebound, terminate the fund, and be sued for forgone gains. Going forward, the fiduciary needs a different kind of process to review employer stock. This different process is offered by *Dudenhoeffer*.

(b) *Dudenhoeffer* Neutralizes Negative Public Information. *Dudenhoeffer* creates a new prudence standard for employer stock: the fiduciary may prudently rely on the market price of a publicly traded stock as the best available estimate of its value, absent special circumstances making reliance on the market's valuation imprudent.⁴ The *Dudenhoeffer* presumption is based on the efficient market hypothesis, which predicts a stock's market price reflects all publicly available information. This legal presumption is long established in federal securities law, from which the Court wrests it for use by the ERISA fiduciary.⁵ Under *Dudenhoeffer's*

³ The general idea underlying this prediction is discussed at Section I(3)(b) of this article.

⁴ *Dudenhoeffer*, 134 S. Ct. at 2471–72 (“[A] fiduciary usually is not imprudent to assume that a major stock market . . . provides the best estimate of the value of the stocks traded on it that is available to him.”) (internal citations and quotations omitted).

⁵ For its fair market price presumption, *Dudenhoeffer* cites *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398, 2014 BL 172975 (2014), which in turn relied on and clarified the foundational securities law opinion, *Basic Inc. v. Levinson*, 485 U.S. 224 (1988). *Basic* held that stock market investors may establish the presumption that the price of a publicly traded stock reflects all available public information. 485 U.S. at 247. *Basic* allows plaintiffs in securities fraud cases to establish the so-called “semi-strong” version of the efficient market hypothesis, a version generally stating that “the value of new information is itself reflected in prices quickly after release, so that only the first recipient of this information (or someone with inside information) makes a profit; everyone else might as well ignore the information and rely on the prices.” *Schleicher v. Wendt*, 618 F.3d 679, 685, 2010 BL 193632 (7th Cir. 2010). In its *Halliburton* decision, handed down two days before *Dudenhoeffer*, the Court re-affirmed the *Basic* presumption, after acknowledging and discussing the numerous theoretical challenges mounted against the efficient market hypothesis since *Basic* was decided in 1988. *Halliburton*, 134 S. Ct. at 2407. In *Dudenhoeffer*, the Court states that the presumption, based on the efficient market hypothesis as set forth in *Basic* and *Halliburton*, applies as well to the fiduciary's decision to buy, hold or sell employer stock. See, e.g., 134 S. Ct. at 2471 (holding “ERISA fiduciaries, who likewise could rea-

fair market price presumption, the fiduciary can't beat the market: the fiduciary has no ability and so no duty to predict on the basis of public information whether the price will go up or down, absent special circumstances showing the stock's market price does not reliably reflect its value.⁶

(c) The Counterintuitive Example of the Long-Collapsing Company. This implication of the *Dudenhoeffer* presumption cannot be stated strongly enough. If the stock trades in an efficient market, its price at any moment reflects all public information—including price history—and its future price is independent of its past price history, no matter how dismal or exuberant. Consider the poster child case: the company whose stock price sags steadily downward during a prolonged period of visible business doldrums, while analysts are bearish, the press negative, and credit rating agencies skeptical. Even here the efficient market hypothesis predicts that at every price point its predicted future price follows a “random walk” randomly distributed around a mean value that itself is independent of the prior mean.⁷ The stock's future price path is “no more predictable than the path of a series of cumulated random numbers.”⁸ Even after a sustained period of stock price drop, the fiduciary has no ability and no duty to predict whether the stock price will go up or down.

This is the key point. Efficient markets have no memory. For stock prices, what goes up (or down) must randomly go up or down.⁹ This is the linchpin of mod-

sonably see ‘little hope of outperforming the market. based solely on their analysis of publicly available information’. may, as a general matter, likewise prudently rely on the market price.”) (quoting *Halliburton*, 134 S. Ct. at 2411); see also *Summers v. State Street Bank & Trust Co.*, 453 F.3d 404, 408, 38 EBC 1065 (7th Cir. 2006) (citing *Basic* and in turn cited by *Dudenhoeffer*, 134 S. Ct. at 2471–72, and holding that an ERISA fiduciary “is not imprudent to assume that a major stock market provides the best estimate of the value of the stocks traded on it that is available to him.”).

⁶ See, e.g., *Summers*, 453 F.3d at 408 (“[A]t every point in the long slide of United’s stock price, that price was the best estimate available [to the fiduciaries] of the company’s value. . . and so neither fiduciary was required to act on the assumption that the market was overvaluing United.”); *White v. Marshall & Ilsley Bank*, 714 F.3d 980, 992, 2013 BL 106032, 55 EBC 1918 (7th Cir. 2013)(77 PBD, 4/22/13; (A fiduciary’s “fail[ure] to outsmart a presumptively efficient market is not a sound basis for imposing liability.”).

⁷ Eugene F. Fama, “Random Walks in Stock Market Prices,” 21 *Financial Analysts Journal* 5, 55–56 (1965); Richard A. Brealey & Stewart C. Myers, *Principles of Corporate Finance* 261 (McGraw Hill, New York, 1981). Stock prices are randomly distributed around the stock’s intrinsic value, which itself drifts randomly over time in response to new information.

⁸ Fama at 58.

⁹ Another familiar process with no memory is the toss of a fair coin. Each toss is 50/50 likely to come up heads notwithstanding a prior string of tails. Like the price of a stock trading in an efficient market with no memory, the path of a series of fair coin tosses is randomly generated and not capable of prediction. Professor Burton Malkiel describes an exercise in which his students generate what looks like the returns on a single stock by flipping a coin. There are many differences between coin tosses and stock market prices, including that stock prices generally drift gradually upward over time. These do not upset the basic prediction of the efficient market hypothesis: stock price history contains no useful information enabling the investor (including the fiduciary investor) to pick whether an

ern financial life, ranging from the existence of mutual funds, to the famous *Wall Street Journal* dart board fund, to the demonstrated failure over time of stock picking strategies as chronicled by economist Burton Malkiel in his book *A Random Walk Down Wall Street*. About predicting stock prices, Malkiel concludes: “Your guess is as good as that of the ape, your stockbroker, or even mine.”¹⁰

Yet this basic tenet of the efficient market hypothesis is not intuitive, and courts’ willingness to accept it is mixed. One early adopter is the Seventh Circuit. In *Summers v. State Street Bank*, it held the ESOP fiduciary was not imprudent to hold United Airlines stock during the stock’s prolonged price fall before the company’s bankruptcy. *Summers* explained “[A]t every point in the long slide of United’s stock price, that price was the best estimate available of the company’s value and so neither fiduciary was required to act on the assumption that the market was overvaluing United.”¹¹ This is a concise statement of the efficient market hypothesis and *Summers* was cited by the Court in setting forth the *Dudenhoeffer* presumption.

But other courts are more reluctant, even after *Dudenhoeffer*. *Gedek v. Perez* similarly involved the steady decline of Kodak’s stock price culminating in its bankruptcy. Plaintiffs claimed the fiduciary was imprudent in not removing Kodak stock, based on the stock’s long price decline, the company’s reliance on “a dying technology and the sale of antiquated products no longer sought by the consumer,” as well as other public information. The court denied the company’s motion to dismiss. The court accepted *Dudenhoeffer*’s presumption the stock was fairly priced by the market, but declined to recognize that plaintiffs’ claims accordingly collapsed. Instead, the court found *Dudenhoeffer* did not contemplate companies like Kodak, whose “downward path was so obvious and unstoppable that, regardless of whether the market was correctly valuing the stock,” further investment was imprudent.¹² This misapplies the *Dudenhoeffer* presumption. An “obvious and unstoppable” downward path is already reflected in the stock price; its future price path at any point is random and unpredictable.

Another striking post-*Dudenhoeffer* example is *Tatum v. RJR Pension Investment Committee*. The Fourth Circuit faulted the fiduciary for failing to consider the stock’s price collapse as evidence of its probable future price increase, invoking an apparent “what goes down must go up” theory of stock price direction.¹³ Common to both *Tatum* and *Gedek* is 20/20 judicial hindsight. Each viewed the fiduciary as arguably imprudent because it failed to consider past price history as evidence

individual stock is likely to outperform or underperform others. Burton G. Malkiel, *A Random Walk Down Wall Street*, 10th Edition, 141-4 (W.W. Norton & Co., New York, 2012)

¹⁰ Malkiel, *supra*, at 196.

¹¹ *Summers*, 453 F.3d at 408 (7th Cir. 2006).

¹² *Gedek v. Perez*, 66 F. Supp. 3d 368, 2014 BL 354915, 59 EBC 1854 (W.D.N.Y. 2014)(243 PBD, 12/19/14) (emphasis added).

¹³ *Tatum v. RJR Pension Inv. Comm.*, 761 F.3d 346, 361, 2014 BL 215589, 58 EBC 2277 (4th Cir. 2014)(150 PBD, 8/5/14) (“RJR adhered to [its decision to liquidate Nabisco stock fund] in the face of sharply declining share prices and despite contemporaneous analyst reports projecting the future growth of those share prices and ‘overwhelmingly’ recommending that investors ‘buy’ or at least ‘hold’ Nabisco stocks.”).

of a future price direction that in fact materialized. The *Dudenhoeffer* presumption forestalls this second-guessing; the fiduciary's task is to establish the presumption applies.

(d) A Process Should Show No Special Circumstances Make Reliance on Market's Valuation Imprudent. It follows the fiduciary should not passively rely on the *Dudenhoeffer* presumption as a matter of law. A fiduciary process should establish no "special circumstances" make it imprudent to rely on the market price as the best available estimate of its value. This process allows the fiduciary prudently to conclude it has no ability to predict future stock price, and so no duty to try.

First, ERISA's duty of prudent investing requires prudent "conduct" and "process," not results.¹⁴ With a robust process the fiduciary satisfies its duty of prudent conduct, establishes the *Dudenhoeffer* presumption applies, and may prudently conclude it has no ability to predict future stock price and no duty to try. Participants challenging the conclusion have the burden to show the process itself was imprudent.¹⁵ In practice, this should be a high hurdle for plaintiffs to jump. We have seen that participants and even some courts hesitate to accept the full implications of the efficient market hypothesis. They might intuitively tend to hold the fiduciary to a duty to predict the stock's future price based on its past price history and other public informa-

tion. But consistent with ERISA's duty of prudent conduct, courts are reluctant to reject any investment decision made according to a robust fiduciary process, no matter how idiosyncratic the underlying theory.¹⁶ (The theory here is of course not idiosyncratic even if possibly counterintuitive.)

An added benefit is that in some circuits a fiduciary's discretionary decision is found to be imprudent only if the decision constituted an abuse of discretion.¹⁷ By making its decision on the basis of a careful process, the fiduciary shows its decision was not arbitrary and capricious and so might be entitled to this deferential standard of review.

Most tellingly, *Dudenhoeffer's* fair market price presumption applies only absent "special circumstances" making reliance on the market price imprudent. What circumstances make reliance on the market price imprudent? The Court does not say, but the fiduciary should. Consider *Gedek*-type allegations stuffed into the *Dudenhoeffer* framework: Plaintiffs allege that

¹⁶ See, e.g., *Lanka v. O'Higgins*, 810 F. Supp. 379, 389, 15 EBC 2851 (N.D.N.Y. 1992) (dismissing claim fiduciary's "contrarian" investment philosophy was imprudent *per se*, and holding that prudence of investment selection is governed by fiduciary's conduct, including whether fiduciary "did employ proper methods to investigate, evaluate and structure the investment").

¹⁷ *Varity Corp. v. Howe*, 516 U.S. 489, 514, 19 EBC 2761 (1996) (noting that claim based on breach of fiduciary duty "does not necessarily change the [deferential] standard a court would apply when reviewing the administrator's decision" and noting that *Firestone* based its decision to review benefit claim denials upon "the same common-law trust doctrines that govern standards of fiduciary conduct. See Restatement (Second) of Trusts § 187 ('Where discretion is conferred upon the trustee with respect to the exercise of a power, its exercise is not subject to control by the court, except to prevent an abuse by the trustee of his discretion'."); *Tussey v. ABB, Inc.*, 746 F.3d 327, 335, 2014 BL 75252, 58 EBC 1085 (8th Cir. 2014)(54 PBD, 3/20/14) ("Like most circuits to address the issue, we see no compelling reason to limit *Firestone* deference to benefit claims. 'Where discretion is conferred upon the trustee with respect to the exercise of a power, its exercise is not subject to control by the court except to prevent an abuse by the trustee of his discretion.'") (internal quotation marks omitted); *Armstrong v. LaSalle Bank Nat'l Ass'n*, 446 F.3d 728, 733, 37 EBC 2256 (7th Cir. 2006)(88 PBD, 5/8/06) ("Even if the general standard of review of an [employee stock ownership plan fiduciary]'s decisions for prudence is plenary, a decision that involves a balancing of competing interests under conditions of uncertainty requires an exercise of discretion and the standard of judicial review of discretionary judgments is abuse of discretion."); *Hunter v. Caliber Sys., Inc.*, 220 F.3d 702, 711, 25 EBC 1301 (6th Cir. 2000)(152 PBD, 8/7/00) (finding "no barrier" to applying a deferential standard to a case "not involving a typical review of denial of benefits"); *Moench v. Robertson*, 62 F.3d 553, 565, 19 EBC 1713 (3d Cir. 1995) ("[W]e believe that after *Firestone*, trust law should guide the standard of review over claims, such as those [arising from an employee stock ownership plan], not only under section 1132(a)(1)(B) but also over claims filed pursuant to 29 U.S.C. § 1132(a)(2) based on violations of the fiduciary duties set forth in section 1104(a)."). But see *John Blair Commc'ns, Inc. Profit Sharing Plan v. Tel-emundo Grp., Inc. Profit Sharing Plan*, 26 F.3d 360, 369, 18 EBC 1325 (2d Cir. 1994) (declining to apply the arbitrary and capricious standard beyond the "simple denial of benefits"); *In re Unisys Sav. Plan Litig.*, 173 F.3d at 154 ("[T]he duties of loyalty and prudence demanded by ERISA should not be reviewed through an 'arbitrary and capricious' lens.") (citing *Struble v. N.J. Brewery Emps. Welfare Trust Fund*, 732 F.2d 325, 333-34, 5 EBC 1676 (3d Cir. 1984)).

¹⁴ *Krueger v. Ameriprise Fin., Inc.*, No. 0:11-cv-02781-SRN-JSM, 2014 BL 76975, 58 EBC 1130 (D. Minn. Mar. 20, 2014)(57 PBD, 3/25/14) (In evaluating whether a fiduciary has acted prudently, the court focuses on the process by which it makes its decisions rather than the results of those decisions.); *Katsaros v. Cody*, 744 F.2d 270, 279, 5 EBC 1777 (2d Cir. 1984) (prudent person standard of investing is an "objective standard, requiring the fiduciary to (1) employ proper methods to investigate, evaluate and structure the investment; (2) act in a manner as would others who have a capacity and familiarity with such matters; and (3) exercise independent judgment when making investment decisions."); *Donovan v. Cunningham*, 716 F.2d 1455, 1467, 4 EBC 2329 (5th Cir. 1983) ("[T]he test of prudence is one of conduct, and not a test of the result of performance of the investment. The focus of the inquiry is how the fiduciary acted in his selection of the investment, and not whether his investments succeeded or failed."); *Meinhardt v. Unisys Corp. (In re Unisys Sav. Plan Litig.)*, 74 F.3d 420, 434, 19 EBC 2393 (3d Cir. 1996) ("[C]ourts measure section 1104(a)(1)(B)'s 'prudence' requirement according to an objective standard, focusing on a fiduciary's conduct in arriving at an investment decision, not on its results, and asking whether a fiduciary employed the appropriate methods to investigate and determine the merits of a particular investment."); *DiFelice v. U.S. Airways, Inc.*, 497 F.3d 410, 420, 2007 BL 70282, 41 EBC 1321 (4th Cir. 2007)(148 PBD, 8/2/07) (In evaluating the prudence requirement, "a court must ask whether the fiduciary engaged in a reasoned decision making process, consistent with that of a 'prudent man acting in a like capacity.'").

¹⁵ Plaintiffs bear the burden of establishing the fiduciary has breached its duty of prudent conduct. See e.g., *McDonald v. Provident Indemnity Life Ins. Co.*, 60 F.3d 234, 237 (5th Cir. 1995); *Martin v. Feilen*, 965 F.2d 660, 671, 15 EBC 1545 (8th Cir. 1992). Once plaintiffs have established the fiduciary's conduct was imprudent, the circuits are split as to whether the plaintiffs must also prove the breach caused losses, or whether burden shifts to the defendant to show any losses were not caused by its imprudent conduct. See generally *Tatum v. RJR Pension Investment Committee*, 761 F.3d 346 at 362. The loss causation point is beyond the scope of this article, which seeks only to establish that the fiduciary is better off with a good process and to suggest what this process might look like.

“special circumstances” included the stock’s downward price history and the company’s reliance on “antiquated products” and a “dying technology,” all making the fiduciary imprudent when it failed to predict further price collapse. To anticipate this approach the fiduciary process should identify and define what special circumstances would make reliance on the market price imprudent, and show they don’t apply.

(e) A Process Exists. A robust and appropriate process exists and is recognized by law. The *Dudenhoeffer* fair market price presumption is expressly based on the identical presumption established by the Court under federal securities law. Plaintiffs seeking class certification in a Rule 10b-5 securities fraud claim are permitted to show that the market price of a defendant company’s publicly traded stock reflects all material public information.¹⁸ Under securities law, this is known as the “fraud on the market” presumption—another name for what under ERISA we here call the *Dudenhoeffer* fair market price presumption, and what economists call the efficient market hypothesis. Rule 10b-5 plaintiffs seeking class certification may not assert the presumption as a matter of law.¹⁹ They must generally prove the stock trades in an efficient market by applying a multi-factor test, routinely used, well developed and firmly established by case law.²⁰ These are sometimes called the Cammer/Krogman factors after the cases in which they were first developed. They are accepted by the federal courts as showing that a security trades in an efficient market:

- (1) Average weekly trading volume;
- (2) Number of analysts following the stock;
- (3) Number of market makers and arbitrageurs for the stock;
- (4) Eligibility for S-3 filing;
- (5) Market capitalization;
- (6) Bid-ask spread;
- (7) Percentage of shares held by insiders;
- (8) Whether the stock is traded on NYSE, NASDAQ, or other major exchange;
- (9) An “event study” showing empirically that stock price reacts to new information as predicted by the efficient market hypothesis; and
- (10) An “autocorrelation” study showing empirically that stock price gains do not have a pattern of following

¹⁸ *Basic Inc. v. Levinson*, 485 U.S. 224, 246 (1988); *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398, 2408 (2014).

¹⁹ *Basic*, 485 U.S. at 248 n. 27 (noting that Rule 10b-5 plaintiffs seeking class certification must prove, among other things, that stock traded in an efficient market in order to establish rebuttable presumption they relied on market price as best estimate of stock’s value); *Halliburton*, 134 S. Ct. at 2408 (explaining that by establishing presumption they were entitled to rely on market price, including any material misstatements presumptively reflected in market price, individual plaintiffs are relieved of need to demonstrate individual reliance on company’s alleged misstatements at the class certification stage, making class formation easier).

²⁰ *Cammer v. Bloom*, 711 F. Supp. 1264 (D. N.J. 1989); *Krogman v. Sterritt*, 202 F.R.D. 467 (N.D. Tex. 2001); *In re DVI Sec. Litig.*, 639 F.3d 623, 634 (3d Cir. 2011); see, e.g., Declaration of David Tabak, PhD. *In Re Merck & Co. Securities Derivative and ERISA Litigation*, 2013 BL 24995, Civ. Action No. 05-1151; Civ. Action No. 05-2367 (D. N.J. Jan. 30, 2013); see also *In re PolyMedica Corp. Sec. Litig.*, 453 F. Supp. 2d 260 (D. Mass. 2006).

gains (or losses, losses), but rather observe the random walk predicted by the efficient market hypothesis.

This robust and well established test forms the template for a prudent process letting the fiduciary conclude no special circumstances make it imprudent to rely on the market price as the best estimate of the stock’s value. When some or all of the Cammer/Krogman factors are satisfied, the fiduciary may prudently conclude that the stock trades in an efficient market and that no “special circumstances” make it imprudent to rely on the stock’s market price as the best available estimate of its value.

The stock of any NYSE-traded or large NASDAQ-traded company is virtually certain to satisfy the Cammer/Krogman factors. For such stock, these factors allow a process that is both robust and virtually certain to support the fiduciary’s decision that no “special circumstances” make reliance on the market price imprudent. The fiduciary may prudently conclude that it can buy, hold or sell at the market price, it may disregard other publicly available information about the stock’s value, it has no ability predict at any time if the stock price will go down or up, and has no duty to try.

(f) Are All Ten Factors Needed for a Prudent Process? Should the fiduciary include all ten Cammer/Krogman factors in its process? This is a fiduciary judgment call. The fiduciary might want to apply only the first eight factors, which can be established easily at low cost. Many of these eight—e.g., average weekly trading volume; bid-ask spread; whether the stock trades on the NYSE or NASDAQ; the company’s market cap—might be found or calculated from a source such as the *Wall Street Journal*. The fiduciary might wish to determine solely on the basis of this easily obtainable information the stock trades in an efficient market, and no special circumstances make it imprudent to rely on the market’s valuation.

Alternatively, the fiduciary might decide it wants its process to be more robust. To establish more firmly the prudence of its decision to buy, hold or sell employer stock at any time at the market price, the fiduciary would perform two additional tests. First, an “event study” using statistical techniques tests whether a company’s stock price reacts as predicted to new public information. For any NYSE-traded or large NASDAQ-traded company, the answer is virtually certain to be yes. Event studies have high probative value in securities litigation, and should amply demonstrate a robust fiduciary process.

The second test is an “autocorrelation” study, proving the stock does not have a pattern of continuing to gain (or fall) after earlier gains (or to gain or fall after earlier losses), but instead fluctuates randomly after each up or down. This protects the fiduciary’s Achilles heel: a prolonged stock price slide. If the employer stock price has dropped steadily, an autocorrelation study may specifically prove the stock’s long downward slide is not a sound basis for predicting (in contrast with *Gedek*) the slide will continue, and not a prudent basis for closing the fund to new investment. Conversely, assume the fiduciary wants to close the fund. An autocorrelation study may show recent gains are not a prudent basis for predicting gains will continue, and recent losses are not a prudent basis for predicting (in contrast with *Tatum*) the price must go up. The efficient market

hypothesis predicts that markets have no memory.²¹ An autocorrelation study proves this prediction applies to the specific employer stock.

To conduct an event study and an autocorrelation study the fiduciary must almost certainly retain an economic consultant. The other eight Cammer/Krogman factors can be established with less sophisticated help.

A real life example of a study applying all ten Cammer/Krogman factors to the employer stock fund of an unnamed plan is summarized on the website of NERA Economic Consultants.²² NERA was retained by the fiduciary to determine if the stock trades on an efficient market under the *Dudenhoeffer* presumption, in order to evaluate the prudence of holding it.

(g) Justifying a Different Process for the Employer Stock Fund. The process we propose for the employer stock fund departs radically from the fiduciary's review of the plan's other fund offerings. The typical review compares an investment fund's performance to that of its stated benchmark or peer group. But for employer stock, we propose the fiduciary review only whether it is prudent to conclude the stock trades in an efficient market

What makes the employer stock different? May the fiduciary prudently have a different review process for the employer stock fund, or is the fiduciary vulnerable to charges it imprudently cherry picked the process to rig the outcome?

There is no cherry picking. The two processes must be different. For a single stock, random price fluctuations make comparison to any broader index (or any other single stock) meaningless. Any single stock will do better in some periods and worse in others, compared to any index (or any other single stock), merely because of the stock's idiosyncratic random price fluctuations not correlated with the rest of the market (also known as its "specific risk"). By contrast, benchmarking a diversified fund is appropriate and meaningful; it measures whether the fund is adequately diversified and representative of its purported benchmark, which is a prudent inquiry.²³ For a single stock fund and its complete absence of diversification, benchmarking is inappropriate and uninformative.

Moreover, comparing mutual funds on the basis of their performance is not an admission the efficient market hypothesis—which generally predicts that all stock pickers should perform pretty much the same—is incorrect. As well as testing adequate diversification, the literature suggests that benchmarking can identify poor performance caused by excessive costs in some funds.²⁴ The fiduciary might wish to memorialize its ra-

tionale in the investment policy statement or another part of the fiduciary record.

(h) Does Process Hurt Company's Position in Potential Rule 10b-5 Action? The process we propose is based on the Cammer/Krogman factors establishing the company stock trades in an efficient market—the same test used by plaintiffs seeking class certification in a Rule 10b-5 securities fraud suit. Does adopting this test jeopardize the company's ability to defeat potential plaintiffs' efforts to form a class? No. For NYSE-traded and most NASDAQ-traded companies, the fiduciary has not materially aided potential plaintiffs' class formation, nor hurt the company's case. Neither a NYSE-traded nor a large NASDAQ traded company in practice expects to defeat class certification by showing its stock did not trade in an efficient market. Rather, other issues are critical both for their efforts to defeat class certification and for their defense at the merits stage (e.g., market impact, loss causation, materiality). A reality check with the company's general counsel may of course be advisable. But for NYSE-traded and most NASDAQ-traded companies, the benefits of the study to the fiduciary should generally overwhelm its negligible impact on the company's position in defending against a potential Rule 10b-5 class action.²⁵

(i) Limit of the *Dudenhoeffer* Presumption. Very generally, the *Dudenhoeffer* presumption is thought to hold if the stock trades on a major stock exchange. The fiduciary may conclude special circumstances make it imprudent to rely on the market's valuation if, for example, the stock is delisted from NYSE because it

superior stock-picking skill. Rather, common factors in stock returns and persistent differences in mutual fund expenses and transaction costs explain almost all of the predictability in mutual fund returns. Only the strong, persistent underperformance by the worst-return funds remains anomalous." (citing previous empirical studies).

²⁵ Rule 10b-5 prohibits fraud in connection with the purchase or sale of a security. 17 C.F.R. § 240.10b-5. To recover damages for a Rule 10b-5 violation, a plaintiff must prove (1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation. *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398, 2407 (2014). The Cammer/Krogman factors are relevant solely for the "reliance" element, and then only at the class certification stage. By showing the stock trades in an efficient market, plaintiffs are allowed to create a rebuttable presumption they relied on the alleged public material misrepresentation. Establishing this presumption is generally perceived as necessary for Rule 10b-5 plaintiffs to create a class. As explained by *Halliburton*, "If every plaintiff had to prove direct reliance on the defendant's misrepresentation, individual issues then would overwhelm the common ones, making class certification under Rule 23(b)(3) inappropriate." *Id.* (internal quotation marks and citations omitted). Even if plaintiffs establish the stock trades in an efficient market by applying the Cammer/Krogman factors, the reliance presumption is rebuttable. *Halliburton* held that even at the class certification stage defendants may rebut the presumption by showing no price impact from the alleged misrepresentation. *Id.* at 23. Moreover, even if the class is certified, the presumption is rebuttable at the merits stage and plaintiffs must in addition establish other elements of the claim, such as materiality and loss causation. For a NYSE-traded or large NASDAQ traded company, defense to a Rule 10b-5 class action in practice does not involve challenging plaintiffs' showing that the stock trades in an efficient market.

²¹ Brealey & Myers, *supra* note 8, at 264.

²² See "NERA's Review of Fortune 500 Company's Employee Stock Ownership Plan" <http://www.nera.com/publications/archive/case-project-experience/nera-s-review-of-fortune-500-company-s-employee-stock-ownership-.html>.

²³ See, e.g., 29 CFR § 2550.404c-1(f) Example 11 (Fiduciary liable for losses from imprudent fund selection when investment fund designed to be invested in a "diversified portfolio of common stocks" but fund manager invests fund assets in a "few highly speculative stocks"). If the fund manager in this example declined to reveal actual fund holdings, the fiduciary could identify the mismatch by comparing fund performance against that of a broad based stock index over time.

²⁴ See, e.g., Carhart, Mark M. "On persistence in mutual fund performance." *The Journal of Finance* 52.1 (1997): 57-82. ("Persistence in mutual fund performance does not reflect su-

trades below one dollar for more than 30 days. This end point is very different from the determination the company's situation is "dire" or on the "brink of collapse"—the abandoned prudence frontier of the discarded *Moench* presumption. Instead, the fiduciary's determination is based on changed circumstances letting it conclude it is no longer prudent to assume the stock trades in an efficient market.

(2) Inside Information. From time to time the fiduciary—especially one who is a Section 16 officer or other high ranking employee—will likely have inside information showing the stock's market price overstates its value. *Dudenhoeffer's* fair market price presumption by definition does not here protect the fiduciary. The fiduciary's duties in this situation are not entirely clear, whether it retains responsibility for the employer stock fund or delegates it to a proxy fiduciary. Under *Dudenhoeffer*, the fiduciary might attempt to clarify the scope of its duties via a fiduciary process and determination.

(a) Fiduciary's Duty to Abstain or Disclose: A *Dudenhoeffer* Process. The fiduciary with material negative inside information is caught between its ERISA duties of prudence and loyalty on the one hand, and its duty not to violate insider trading laws on the other. *Dudenhoeffer* partly resolved this conflict. Affirming numerous lower court decisions, *Dudenhoeffer* held the fiduciary's ERISA duties cannot compel the fiduciary to violate Federal securities laws. Accordingly, the fiduciary cannot divest the employer stock fund on the basis of material negative inside information,²⁶ and cannot provide information to participants not also disclosed to the market.²⁷

The Labor Department takes the position the fiduciary can fulfill its ERISA duties without violating federal securities laws: the fiduciary can either close the employer stock fund to new investments, or disclose the information publicly so that the market can adjust the price to its appropriate level. The idea is based on the SEC's longstanding "abstain or disclose" duty for insiders with material inside information.²⁸ Under this view, the fiduciary with material negative inside information

is permitted by securities law and in some cases may be compelled by ERISA to do one or the other. This position been adopted by the Second, Fifth and Ninth Circuits.²⁹ But *Dudenhoeffer* treats it as an open question. The Court instructs the lower courts to develop standards on when halting a "planned trade" might violate inside trading laws or the "objectives" of those laws, and invites the SEC to issue guidance.³⁰

Threshold Question: The fiduciary's threshold question is this: is the fiduciary required by ERISA to close the employer stock fund to new investments on the basis of inside information the company is not yet required to disclose under federal securities laws? Put another way: Is the fiduciary's duty to abstain or disclose under ERISA broader than the company's duty to disclose under federal securities laws?

Any answer begins with *Dudenhoeffer*, which states the fiduciary with material negative inside information may have a duty to halt purchases or publicly disclose the information, but only after determining its actions would not (i) violate securities laws or the "spirit" or "objectives" of the securities laws, or (ii) do more harm than good to the plan.³¹

Under a narrow application of the *Dudenhoeffer* standard, the fiduciary could decide it has no duty to close the fund on the basis of inside information unless the fiduciary knows or has reason to know its concealment has violated federal securities laws. This approach is supported by *Harris v. Amgen*, decided by the Ninth Circuit and the first case to apply *Dudenhoeffer's* more-harm-than-good standard.³² Rejecting the company's motion to dismiss, *Harris* held the fiduciary has a duty to halt purchases when it knows or has reason to know the company stock price is inflated because of information concealed in violation of federal securities laws.³³ *Harris* further said in dictum its holding does not apply to inside information short of this point, as in this case halting new purchases "might indeed" do more harm than good to the plan.³⁴

Harris is more conservative than *Dudenhoeffer*, because it recognizes no daylight between the company's

²⁶ *Dudenhoeffer*, 134 S. Ct. at 2469–70; see, e.g., *Rinehart v. Akers*, 722 F.3d 137, 147, 2013 BL 186878, 57 EBC 1220 (2d Cir. 2013)(136 PBD, 7/16/13), vacated, remanded for further consideration in light of *Fifth Third Bancorp v. Dudenhoeffer*, 134 S. Ct. 2459 (2014); *White v. Marshall & Ilsley Corp.*, 714 F.3d 980 at 992 (7th Cir. 2013); *Lanfear v. Home Depot, Inc.*, 679 F.3d 1267, 1282, 2012 BL 111981, 53 EBC 1261 (11th Cir. 2012)(92 PBD, 5/14/12); *Kirschbaum v. Reliant Energy, Inc.*, 526 F.3d 243, 256, 2008 BL 88480, 43 EBC 2281(5th Cir. 2008)(82 PBD, 4/29/08); *Edgar v. Avaya, Inc.*, 503 F.3d 340, 350, 2007 BL 107798, 41 EBC 2249 (3d Cir. 2007)(187 PBD, 9/27/07). See Selective Disclosure and Insider Trading, Exchange Act Release Nos. 33-7881, 34-43154, 2000 SEC LEXIS 1672 at *79–86 (Aug. 15, 2000) (plan administrator cannot influence buying or selling of shares by plan while in possession of material, nonpublic information).

²⁷ *Lanfear*, 679 F.3d at 1284–86; *Gray v. Citigroup Inc. (In re Citigroup ERISA Litig.)*, 662 F.3d 128, 143, 2011 BL 268338, 51 EBC 1737 (2d Cir. 2011)(203 PBD, 10/20/11); *Edgar*, 503 F.3d at 350.

²⁸ See, e.g., Amended Brief of the Secretary of Labor as Amicus Curiae Opposing the Motions to Dismiss, *Tittle v. Enron Corporation*, No. H-01-3913 (S.D. Tex. Filed Aug. 30, 2002) (citing *In re Cady, Roberts & Co.*, Exchange Act Release Nos. 6668, 34-6668, 40 SEC 907, 911 1961 WL 60638 (Nov. 8, 1961)) (adopting the "disclose or abstain" principle); *Chiarelli v.*

United States, 445 U.S. 222 (1980); *Dirks v. SEC*, 463 U.S. 646 (1983).

²⁹ *Rinehart*, 722 F.3d at 147 ("ceasing to offer the LSF as an investment option would not run afoul of federal securities laws given the absence of a purchase or sale of stock"); *Kopp v. Klein*, 722 F.3d 327, 340, 2013 BL 181822, 56 EBC 2757 (5th Cir. 2013)(133 PBD, 7/11/13) ("ceasing making new investments in stock because of access to inside information is not barred by insider trading law") vacated, remanded for further consideration in light of *Fifth Third Bancorp v. Dudenhoeffer*, 134 S. Ct. 2459 (2014); *Harris v. Amgen, Inc.*, No. 10-56014, 2015 BL 183668 (9th Cir. 2015) (as amended May 26, 2015)(101 PBD, 5/27/15).

³⁰ *Dudenhoeffer*, 134 S. Ct. at 2473.

³¹ *Id.*

³² *Harris v. Amgen, Inc.*, No. 10-56014, 2015 BL 183668 (9th Cir. 2015) (as amended May 26, 2015)(101 PBD, 5/27/15).

³³ *Id.* at 46. The court reasoned that any negative price impact of halting new purchases on the basis of wrongly concealed inside information would only "anticipate" the inevitable result of the company's "eventual compliance with the federal securities laws."

³⁴ *Id.* at 9. This is technically the concurring opinion to the Ninth Circuit's decision to deny *en banc* review. The so-called concurring opinion was written by the author of the merits decision (original and amended) and its principal purpose is to rebut the dissent to the *en banc* review decision.

duties under federal securities laws, and the fiduciary's duties under ERISA. Under a more broadly defined *Dudenhoeffer* standard, the fiduciary could determine it will not close the fund if this would violate the "spirit" or "objectives" of the securities laws. This conclusion is supported by at least one district court decision.³⁵ Under this approach, the fiduciary uses its discretion to determine at what point, if any, its duty to close the fund to new investment begins. This approach would not necessarily be effective in the Ninth Circuit under the *Harris* standard.

(b) An Uninformed Proxy Fiduciary Offers Uncertain Protection. It has been suggested the fiduciary might insulate itself from the potential liability created by inside information by appointing an uninformed proxy fiduciary to handle the employer stock fund. This could be an independent fiduciary or a junior varsity fiduciary of lower-level employees with little access to insider information.

It is unclear whether the uninformed-proxy-fiduciary strategy works to neutralize the impact of material negative inside information. The Labor Department takes the position the appointing fiduciary has a duty to disclose material negative inside information to the appointed fiduciary—a duty not impeded by federal securities laws.³⁶ This position has received a mixed reception in the case law. It is well established the appointing fiduciary has a duty to monitor the appointed fiduciary.³⁷ Many district courts have held that when the employer stock fund is in the hands of the appointed fiduciary the duty to monitor includes the duty to disclose material adverse inside information to the appointed fiduciary.³⁸ As one court explained, "If one fiduciary is legally prohibited from investing in [employer] stock because of his knowledge of certain

facts, he should not be permitted to employ another fiduciary to do so *without providing necessary information* and monitoring the proxy's decisions."³⁹ The Seventh Circuit observed more generally "The duty [to monitor] exists so that a plan administrator or sponsor cannot escape liability by passing the buck to another person and then turning a blind eye."⁴⁰

Not all courts agree. After *Dudenhoeffer*, the district court in *Lehman Brothers* dismissed plaintiffs' claims the appointing fiduciary breached its duty to monitor the appointed fiduciary when it failed to inform the appointed fiduciary of negative inside information. First, *Lehman Brothers* reasoned the duty to monitor is "derivative": no breach by the appointed fiduciary, none by the appointing fiduciary.⁴¹ In so concluding the court followed the Second Circuit's reasoning in *Rinehart v. Akers* and the Fifth Circuit in *Kopp v. Klein*.⁴²

Interestingly, and in contrast with *Rinehart* and *Kopp*, *Lehman Brothers* next analyzed the duty to inform as separate and distinct from the duty to monitor, and thus as non-derivative. It nonetheless dismissed plaintiffs' claim based on this independent duty, and held the appointed fiduciary has no duty to inform the appointed fiduciary of nonpublic information.⁴³

To get there, *Lehman Brothers* analyzed the appointed fiduciary as a stand-in for plan participants. The fiduciary has no duty to provide nonpublic information to plan participants, *Lehman* reasoned; so too it has no duty as to its appointed fiduciary.⁴⁴ By contrast, courts who recognize a duty-to-inform analyze the appointed fiduciary as a stand-in for the appointing fiduciary (rather than plan participants). These two starting points arrive at different end points. Viewing the appointed fiduciary as a proxy for plan participants, *Lehman Brothers* expressed concern a duty to inform would be tantamount to "whisper[ing] nonpublic information into the ears of plan participants without it becoming immediately available to the market as a whole."⁴⁵ By contrast, courts viewing the appointed fiduciary as a proxy for the appointing fiduciary are more likely to agree with the Seventh Circuit in *Howell* that the fiduciary "cannot escape liability by passing the buck to another person and then turning a blind eye."⁴⁶

³⁵ See *Camera v. Dell Inc.*, No. 1:13-cv-00876-SS, 2014 BL 170606, 58 EBC 2116 (W.D. Tex. June 17, 2014)(118 PBD, 6/19/14) (upholding fiduciary's decision not to halt liquidation of the employer stock fund, where fiduciary had inside information of possible going-private offer that ultimately drove up stock price, reasoning in part that halting planned sales would in such case be "wholly inconsistent with the spirit of the securities laws; it is, in essence, insider trading on a time delay").

³⁶ Amended Brief of the Secretary of Labor as Amicus Curiae Opposing the Motions to Dismiss, *Titte v. Enron Corporation*, No. H-01-3913 (S.D. Tex. Filed Aug. 30, 2002).

³⁷ 29 C.F.R. § 2509.75-8, FR-17; *Leigh v. Engle*, 727 F.2d 113, 134-35, 4 EBC 2702 (7th Cir. 1984).

³⁸ See, e.g., *Cannon v. MBNA Corp.*, No. 05-429 GMS, 41 EBC 1423 (D. Del. July 6, 2007)(131 PBD, 7/10/07) (holding that plaintiffs state a claim in alleging that fiduciary breached its duty to monitor by failing to inform appointed fiduciary); *Woods v. Southern Co.*, 396 F. Supp. 2d 1351, 35 EBC 2793 (N.D. Ga. 2005)(197 PBD, 10/13/05) ("[T]he duty to keep appointees informed has gained reasonably wide acceptance as an inherent facet of the more general 'duty to monitor.'") and cases cited therein; *In re Polaroid ERISA Litig.*, 362 F. Supp. 2d 461, 477, 34 EBC 2322 (S.D.N.Y. 2005)(66 PBD, 4/7/05) ("Plaintiffs' allegation that [the named fiduciary] failed to adequately monitor or keep [appointed fiduciaries] informed states a claim for breach of fiduciary duty."); *In re Sears, Roebuck & Co. ERISA Litig.*, No. 02 C 8324, 32 EBC 1699 (N.D. Ill. March 2, 2004)(45 PBD, 3/9/04) (rejecting fiduciary's argument that duty to monitor does not include duty to keep appointees informed of material non-public information); *In re General Motors ERISA Litig.*, No. 05-71085, 2006 BL 145635, 37 EBC 1951 (E.D. Mich. April 6, 2006)(69 PBD, 4/11/06) *motion granted in relevant part*, No. 05-71085, 2007 BL 209762, 42 EBC 1171 (E.D. Mich. Aug. 28, 2007)(169 PBD, 8/31/07) .

³⁹ *In re GM ERISA Litig.*, 37 EBC 1951 (E.D. Mich. 2006) *motion granted in relevant part*, 42 EBC 1171 (E.D. Mich. 2007).

⁴⁰ *Howell v. Motorola, Inc.*, 633 F.3d 552, 572, 2011 BL 16211, 50 EBC 1865 (7th Cir. 2011)(16 PBD, 1/25/11) .

⁴¹ *In re Lehman Bros. Sec. & ERISA Litig.*, No. 1:08-cv-05598-LAK, 2015 BL 221282 (S.D.N.Y. July 10, 2015).

⁴² *Rinehart*, 722 F.3d at 147; *Kopp*, 22 F.3d at 340.

⁴³ *In Re Lehman Brothers Securities and ERISA Litigation*, at 35.

⁴⁴ *Id.* at 39 ("We will not create a rule that converts the fiduciary into an investment advisor. Such a rule would force them to guess whether and if so to what extent adverse non-public information will affect the price of employer stock and then would require them to disclose the information to the plan participants if they believe that the information will have a material adverse effect on the value of the investment fund." Internal citations and quotations omitted).

⁴⁵ *Id.* at 39 (internal citations omitted).

⁴⁶ *Howell*, 633 F.3d at 572; See also, e.g., *In re GM ERISA Litig.*, 37 EBC 1951 (E.D. Mich. 2006) *motion granted in relevant part*, 42 EBC 1171 (E.D. Mich. 2007). ("If one fiduciary is legally prohibited from investing in [employer] stock because of his knowledge of certain facts, he should not be permitted to employ another fiduciary to do so *without providing*

Lehman Brothers is helpful for the fiduciary who prefers to appoint a proxy fiduciary. But we expect these dueling views of the appointed fiduciary—on the one hand as standing in the shoes of participants, on the other of the appointing fiduciary—will continue as before, with mixed results as before.

Moreover, this uncertainty lies atop a logically prior issue, also uncertain. Assume the appointing fiduciary accepts that negative inside information could at some point compel it to instruct its proxy to close the fund to new investment. At what point does this occur? It could reasonably conclude this point is where its own duty-to-close would arise if acting by itself. But where this first point lies is in turn undeveloped. *Dudenhoeffer* instructs the lower courts (and the SEC) to create law on when a fiduciary is permitted to halt “planned trades” on the basis of inside information without violating the securities laws or their purpose. Before this prior question is settled, the next question is unlikely to be as well.

Naming the Proxy Fiduciary in the Plan Document. The Company might try to short-circuit the appointing fiduciary’s duties to monitor and inform by naming the proxy fiduciary in the plan document. The idea is that the appointment is thus a settlor act—no appointing fiduciary, no duty to monitor. Here too authorities are conflicted. The Eighth Circuit has held that the plan document can allocate duties among fiduciaries.⁴⁷ The Fourth Circuit has held that appointing a fiduciary is itself a fiduciary act even if done by plan amendment.⁴⁸ The Labor Department’s *Tatum* amicus brief attempts to split the baby by stating that, in amending the plan to appoint a fiduciary, the company simultaneously acted as settlor and fiduciary.⁴⁹

Other Roles of the Independent Fiduciary. The traditional purpose of retaining an independent fiduciary is to ensure a decision maker whose interests are not structurally adverse to those of participants, and so promote compliance with the fiduciary’s duty of undivided loyalty to plan participants. The role of the independent fiduciary as non-conflicted decision-maker is not affected by the foregoing discussion. Many independent fiduciaries in addition bring experience, knowledge and skill to issues of plan investment.

(3) Risk. If the fiduciary establishes the employer stock trades in an efficient market, may it conclude the stock is therefore a prudent investment? Or can a fairly priced stock ever be too “risky” for a retirement plan? If so, the fiduciary might need an additional process to evaluate the stock’s riskiness.

necessary information and monitoring the proxy’s decisions.”)

⁴⁷ *Walker v. National City Bank*, 18 F.3d 630, 18 EBC 1249 (8th Cir. 1994) (holding that where the plan document allocates the fiduciary duties among different individuals or other entities, the failure of one fiduciary to fulfill his or her responsibility does not impose that duty on the other fiduciaries).

⁴⁸ *Coyne & Delaney Co. v. Selman*, 98 F.3d 1457, 1465, 20 EBC 2136 (4th Cir. 1996).

⁴⁹ The brief explains: “Coyne & Delaney thus exercised both the fiduciary discretion to appoint, monitor, and remove the Plan Administrator and Plan Supervisor, and the settlor power to amend the plan to effectuate those decisions. The fact that these two separate functions were performed by one entity did not make the act of amending the plan a fiduciary act.” Brief of the Secretary of Labor at 7, *Tatum v. R.J. Reynolds Tobacco Co.*, 392 F.3d 636 (4th Cir. 2004) (No. 04-1082), <http://www.dol.gov/sol/media/briefs/tatum%28A%29-5-7-2004.pdf>.

Some readers may prefer to skip the rest of this dense section and get to the bottom line, which is this: under ERISA, *Dudenhoeffer*, and their underlying financial market theory, *no employer stock fairly priced by an efficient market is intrinsically too risky* for an ERISA plan. Having established the stock trades in an efficient market, the fiduciary may prudently determine the stock is not too risky; no further inquiry into risk is needed. This position already has some post-*Dudenhoeffer* case law support.⁵⁰

Of course, some fiduciaries might hesitate to rely solely on the courts’ acceptance of this sound but perhaps counterintuitive implication of *Dudenhoeffer*’s underlying financial market theory. These fiduciaries might prefer to establish the stock’s “volatility” falls below an acceptable upper bound—arguably arbitrary, as no upper limit is supported by theory or case law—selected by the fiduciary at its discretion, perhaps with the help of a financial advisor.

(a) Defining Risk in a Post-*Dudenhoeffer* World. Consider a \$50 share in a public biotech company with a single miracle drug in development, but not yet FDA approved. Or a \$50 share in a company whose sole asset is a basket of Greek sovereign debt bonds, or Russian rubles, or Bitcoin. The fiduciary determines all trade in an efficient market and are thus fairly priced at \$50. But are they therefore prudent plan investments?

These examples illustrate what is meant by “risk,” which is distinct from value. As long as a publicly traded stock’s market price is above zero, the efficient market hypothesis predicts the price is the market’s best estimate of the company’s value. The stock remains a fair buy at its market price.⁵¹ Under this framework, a stock’s “risk” is its volatility or variance—its potential range of possible outcomes. Our hypothetical fairly priced biotech company is risky not because its situation is “dire” or on the “brink of collapse.” Indeed its situation is neither and tomorrow its fortunes might be spectacular. It is risky because its range of potential returns is so extreme.

(b) No Fairly Priced Stock Is Intrinsically too Risky for an ERISA Plan. How risky is too risky? Here, financial theory and the ERISA case law overlap, but imperfectly. The financial theory underlying ERISA and *Dudenhoeffer* predicts that *no stock trading in an efficient market is too risky for the employer stock fund.*

Here’s why.

Under *Dudenhoeffer*, the fiduciary may presume the market price of a publicly traded stock reflects all material public information. Under our proposed process, the fiduciary may demonstrate that this presumption applies. The fiduciary may also presume its duty of pru-

⁵⁰ *In re Lehman Bros. Sec. & ERISA Litig.*, No. 1:08-cv-05598-LAK, 2015 BL 221282 (S.D.N.Y. July 10, 2015) (“In the absence of factual allegations justifying a conclusion that ‘reliance on the market price [was] imprudent,’ the Court interprets *Dudenhoeffer* to foreclose breach of prudence claims based on public information irrespective of whether such claims are characterized as based on alleged overvaluation or alleged riskiness of a stock”). See also *In re Citigroup Erisa Litig.*, No. 1:11-cv-07672-JGK, 2015 BL 148422 (S.D.N.Y. May 13, 2015) (“[S]uch risk is accounted for in the market price, and the Supreme Court held that fiduciaries may rely on the market price, absent any special circumstances affecting the reliability of the market price.”)

⁵¹ See, e.g., *Summers v. State St. Bank & Trust Co.*, 453 F.3d 404, 408, 38 EBC 1065 (7th Cir. 2006).

dent investing under ERISA is governed by modern portfolio theory.⁵² Assuming the stock trades in an efficient market, the stock's risk or volatility can generally be divided into two pieces: its risk correlated with the rest of the market, sometimes called its "market" or "systemic" risk; and its unique or "specific" risk—its random price movements not correlated with the market. An investment's specific risk can be eliminated by including it in a sufficiently diversified portfolio of investments whose noncovariant (by definition) specific risks cancel each other. Because the investor can eliminate specific risk costlessly by diversification, nobody pays her a greater rate of return to assume it. Specific risk is thus "uncompensated" risk; the investor who fails to diversify assumes it without being rewarded for it.⁵³ By contrast, an investment's market or systemic risk cannot be reduced by diversification. This is true by definition because a fully diversified portfolio is the market portfolio.⁵⁴ Market or systemic risk is the bedrock risk assumed by the investor. Because market or systemic risk cannot be eliminated by diversification, the investor must be paid to assume it at whatever higher rate of return is established by the market.⁵⁵

Accordingly, the ERISA fiduciary could prudently conclude a fairly priced publicly traded employer stock is never too risky *per se*. Its risk can be judged only in the context of the entire portfolio. Its systemic or market risk is not too risky because it is fairly rewarded by its market rate of return. Any investor unwilling to stomach market risk at the market rate of return can most efficiently achieve her preferred risk/return level by dividing her portfolio between risky and riskless assets, in whatever proportion her risk tolerance prefers.⁵⁶

⁵² 29 C.F.R. § 2550.404a-1; Preamble to Interpretive Bulletin 96-1, 61 F.R. 29586, 29587 (June 11, 1996); *DiFelice v. U.S. Airways, Inc.*, 497 F.3d at 423 ("The [district] court correctly recognized that modern portfolio theory has been adopted for the purposes of ERISA, by the Department of Labor.").

⁵³ John H. Langbein, 81 Iowa L. Rev. 641, 648 (1996) ("[A] telling expression has been coined to describe what is wrong with under-diversification: uncompensated risk. [N]o one compensates the investor for having a portfolio that neglects. . . to achieve sufficient diversification. Underdiversification entails needless risk."); Restatement (Third) of Trusts § 90, General Note on Comments e through h ("Thus, pricing rewards only market (or 'systemic') risk, which cannot be diversified away; but the marketplace, in effect, offers no compensation for specific risk.").

⁵⁴ Edward J. Elton & Martin Gruber, *Lessons of Modern Portfolio Theory* in Bevis Longstreth, *Modern Investment Management and the Prudent Man Rule* 173 Oxford University Press, New York (1986) ("[A]ccording to the CAPM, the market portfolio should include all risky assets.").

⁵⁵ Brealey & Myers, *supra* note 8, at 126-7.

⁵⁶ Elton & Gruber, *supra* note 54 ("For example, if an investor desires less risk than is inherent in the market portfolio, the investor might place one-half of the funds in the market and one-half of the funds in Treasury bills. . . This conclusion is so important it has been given a name in the literature—the two mutual fund theorem. It says that all investors can form an optimal portfolio by mixing two mutual funds—the market portfolio and a fund holding the riskless asset. The proportions in which they are mixed is determined by the investor's risk-return preference."); see Brealey & Myers, *supra* note 8, at 159 ("If investors can borrow and lend at the riskfree rate of interest, then they should always hold a mixture of the risk free investment and one particular common stock portfolio.") John H. Langbein & Richard A. Posner, *Market Funds and Trust In-*

The investment's remaining risk is "specific" risk. Under modern portfolio theory, a stock's specific risk is ignored (uncompensated) by the market because it can be eliminated without cost by diversification. Under ERISA, the specific risk of employer stock may be ignored by statute. The employer stock fund creates uncompensated risk solely because it is nondiversified and potentially reduces portfolio diversification. ERISA says the fiduciary may ignore the employer stock fund's nondiversification when evaluating its prudence, meaning under ERISA the fiduciary may ignore the uncompensated risk it creates.⁵⁷ In short, for employer stock trading in an efficient market, no risk is too risky.

This conclusion has been expressed for trust investments generally by Professor John Langbein as follows: "The idea that some securities are intrinsically too risky for trust investors collides with the central findings of Modern Portfolio Theory. MPT teaches that the risk intrinsic to any marketable security is presumptively already discounted into the current price of the security. Hence, on an expected return basis, the risk is compensated risk."⁵⁸

For ERISA investments, this principle was expressly adopted by Labor Department guidance stating that "an investment reasonably designed—as a part of the portfolio—to further the purposes of the plan, and that is made upon appropriate consideration of the surrounding facts and circumstances, should not be deemed to be imprudent merely because the investment, standing alone, would have, for example, a relatively high degree of risk."⁵⁹ As under ERISA, the duty of prudent investing under the Restatement (Third) of Trusts and the Uniform Prudent Investor Act is based on modern portfolio theory, and like ERISA both adopt the principle that *no investment is intrinsically too risky*.⁶⁰ Rather, whether a stock is too risky can be judged only by its role within the entire portfolio, and its contribution to portfolio diversification and compensated risk.⁶¹

vestment Law, 1976 Am. B. Found. Res. J. 1, 9 at 12 ("The best method of achieving the desired risk/return combination is to adjust the proportions in which either relatively risk free assets are included in the portfolio, or borrowed money is used to increase the portfolio's holdings.").

⁵⁷ ERISA § 404(a)(2) (providing that in the case of an "eligible individual account plan" ERISA's diversification requirement and prudence requirement to the extent it requires diversification are not violated by acquisition or holding of qualifying employer securities); ERISA § 407(d)(4) (generally defining "eligible individual account plan" as an individual account plan which is a profit-sharing, stock bonus, thrift, or savings plan or an employee stock ownership plan). *Dudenhofer*, 134 S. Ct. at 2467 (2014).

⁵⁸ Langbein, *supra* note 53, at 649.

⁵⁹ 44 Fed Reg. 37255 (June 26, 1979), Preamble to 29 C.F.R. 2550.404a-1

⁶⁰ See Uniform Prudent Investor Act § 2 comment (1994) (Abrogating Categorical Restrictions) ("Subsection 2(e) clarifies that no particular kind of property or type of investment is inherently imprudent"); Restatement (Third) of Trusts § 90 comment e(1) (stating that speculative investments "are not prohibited" and that "the prudent investor rule, despite its requirement of caution, does not classify specific investments or courses of action as prudent or imprudent").

⁶¹ Restatement (Third) of Trusts § 90 cmt. e(1) ("[I]nvestments or techniques that are often characterized as risky or 'speculative.' . . . are not prohibited as long as they are employed in a manner that is prudently designed to reduce

Under modern portfolio theory, of course, the no-investment-is-too-risky principle is based on the premise of adequate diversification.⁶² Under ERISA, the principle applies to the employer stock fund specifically because the fiduciary is permitted by statute to ignore the employer stock fund's impact on overall portfolio diversification and resulting uncompensated risk.

(c) The Case law on When Risk is Too Risky. We have seen that under *Dudenhoeffer*, ERISA and their underlying financial market theory, no stock trading in an efficient market is intrinsically too risky for the employer stock fund. Some courts grasp this. Reasoning the stock's risk as well as its value is presumptively reflected in its market price, *Lehman Brothers* held that under *Dudenhoeffer* the fiduciary is not imprudent to ignore a stock's riskiness in the absence of special circumstances making reliance on the market price imprudent.⁶³ In a pair of pre-*Dudenhoeffer* ESOP cases, the Seventh Circuit concluded (after extraordinarily circuitous dictum) that a stock's riskiness can be evaluated only at the portfolio level, and not at the individual investment level.⁶⁴

the overall risk of the trust portfolio or to allow the trust, in appropriate circumstances, to achieve a higher return expectation without a disproportionate increase in the overall level of portfolio risk.”)

⁶² For an excellent discussion of the role of financial market theory in ERISA generally, including its implications for portfolio risk, see Dana M. Muir and Cindy A. Schipani, *The Use of Efficient Market Hypothesis: Beyond SOX*, 105 Mich. L. Rev. 1941, 1968 (June 2007).

⁶³ *In re Lehman Bros. Sec. & ERISA Litig.*, No. 1:08-cv-05598-LAK, 2015 BL 221282 (S.D.N.Y. July 10, 2015) (“In the absence of factual allegations justifying a conclusion that ‘reliance on the market price [was] imprudent,’ the Court interprets *Dudenhoeffer* to foreclose breach of prudence claims based on public information irrespective of whether such claims are characterized as based on alleged overvaluation or alleged riskiness of a stock”). See also *In re Citigroup Erisa Litig.*, No. 1:11-cv-07672-JGK, 2015 BL 148422 (S.D.N.Y. May 13, 2015) (“[S]uch risk is accounted for in the market price, and the Supreme Court held that fiduciaries may rely on the market price, absent any special circumstances affecting the reliability of the market price.”) This point is correct to the extent of the stock's risk correlated with market risk, which financial theory predicts is reflected in its market price. The stock's non-correlated or specific risk is not reflected in the market price, because it can be diversified away costlessly. For an ESOP or employer stock fund, the uncompensated risk created by non-diversification and not reflected in the market price is permitted to be ignored by statute.

⁶⁴ *In Steinman v. Hicks*, the Seventh Circuit says in *dictum* the fiduciary's duty of prudence might require it to diversify the ESOP when the stock becomes excessively risky, as measured by the company's debt equity ratio (here applying the basic tenet of financial theory that leverage amplifies risk); participants' other investment holdings, and their risk tolerance measured as time left to retirement. *Steinman v. Hicks* 323 F.3d 1101, 1106, 31 EBC 2415 (7th Cir. 2003). As its later *Summers* opinion acknowledges, the ESOP fiduciary's duty of prudence under *Steinman* must take into account the participant's overall portfolio diversification, including all assets. *Summers* explains that where ESOP stock becomes “excessively risky” under the *Steinman* factors “would depend in the first instance on the amount and character of the employees' other assets, for, as we have already indicated, it is the riskiness of one's portfolio, not of a particular asset in the portfolio, that is important to the risk-averse investor.” *Summers v. State St. Bank & Trust Co.*, 453 F.3d 404, 411, 38 EBC 1065 (7th Cir. 2006) (emphasis added). *Summers* concedes that “de-

But at least one efficient market case decided before *Dudenhoeffer* expressly disagreed that a fairly priced stock cannot be too risky. In *Ford Motor Co.* the district court stated that, even conceding a stock is fairly priced by the market as predicted by the efficient market hypothesis, the stock might nonetheless be “too volatile” to be prudent.⁶⁵ Its example was a company with “no clear path to profitability but with possibly tremendous potential.”⁶⁶ The court concluded that an employer stock is “too volatile” where “holding it becomes so risky. . . that the problem could not be fixed by diversifying into other assets.”⁶⁷ The *Ford Motor* standard is literally devoid of meaning. ERISA's underlying financial theory predicts there is no theoretical point at which a stock's risk cannot be cured by holding the stock within a sufficiently diversified portfolio.

Other than this handful of decisions, the cases on employer stock “risk” are generally inapposite. Almost all were decided before *Dudenhoeffer*, and so tended to conflate “risk” as volatility (which it is) with the defunct *Moench* concept of “dire situation” or “brink of collapse” (which it isn't).⁶⁸ *Ford Motors* is the rare pre-*Dudenhoeffer* exception. *Gedek*, though decided after *Dudenhoeffer*, may be read as continuing this *Moench*-related confusion, dressed in different terms. Further development of this issue awaits, hopefully along the lines of *Lehman Brothers*' sound analysis of the issue of a stock's riskiness.

The Added Confusion of Section 404(c). The gap between the financial market theory informing ERISA's duty of prudent investing and the ERISA case law is even wider for employer stock funds in participant-directed 404(c) plans. The culprit is the law's scrambled approach to the fiduciary's duty to construct the plan's menu of investment options. To get 404(c) safe harbor protection, the fiduciary must offer a “broad range of investment alternatives” allowing the participant “the opportunity to diversify his account.”⁶⁹ A threshold issue is whether Section 404(c) protects the fiduciary's

termining the ‘right’ point, or even range of ‘right’ points, for an ESOP fiduciary to break the plan and start diversifying may be beyond the practical capacity of the courts to determine.” *Id.* at 411.

⁶⁵ *In re Ford Motor Co. ERISA Litig.*, 590 F. Supp. 2d 883, 891, 45 EBC 2057 (E.D. Mich. 2008) (246 PBD, 12/24/08) (rejecting defense that “the only. . . duty of such a fiduciary would be to ensure that nothing is impeding market mechanisms from accurately pricing the stock”).

⁶⁶ *Id.* at 892 (providing example of a hypothetical fairly priced stock in a company with “no clear path to profitability, but with possibly tremendous potential. [and] in no danger of imminent collapse despite being extraordinarily risky.”)

⁶⁷ *Id.* at 892-93.

⁶⁸ See, e.g., *In re Fannie Mae 2008 ERISA Litigation*, 09 Civ. 1350 (PAC), 09 MDL.2013 (PAC), 2012 BL 276171 (S.D.N.Y. Oct. 22, 2012) (Denying motion to dismiss claim that fiduciaries imprudently ignored “dire” situation, where defendants argued that stock was not overvalued because correctly priced by market, reasoning that claims relating to defendant's knowledge of “dire” situation go to stock's risk rather than its value); *Veera v. Ambac Plan Admin. Committee*, 769 F.Supp. 2d 223, 225, 2011 BL 3468, 50 EBC 1609 (S.D.N.Y. 2011) (Denying motion to dismiss claim where company “expos[ed] itself to billions of dollars of losses on high-risk transactions,” reasoning that risk combined with prolonged stock price drop, could overcome presumption of prudence by showing defendants' knowledge of “imminent collapse”).

⁶⁹ 29 CFR § 2550.404c-1(b)(3)(i)(C).

selection of investment alternatives. The Labor Department regulations say it does not, and the fiduciary has a duty prudently to select each fund offering.⁷⁰ Some courts agree.⁷¹ Others disagree.⁷²

But assuming, as stated by Labor Department regulations, the fiduciary must select each investment fund prudently, an even more basic question arises about what prudent fund selection entails given that the participant can spread her account among multiple funds. For example, consider a 404(c) plan with three adequately diversified investment funds (the minimum required by regulations), plus several hundred funds each invested only in a single NYSE- or NASDAQ-traded stock, plus a Treasury bond fund. Can any of the single-stock funds be “too” risky, or are they prudent taken together if the participant can theoretically construct a fully diversified, portfolio among them? On this very basic question, the case law is hideously conflicted.⁷³ And

⁷⁰ § 2550.404a-1(d) (2)(iv) as amended by 75 Fed. Reg. 64909 (Oct. 10, 2010) (“Paragraph (d)(2)(i) [relieving fiduciary of any loss or with respect to any breach that is the direct and necessary result of that participant’s or beneficiary’s exercise of control] does not serve to relieve a fiduciary from its duty to prudently select and monitor any service provider or designated investment alternative offered under the plan”). Preamble to Reg. 29 C.F.R. § 2550.404(c)-1, 57 Fed. Reg. 46906, 46922 (October 13, 1992), (the act of designating investment alternatives in an ERISA section 404(c) plan is a fiduciary function to which the limitation on liability provided by section 404(c) is not applicable.”).

⁷¹ See, e.g., *DiFelice*, 497 F.3d at 423–24 (4th Cir. 2007); *Pfeil v. State St. Bank & Trust Co.*, 671 F.3d 585, 599–600, 2012 BL 39978, 52 EBC 1641 (6th Cir. 2012)(35 PBD, 2/23/12) (; *Howell*, 633 F.3d at 567; *Tibble v. Edison Int’l*, 729 F.3d 1110, 1125, 2013 BL 204469 (9th Cir. 2013)(150 PBD, 8/5/13) .

⁷² *Langbecker v. Elec. Data Sys. Corp.*, 476 F.3d 299, 311, 39 EBC 2352 (5th Cir. 2007)(13 PBD, 1/22/07) (disagreeing with Labor Department’s position that 404(c) does not protect fiduciary’s selection of investments); *Meinhardt v. Unisys Corp.* (*In re Unisys Sav. Plan Litig.*), 74 F.3d 420, 444–48 & n.21 (3d Cir. 1996) (holding that on the basis of the statute alone, 404(c) protects fiduciary’s selection of investments). *But see Renfro v. Unisys Corp.*, 671 F.3d 314, 328, 2011 BL 215021, 51 EBC 1609 (3d Cir. 2011)(162 PBD, 8/22/11) (in dictum, saying the court might revisit *In re Unisys Sav. Plan Litig.* on this point, because of Labor Department’s codification of position in regulation).

⁷³ Compare, e.g., *DiFelice*, 497 F.3d at 423–24 (“[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.”), and *Brieger v. Tellabs, Inc.*, 245 F.R.D. 345, 351 (N.D. Ill. 2007) (citing *DiFelice*), with *Young v. GM Inv. Mgmt. Corp.*, 325 Fed. Appx. 31, 33 (2d Cir. 2009) (dismissing plaintiffs’ complaint that fiduciary offered undiversified single-equity funds that they “knew or should have known [were] too risky and volatile [as] investment[s] for a pension [because] complaint’s narrow focus on a few individual funds, rather than the plan as whole, is insufficient to state a claim for lack of diversification”), and *Tatum*, 761 F.3d at 356 (“[D]iversification and prudence duties do not prohibit a plan trustee from holding single-stock investments as an option in a plan that includes a portfolio of diversified funds,” citing H.R. Rep. No. 93-1280 (1974) (Conf. Rep.), stating that in a 404(c) plan, “if the participant instructs the plan trustee to invest the full balance of his account in, e.g., a single stock, the trustee is not to be liable for any loss because of a failure to diversify or because the investment does not meet the prudent man standards.” (emphasis added)). See also 29 CFR § 2550.404(c)-1(f) example (5) (If participant directs the fiduciary to invest 100% of his account

in *White v. Marshall & Ilsley*, the Seventh Circuit even suggested a sliding scale: while the fiduciary cannot offer a “wildly speculative and unsuitable” investment fund, the availability of other investment funds is a “relevant factor” in determining whether the employer stock fund is imprudently risky.⁷⁴

The real and unsolvable excessive risk problem. White’s reference to a “wildly speculative and unsuitable” investment fund highlights the real problem raised by the employer stock fund—a problem some courts grapple with but cannot solve. The notion of a too “speculative” investment clashes with the core theory underlying ERISA’s duty of prudent investing. Whether an investment is “wildly speculative and unsuitable” has no meaning except in terms of its contribution to the participant’s overall portfolio diversification and compensated risk, taking into account all investment portfolio assets (including its concentration of riskless assets). But the ERISA fiduciary has no duty to consider nondiversification when evaluating whether the employer stock fund is a prudent offering, and no duty to review whether the participant in a self-directed 404(c) plan has appropriately allocated his account balance among the plan’s investment funds. These two yawning statutory gaps in the ERISA fiduciary’s duties are the true sources of inappropriate investment risk born by the participant in a self-directed plan. When courts attempt to address the problem of “excessively risky” employer stock, they address a poor proxy for the real problem, but very possibly in recognition that the real problem is beyond solution because created by Congress when it enacted ERISA.⁷⁵

balance in a single stock, the fiduciary will not be liable for any losses that necessarily result from participant’s investment instruction.). Cf. *Hecker v. Deere & Co.*, 556 F.3d 575, 586, 2009 BL 27940, 45 EBC 2761 (7th Cir. 2009)(28 PBD, 2/13/09) (even assuming that fiduciary has duty to select fund offerings prudently, holds that fiduciary’s selection of high cost fund is not imprudent when participant can select among a broad array of funds). For an excellent discussion of this point and of the fiduciary’s duties of prudent investing generally, see John M. Vine, *Prudent Investing*, 38 *Tax Management Compensation Planning Journal* 1 (2010).

⁷⁴ *White*, 714 F.3d at 996 (“The availability of other options does not necessarily excuse offering one imprudent investment. ERISA imposes a duty of prudence with regard to every offering and one can imagine wildly speculative and unsuitable investments. When fiduciaries are considering specific alternatives, though, including whether to remove the employer’s stock from the available options, the availability of other options is a relevant factor, especially where employees may face a wide range of financial circumstances.”); see also *Howell*, 633 F.3d at 569 (“The very existence of the three other investment options (until July 1, 2000) or eight other options (after that date), in the absence of any challenge to any of those other funds, offers assurance that the Plan was adequately diversified and no participant’s retirement portfolio could be held hostage to Motorola’s fortunes.”).

⁷⁵ Cf. *DiFelice*, 497 F.3d at 425 (“As more employers shift toward participant-driven, defined-contribution plans, and participant-driven 404(c) plans in particular, Congress may reconsider the necessity of more safeguards for participants. For example, ERISA already limits the amount of employer stock that can be held in any defined-benefit pension plan to 10% of total plan assets. . . In light of the losses that have accrued to the Employees here, and others similarly situated, Congress may well decide that a similar limitation is appropriate for participant-driven, non-ESOP, defined-contribution plans.

(d) A Fiduciary Process to Address Risk. We have seen that financial market theory, which underlies *Dudenhoeffter* and ERISA's duty of prudent investing, predicts that no stock trading in an efficient market is inherently too risky for a retirement fund—assuming adequate portfolio diversification and an appropriate mix of riskless assets. We have seen that the employer stock fund may cause the portfolio to fail the “adequate diversification” criterion but that under ERISA the uncompensated risk created by non-diversification of the employer stock fund can be ignored by statute. We have seen the case law on the riskiness of employer stock as yet somewhat underdeveloped. We have seen this is especially so in a participant-directed 404(c) plan, where courts take different approaches to the fact that participants can create a portfolio satisfying virtually any risk tolerance by diversifying among its different funds.

The fiduciary has a number of choices. It may prudently determine that, if the stock is fairly priced by an efficient market, it is not too risky for the employer stock fund. No further inquiry into riskiness is required. This approach is supported by ERISA, *Dudenhoeffter*, their underlying financial theory, and by some case law.

Alternatively, the fiduciary might determine that in light of the very sparse and somewhat inconsistent case law, this first approach puts too much weight on courts' acceptance of the counterintuitive implication of a counterintuitive theory. This fiduciary could determine, possibly with the help of a financial consultant, the stock is an appropriate investment for a diversified retirement portfolio, and the stock's volatility falls below a prudent upper limit arbitrarily determined by the fiduciary at its discretion, with the assistance of its advisor. The line is arguably arbitrary because there is no theoretical or legal point at which a stock's volatility is excessive per se. But fiduciaries have the discretion to draw lines. If there is a line, plaintiffs must show the process drawing the line was imprudent—a difficult task given the total absence of any legal or theoretical basis on which to make this claim.

(e) The Importance of Educating Participants. In any event, the fiduciary should educate participants about the risks of investing in a single stock fund. This is a condition of ERISA Section 404(c) safe-harbor protection for an employer stock fund offering. Moreover, in a number of stock drop cases, similar education efforts have been viewed by the court as evidence that the company stock fund was prudently offered. How far to go in this effort is a judgment call. A good example of a robust education effort is seen in *DiFelice v. U.S. Air*, which cited the following information: (1) the company repeatedly explained the importance of investment diversification in different asset classes having different risk/return profiles, (2) the company warned that the company stock fund was the highest risk fund offered under the plan, and plainly explained the range of volatility in recent years (67% loss one year, followed by 212% gain the next year), (3) plan materials stated that only those who do not rely on the plan for their entire portfolio should invest in the common stock fund, and (4) plan materials cautioned plan participants against investing more than 10% of their assets in stock of a

However, this policy decision is one for Congress and not for the courts.”).

single industry.⁷⁶ Some courts also have suggested that the age of plan participants is a consideration when evaluating the risks of investing in company stock.⁷⁷ The thinking is that participants approaching retirement are, and should be, more risk averse.

II. Terminating the Fund: A Fiduciary Process

The fiduciary might want to terminate and liquidate the employer stock fund, for many good reasons. First the fiduciary might be concerned the fund potentially hurts participants' retirement savings: it invites participants to hold an under-diversified portfolio and exposes them to uncompensated risk. This concern has strong empirical support. A well-known study estimates that employees sacrifice an average 42% of the company stock's market value by taking on risk that could otherwise have been diversified away; follow-on studies have reached similar results.⁷⁸ Both theory and research predict participants' retirement savings will be strengthened if the employer stock fund is removed and its potential contribution to under-diversification eliminated.

Both the fiduciary and company could have sound additional reasons to prefer termination. Employer stock funds invite lawsuits whenever the stock price underperforms. The fiduciary's decision to keep the fund open to new investment must be prudent but key aspects of this duty are undefined or defined in contradictory ways. No process is assuredly prudent. While a prudent process can help, it does not necessarily protect the fiduciary from claims based on its many other duties under ERISA with respect to the employer stock fund, all of the similarly incompletely defined. And no company and no fiduciary welcomes a stock drop suit, with its expense, managerial distraction, and reputational risk.

On the other hand, terminating the stock fund raises risks of its own. It exposes the fiduciary to liability for an imprudent decision if the stock price later rises. And the decision to reverse course and remove a fund long held open to participant investments invites questions whether the fiduciary was imprudent not to close the fund earlier, whether the fiduciary is closing it now because of improper motives, and whether management has lost faith in the company and the stock.

The fiduciary's perils are partly illustrated by the cautionary tale of *Tatum v. RJR Pension Inv. Committee de-*

⁷⁶ *DiFelice v. US Airways, Inc.*, 436 F. Supp. 2d 756, 789 (E.D. Va. 2006), *aff'd* 497 F.3d 410 (4th Cir. 2007).

⁷⁷ *Steinman v. Hicks*, 352 F.3d 1101, 31 EBC 2415 (7th Cir. 2003) (239 PBD, 12/16/03) (; *Landgraff v. Columbia HCA*, No. 3-98-0090 (M.D. Tenn. May 24, 2000).

⁷⁸ See, e.g., Lisa Meulbroek, *Company Stock in Pension Plans: How Costly Is it?*, Pension Institute Discussion Paper PI-0205 (2002), <http://www.pensions-institute.org/workingpapers/wp0205.pdf> (finding that participants in defined contribution plans sacrifice an average 42% of the company stock's market value by taking on risk that could otherwise have been diversified away); Shlomo Benartzi et al., *The Law and Economics of Company Stock in 401(k) Plans*, 50 J.L. & Econ. 45, 49–50 (2007) (risk to employee of investment in single employer stock may be greater than Meulbroek's calculations because “it exposes them to idiosyncratic risk as well as to the possibility of suffering simultaneous reductions in both retirement savings and wages”).

cided by the Fourth Circuit in 2014.⁷⁹ Here a committee decided to terminate the Nabisco single-stock fund maintained by R.J. Reynolds Tobacco Company (RJR). It was no longer the employer stock fund because of Nabisco's earlier divestiture of RJR. After the liquidation Nabisco stock price shot up because of a takeover bidding war initiated by Carl Icahn. Participants sued. The Fourth Circuit affirmed the district court's holding the committee violated ERISA's duties of procedural prudence and of loyalty. The court's list of actions the committee should have undertaken but imprudently failed to is instructive:

(1) The committee failed to consider the Nabisco stock price might go up in the long run.⁸⁰

(2) The committee failed to evaluate evidence the price was *likely* to go up—including the stock's prior price decline; analysts' predictions of price gains; "buy" recommendations; and the divestiture's purpose, which was to increase Nabisco stock price over time by shedding its "tobacco taint."⁸¹

(3) The committee set a shutdown period over an "arbitrary" time frame not adequately justified.⁸²

(4) The committee breached its duty of loyalty when it acted out of "its fear of liability, not out of concern for its employees' best interests."⁸³ On brief the committee argued that a single stock fund is "inherently imprudent," but its fiduciary process never established this, and the court didn't buy the *per se* imprudence argument, at least as a legal defense unsupported by a process.⁸⁴

(a) What a Strong Process Should Accomplish. The fiduciary's process for establishing its decision to terminate the plan and liquidate the stock should accomplish several objectives.⁸⁵

First, a process preceding the decision should show that the fiduciary prudently concluded the *Dudenhoeffer* presumption applies, that no "special circumstances" make it imprudent to rely on the market price as the best available estimate of the stock's value, and that the fiduciary thus has no ability to predict the stock's future price path, and so no duty to try.

⁷⁹ 761 F.3d 346, 352, 2014 BL 215589, 58 EBC 2277 (4th Cir. 2014) (150 PBD, 8/5/14).

⁸⁰ *Id.* at 359 (noting that committee failed to consider "the purpose of the Plan, which was for long term retirement savings").

⁸¹ *Id.* at 361 (noting that committee persisted in decision to sell "in the face of sharply declining share prices and despite contemporaneous analyst reports projecting the future growth of those share prices and 'overwhelmingly' recommending that investors 'buy' or at least 'hold' Nabisco stocks. . . RJR did so without consulting any experts, without considering that the Plan's purpose was to provide for retirement savings, and without acknowledging that the spin-off was undertaken in large part to enhance the future value of the Nabisco stock by eliminating the tobacco taint.") See also *Id.* at 359 (noting that committee failed to consider "that, perhaps, it would take a while for the tobacco taint to dissipate.")

⁸² *Id.*

⁸³ *Id.* at 361.

⁸⁴ *Tatum*, 761 F.3d at 360 ("RJR contends [on brief] that '[n]on-employer, single stock funds are imprudent per se' due to their inherent risk. But this per se approach is directly at odds with our case law and federal regulations interpreting ERISA's duty of prudence.")

⁸⁵ The need to support the fiduciary decision with a process is explained in Section I(1).

Second, the fiduciary process should show more than that the stock is efficiently priced. It should also establish the decision affirmatively promotes the plan's purpose of enabling retirement savings. This shows the decision is prudent and in participants' best interests, and also helps protect the fiduciary and company from the potential legal and reputational risks caused changing course and closing an employer stock fund long held open to participant investments.

Fourth, a fiduciary process should justify the timetable of the termination decision.

Fifth, a process should consider whether and when the fiduciary should suspend the termination upon inside information showing the stock price might go up (say a possible tender offer).

Sixth, the fiduciary should consider whether a plan amendment commanding the termination helps or hurts.

Seventh, the fiduciary should evaluate the possible role of an independent fiduciary.

(b) Mechanics of the Termination. The typical termination follows a two stage process. In Stage 1, the fiduciary closes the employer stock fund to new investments. Participants can move money out of the employer stock fund, but can't move money into it. The Stage 1 transition period benefits participant-shareholders in several ways. It warns participants about the ultimate termination; it allows participants to select their own preferred sales timing and sales price, as well as their preferred investment of the funds; and by elongating the total liquidation period reduces the number of shares the fiduciary must sell into the market all at once. In addition, it anticipates the end point of the process: transfer of any remaining assets from the terminated employer stock fund to the QDIA. Only by giving participants the prior opportunity to elect investment of their account balances does the fiduciary obtain safe harbor protection under ERISA Section 404(a)(5) when it transfers non-elected assets into a QDIA.⁸⁶ Of course, in most 404(c) plans participants have this right on an ongoing basis. But a Stage 1 warning puts participants on notice and should forestall potential claims they lacked a meaningful opportunity to invest their employer stock fund balance before its ultimate termination. Moreover the delay before involuntary liquidation begins in Stage 2 draws some of the sting from potential claims the fiduciary imprudently ignored inside information available the time of the decision tending to predict a price increase.

In Stage 2, the fund is terminated, the stock liquidated and the proceeds invested in the QDIA. No proceeds are allocated to any single account until the end of Stage 2; at that point, each participant with a remaining balance in the employer stock fund receives a pro rata share of the proceeds, based on the weighted average share price realized over the Stage 2 liquidation period. Because each participant gets the average price, no participant gets the accidental benefit or detriment of stock price movements during the Stage 2 liquidation period. However, trades, loans and distributions from the employer stock fund must be suspended during the entire period. Stage 2 is thus an ERISA blackout period

⁸⁶ 29 C.F.R. 2550.404(c)-5(c) (QDIA safe harbor protection available only if a participant had the opportunity to direct the investment of the assets in his or her account but did not direct the investment of the assets).

if it is expected to last more than 3 business days. Stage 2 might also be a Sarbanes Oxley blackout period if affected participants exceed the 50 percent threshold.

(c) Process Should Establish Stock Is Fairly Priced by the Market. *Tatum* supports the fiduciary's fear if it terminates and liquidates the employer stock fund, the stock price might bounce back and participants successfully sue for imprudence. Under *Dudenhoeffer* this should not be a concern; the fiduciary may rely on the market price as the best available estimate of the stock's value, absent special circumstances showing it is imprudent to rely on the market's valuation. Under *Dudenhoeffer*, the fiduciary has no ability and no duty to predict future stock price.⁸⁷ *Tatum* ignored *Dudenhoeffer* and the efficient market hypothesis, and faulted the fiduciary for failing to evaluate public information the court found to be compelling predictors of a future price increase.

The fiduciary divesting employer stock should have a process proving that the stock trades in an efficient market, and no special circumstances make it imprudent to presume the stock is fairly priced by the market. Consider future *Tatum*-like allegations recast under the *Dudenhoeffer* framework: plaintiffs claim "special circumstances" included analysts' bullish price forecasts, positive press and even recent price history (whether up or down), all showing the fiduciary was imprudent in failing to try to predict future stock price direction. When terminating the fund as when keeping it open, the fiduciary needs a process establishing no special circumstances make it imprudent for the fiduciary to conclude it has no ability and no duty to predict future stock price.

The multi-factor test based on the Cammer/Krogman factors and described in Section I(1) is the template for this process. These factors establish the presumption the stock trades in an efficient market. Using this approach, the fiduciary defines "special circumstances" as the stock's failure to satisfy the Cammer/Krogman factors, because such failure would tend to show market failure. The fiduciary could prudently conclude that when some or all of the Cammer/Krogman factors are satisfied, the stock trades in an efficient market and no "special circumstances" make it imprudent to rely on the market's valuation of the stock. Accordingly, the fiduciary has no ability to outguess the market, and no duty to predict or even inquire whether the stock price will go up or down.

The fiduciary could choose to apply all 10 factors, or only those eight not requiring the assistance of a professional economist. That said, *Tatum* is a nice illustration of the potential utility of an economist's "autocorrelation study" (the tenth factor). *Tatum* faulted the fiduciary for failing to predict a price rise in part on the basis of the stock's historic price low. An autocorrelation study may show recent losses are not a prudent basis for predicting (in contrast with *Tatum*) the price has nowhere to go but up. And if the stock price has been es-

⁸⁷ *Summers v. State St. Bank & Trust Co.*, a stock drop case, recognizes that the efficient market hypothesis set forth in the opinion would similarly support the fiduciary's decision to sell stock. 453 F.3d at 411 ("Of course, if State Street had sold earlier and the stock had then bounced back, as American Airlines' stock did, State Street might well have been sued by the same plaintiffs, though the analysis presented in this opinion would have bailed it out.").

pecially exuberant, an autocorrelation study may show recent gains are not a prudent basis for predicting gains will continue. The efficient market hypothesis predicts the fiduciary cannot predict future price on the basis of past price; an autocorrelation study may show this is specifically true for the employer stock.⁸⁸

(d) A Process Should Also Establish Termination Promotes Plan's Purpose by Reducing Uncompensated Risk. The fiduciary might wish to do more than merely show the stock is fairly priced by the market. The termination will follow a lengthy period in which the fund was held open to participants' investments. Why deprive them of this opportunity now? And why now and not sooner? Both fiduciary and company have a strong stake—in and outside of the ERISA context—in answering this question truthfully and convincingly. A sound, credible and supportable answer is that the decision promotes the plan's goal of enabling retirement savings by reducing "uncompensated risk"—risk participants assume but aren't paid more to do so. A good process can establish this is so.

Volatility Study Shows Costs of Uncompensated Risk. Financial market theory furnishes helpful tools and the foundations of a robust process. We have explained at section I(3) that an under-diversified investment portfolio creates "uncompensated risk" impeding its purpose of creating retirement wealth. Since we invited readers to skip the technical parts of that discussion, we briefly recapitulate this cost of non-diversification in the following paragraph. Readers who plowed through this discussion in section I(3) can skip to the next following paragraph.

Assuming it trades in an efficient market, a stock's "specific risk" is that piece of its random price movements not correlated with the rest of the market. Its specific risk can be eliminated by including it in a sufficiently diversified portfolio of investments whose specific risks (non-covariant random price movements) cancel each other. Because specific risk can be cancelled without cost, the investor is not paid a higher rate of return to assume it. It is "uncompensated" risk. Underdiversification depresses participants' retirement wealth. By underdiversifying, the participant at any given level of investment risk is predicted to end up with a *smaller* retirement fund than had he adequately diversified. The cost of the uncompensated risk created by nondiversified employer stock funds has been quantified in a number of studies.⁸⁹ But under ERISA, the fiduciary is not required to consider the employer stock's nondiversification in evaluating its prudence. This is another way of saying that, by law, the fiduciary is not required to consider the costs of the uncompensated risk created by the employer stock fund.

⁸⁸ For such a study, see n. 22 and accompanying text, and "NERA's Review of Fortune 500 Company's Employee Stock Ownership Plan" <http://www.nera.com/publications/archive/case-project-experience/nera-s-review-of-fortune-500-company-s-employee-stock-ownership-.html>.

⁸⁹ See, e.g., Meulbroek, *supra* note 75 (finding that participants in defined contribution plans sacrifice an average 42% of the company stock's market value by taking on risk that could otherwise have been diversified away); Benartzi, *supra* note 75, at 49-50 (explaining that the risk to employee of investment in single employer stock may be greater than Meulbroek's calculations because "it exposes them to idiosyncratic risk as well as to the possibility of suffering simultaneous reductions in both retirement savings and wages").

Taking the costs of nondiversification as its starting point, the fiduciary can demonstrate and quantify the uncompensated risk potentially created by the nondiversified employer stock fund. Key here is the case the fiduciary is *not* making. The fiduciary does not seek to show the employer stock is excessively risky, imperiled by company business troubles, or otherwise unsuitable for a retirement plan. The fiduciary seeks only to prove that, as predicted by financial market theory, the fund's nondiversification frustrates the plan's purpose of promoting retirement savings.

A simple way to accomplish this is to obtain a "volatility study" from a consulting economist. Using standard financial tools, the study examines the historical volatility of the company stock fund relative to the plan's other investment funds over a given period (say, a year). If the plan's other funds are diversified, financial market theory predicts that participants' investment portfolios will be more volatile if they include investments in the employer stock fund (above very small concentrations of holdings); participants' predicted portfolio volatility is reduced if the employer stock fund is removed from the plan's investment line-up. Generally the volatility study should bear out this prediction. By modeling a range of hypothetical portfolios based on the plan's actual fund offerings and their historic volatility, it will show that the employer stock fund creates volatility and uncompensated risk. Based on this study, the fiduciary may prudently conclude that the nondiversified employer stock fund leads to participants assuming uncompensated risk in their retirement plan accounts, risk that can be eliminated by eliminating the fund.

This process should help save the fiduciary from the situation faced by the *Tatum* defendants. They were unable to convince the court on brief that a nondiversified stock fund is imprudent per se. But here the fiduciary shows by its prudent process that the nondiversified employer stock fund creates excessive volatility and uncompensated risk relative to the plan's diversified funds.

A real-life example of a volatility study conducted for the employer stock fund of an unnamed company can be found on the website of NERA Economic Consultants.⁹⁰ NERA was retained by the fiduciary to evaluate whether the employer stock fund created uncompensated risk.

Process Protects Other Fiduciary and Company Interests, as Permitted by ERISA. The process also protects the fiduciary and company by allowing them to explain the termination truthfully, credibly and in a way not injurious to their other legal interests or their reputation. These incidental benefits are permitted by ERISA, which does not prohibit an investment decision merely because undertaken partly to benefit persons other than participants. Rather, under the longstanding ERISA doctrine of "incidental benefit," if the investment decision is prudent and in participants' interests, it does not violate the fiduciary's duty of loyalty merely

⁹⁰ See "NERA's Review of Fortune 500 Company's Employee Stock Ownership Plan" <http://www.nera.com/publications/archive/case-project-experience/nera-s-review-of-fortune-500-company-s-employee-stock-ownership-.html>.

because it also benefits the employer, or reduces the employer's risk of maintaining the plan.⁹¹

First, as a realistic matter, it is not impossible internal records might show the fiduciary or management was concerned about liability from continuing to hold the stock fund. *Tatum* held the fiduciary breached its duty of loyalty because it acted out of "its fear of liability, not out of concern for its employees' best interests."⁹² *Tatum* is noteworthy because the district court appeared to find the fiduciary's self-protective motive was unaccompanied by any motive to act in participants' interests. By establishing the decision promotes the plan's retirement savings goals, the proposed process shows the decision is prudent and consistent with the fiduciary's duty of loyalty to act solely participant's' interests. Any incidental benefit should not taint the decision.

Second, the process lets the fiduciary establish the termination is not an admission or evidence it was imprudent not to terminate earlier. Under ERISA, the fiduciary is permitted to ignore the stock's nondiversification. But it is not compelled to do so. The fiduciary has broad discretion to select investment strategies promoting participants' best interests.⁹³ The fiduciary here uses its discretion to evaluate the fund's nondiversification and the resulting uncompensated risk it creates, and to decide that this uncompensated risk makes it appropriate to remove the employer stock fund. But the fiduciary should not be found imprudent for not having earlier undertaken an inquiry expressly exempted from ERISA's duty of prudence.

Third, the process lets the company truthfully and credibly explain to the market and its employees that the decision reflects the fiduciary's well-founded concern about the fund's non-diversification and its potential impact on retirement savings. This anticipates and responds to potential market suspicions that the termination signals management's loss of faith in the company, or wrongful concealment of material inside information. If challenged, the explanation is fully backed by the fiduciary record.

(e) Establishing a Timetable. The *Tatum* committee was held to be imprudent in part because it failed to establish a reason for the termination timeline chosen. In subsection (a) above we describe the typical two-stage timetable typically used for terminating the fund, and the reasons for it. Like many other aspects of the deci-

⁹¹ ERISA Opinion Letter 2006-08A, 2006 (A fiduciary did not breach its fiduciary duties by considering an investment portfolio designed to match assets with liabilities, undertaken in part to minimize expected volatility in the employer's future funding obligations. The Department reasons "ERISA's prudence requirement provides fiduciaries with broad discretion in investment strategies, and does not limit a plan fiduciary's ability to take into account the plan's liability obligations and risks associated with those liabilities. Thus, despite the fact that there were incidental benefits to the plan sponsor, the reduction of volatility in plan funding requirements and the minimizing of an underfunding risk primarily benefited the plan, its participants, and beneficiaries."); see also, e.g., *District 65, UAW v. Harper & Row, Publishers, Inc.*, 576 F Supp. 1468, 1481, 4 EBC 2586 (S.D.N.Y. 1983) (holding that purchase by profit sharing plan of employer stock is not a violation of the duty of loyalty merely because it benefits the employer).

⁹² *Id.* at 361.

⁹³ ERISA Opinion Letter 2006-08A, 2006 ("ERISA's prudence requirement provides fiduciaries with broad discretion in investment strategies").

sion, a staged timetable is in participants' interests, but could also be viewed as conveying incidental benefits to the fiduciary and company alike. The fiduciary should have a deliberative decision showing the timetable is in participants' interests.

(f) Halting the Liquidation on Inside Information. Once the liquidation has commenced or is scheduled to commence, the fiduciary might obtain nonpublic information about tentative merger talks, a possible tender offer or other potential future event likely to increase the stock price when revealed to the market. When does the fiduciary with material positive inside information have a duty to halt or suspend the liquidation?

Under one approach, the fiduciary might avoid the question by determining it has no duty suspend the liquidation, because this would violate the securities laws or the "spirit" of the securities laws. At least one district court case supports this determination.⁹⁴ However the law on this issue remains uncertain.⁹⁵

Under a more conservative approach the fiduciary would determine it has no duty to suspend the liquidation on the basis of inside information unless the fiduciary knows its concealment has violated federal securities law, on the grounds that halting planned sales before this point would do more harm than good to the plan. This approach is supported by the Ninth Circuit's decision in *Harris*, which identified this as the point at which the fiduciary has a duty to halt new investments in the fund. Justifying this determination should be fairly straightforward. Once the liquidation period starts, the harm of delaying or halting sales is known and concrete: it extends the blackout period during which participants cannot trade, move or distribute assets out of employer stock fund, and during which any liquidated assets remain in cash. By contrast, the benefits of a possible tender offer or merger are speculative and uncertain; many or most preliminary talks collapse before fruition.

(g) Plan Amendment Compelling Termination: Does it Help or Hurt? One additional idea is that the company make the termination a settlor decision by amending the plan to prohibit an employer stock fund and to require liquidation of its assets. Of course, since removing an investment fund entails a discretionary fiduciary decision,⁹⁶ before implementing this amendment the fiduciary must still evaluate whether termination is prudent. The idea is the amendment adds a second string to the fiduciary bow: the fiduciary's decision is doubly prudent because it is consistent with the fiduciary's duty to follow plan terms, and the decision commanded by the plan's terms has been determined by the fiduciary not to be imprudent. Under this approach, an

⁹⁴ *Camera v. Dell Inc.*, No. 1:13-cv-00876-SS, 2014 BL 170606, 58 EBC 2116 (W.D. Tex. June 17, 2014) (upholding fiduciary's decision not to halt liquidation of the employer stock fund, where fiduciary had inside information of possible going-private offer that ultimately drove up stock price, reasoning in part that halting planned sales would in such case be "wholly inconsistent with the spirit of the securities laws; it is, in essence, insider trading on a time delay").

⁹⁵ *Cf.* ns. 31 and 32 *supra*, for cases holding that a fiduciary is not barred by insider trading laws from closing down employer stock fund to new investment, as this does not involve a prohibited trade.

⁹⁶ ERISA § 3(21) (a person is a fiduciary "to the extent" he exercises "any authority or control respecting management or disposition" of plan assets); *Tatum*, 761 F.3d 346 at 350.

amendment is an additional factor among others to be weighed when evaluating the fiduciary's conduct.

This is a close call. A plan amendment has pluses and minuses. Here is the balancing act the fiduciary should consider.

On the plus side, a plan amendment might possibly place a thumb on the "prudence" side of the scale. But after *Dudenhoeffer*, the helpfulness of a plan amendment is by no means certain. *Dudenhoeffer* is arguably best read as saying the fiduciary's duty to follow plan terms is separate from and subordinate to the fiduciary's duty of prudent investing, rather than merely one element of the duty of prudence. Under this reading, the fiduciary must first evaluate whether the investment decision is prudent without regard to the plan's terms. Only after deciding it is *permitted* by ERISA without regard to the plan, can the fiduciary then inquire whether the investment is *required* by the plan.⁹⁷ That is, the threshold prudence determination is not affected by the plan amendment. The issue however is unclear and still awaits development by the post-*Dudenhoeffer* case law.⁹⁸

On the minus side are two items. First, the case law has considerable support for the idea that a plan amendment affecting the investment of *existing* plan assets, including an existing investment option, is intrinsically fiduciary, rather than settlor.⁹⁹ We believe

⁹⁷ *Dudenhoeffer*, 134 S. Ct. at 2468 (rejecting defendants' argument that "the content of ERISA's duty of prudence varies depending upon the specific nonpecuniary goal set out in an ERISA plan," and reasoning as follows: "Consider the statute's requirement that fiduciaries act 'in accordance with the documents and instruments governing the plan *insofar as such documents and instruments are consistent with the provisions of this subchapter.*' (emphasis added). This provision makes clear that the duty of prudence trumps the instructions of a plan document, such as an instruction to invest exclusively in employer stock even if financial goals demand the contrary.")

⁹⁸ At least one district court case ascribes significant weight to a plan amendment, but its vitality after *Dudenhoeffer* is doubtful. *Camera v. Dell Inc.* upholds the fiduciary's decision not to halt liquidation of the employer stock fund, where the fiduciary had inside information of a possible going-private offer that ultimately drove up the stock price. *Camera* is based on the *Moench* presumption as adopted by the Fifth Circuit. Under this standard, *Camera* holds that plaintiffs must "present 'persuasive and analytically rigorous facts demonstrating that reasonable fiduciaries would have considered themselves bound' to countermand the ERISA plan." *Camera*, 2014 BL 170606 (citing *Kirschbaum v. Reliant Energy, Inc.*, 526 F.3d 243, 256, 43 EBC 2281 (5th Cir. 2008) (82 PBD, 4/29/08), holding that plaintiffs could not overcome the *Moench* presumption that an employer stock fund commanded by the terms of the plan is prudent.) *Camera* reads *Kirschbaum* and *Moench* as placing a presumption of prudence on any fiduciary decision implementing any plan terms. *Camera*, 2014 BL 170606. ("But the presumption of prudence is designed to protect those fiduciaries who do what the ERISA plan tells them to do.")

⁹⁹ ERISA § 3(21) (a person is a fiduciary "to the extent" he exercises "any authority or control respecting management or disposition" of plan assets). *Stanford v. Foamex L.P.*, 822 F. Supp. 2d 455, 470, 2011 BL 250488, 52 EBC 1677 (E.D. Pa. 2011) (192 PBD, 10/4/11) (holding that assuming plan document amended to require liquidation of plan investment, settlor function doctrine "does not apply where, as here, a plan amendment affects the investment of existing plan assets" and that decision is fiduciary notwithstanding done by plan amendment); *Nelson v. IPALCO Enters.*, 480 F. Supp. 2d 1061, 1109-1110, 40 EBC 1983 (S.D. Ind. 2007) (63 PBD, 4/3/07) (When sponsor amended 401(k) plan to require liquidation of single-

these cases are incorrect on this point, but the fiduciary should be aware they exist. The idea is similar to and supported by the Fourth Circuit's position that a plan amendment designating a fiduciary is intrinsically fiduciary, rather than settlor.¹⁰⁰ Labor Department guidance is conflicted. The preamble to its regulations under ERISA Section 404(c) state that the act of "limiting or designating investment options" under a Section 404(c) plan "is a *fiduciary function* whether achieved through fiduciary designation or *express plan language* (emphasis added).¹⁰¹ This preamble statement has been accorded *Chevron* deference (although not on this precise issue).¹⁰² Ignoring this earlier guidance, the Department takes a different position on amicus brief,¹⁰³ and ultimately leaves its position unclear.¹⁰⁴ While the law is unsettled, the consequences of an "it's fiduciary" holding are bad. If plaintiffs prevail, the plan amendment strategy leaves the company worse off if the company must defend an intrinsically fiduciary act supported by no fiduciary process. This outcome risks a *Tatum*-like decision the fiduciary breached its duty of prudent conduct and prudent process.¹⁰⁵

stock fund and reinvestment in different fund, with no opportunity for intervening decisions by named fiduciary, it exercised "authority and control of existing plan assets" and was accordingly "undertaking a fiduciary role under ERISA."); *King v. National Human Resource Committee, Inc.*, 218 F.3d 719, 724, 24 EBC 2702 (7th Cir. 2000)(130 PBD, 7/6/00) (plan sponsor's spinoff of 401(k) plan to new plan is settlor, but decision about investment of existing plan assets is subject to ERISA fiduciary standards); *In re Ford Motor Co. ERISA Litig.*, 590 F. Supp. 2d at 889-890 (without deciding the question, states it is "inclined to agree" that plan amendment requiring plan to invest in employer stock fund was fiduciary rather than settlor act").

¹⁰⁰ *Coyne & Delany Co.*, 98 F.3d at 1465 (appointing a fiduciary is itself a fiduciary function even if done by plan amendment).

¹⁰¹ 57 Fed. Reg. 56906, n. 27 (October 13, 1992), Preamble to Reg. 29 C.F.R. § 2550.404(c)-1 ("the act of limiting or designating investment options" under a section 404(c) plan is a 'fiduciary function' whether achieved through fiduciary designation or *express plan language*") (emphasis added).

¹⁰² *DiFelice* 497 F.3d at 418, n.3. *But see Hecker*, 569 F.3d at 710 (footnote in preamble not entitled to full *Chevron* deference).

¹⁰³ Brief of the Secretary of Labor at 7, *Tatum v. R.J. Reynolds Tobacco Co.*, 392 F.3d 636 (4th Cir. 2004) (No. 04-1082), <http://www.dol.gov/sol/media/briefs/tatum%28A%29-5-7-2004.pdf>. (Stating that an amendment deleting a single stock fund is settlor, reasoning that, "Generally, when a plan sponsor amends an ERISA plan, it does not act as a fiduciary.")

¹⁰⁴ Confusingly, the *Tatum* amicus brief addresses the holding of *Coyne & Delany Co.* that a plan amendment appointing a fiduciary is a fiduciary act. The brief explains: "Coyne & Delaney thus exercised both the fiduciary discretion to appoint, monitor, and remove the Plan Administrator and Plan Supervisor, and the settlor power to amend the plan to effectuate those decisions. The fact that these two separate functions were performed by one entity did not make the act of amending the plan a fiduciary act." *Id.* at 10. While very unclear, this can be read as stating that in appointing the fiduciary, the settlor simultaneously acts as a fiduciary, and that the fiduciary aspects of the act are reviewable.

¹⁰⁵ *Tatum v. R.J. Reynolds Tobacco Co.*, 926 F. Supp. 2d 648, 674, 2013 BL 47936, 55 EBC 1227 (M.D.N.C. 2013)(39 PBD, 2/27/13)(40 BPR 532, 3/5/13), *aff'd*, 761 F.3d 346 (4th Cir. 2014) ("ERISA's prudence standard requires that a plan investment decision, including the decision to keep or eliminate

Second—and this is decisive in our view—if the decision is initially made by the settlor it lacks a process helpful for explaining the decision to employees and investors in a way not injurious to the company. For reasons we have explained above, the termination will virtually certainly be preceded by a decision to close the plan to new investments. This may well be viewed by the market as a signal of business troubles not yet revealed to investors. This perception is regrettable under any circumstances. It is hazardous if the stock by coincidence then takes a downturn. Investors may question whether the company's decision to close the stock to new investment signaled material negative inside information that should have been disclosed to the market.

By contrast, the process we suggest creates a strong record that the decision to close the fund was made by the fiduciary specifically in participants' interests. Its purpose is to improve participants' retirement investment portfolios by eliminating the uncompensated risk created by the employer stock fund. The existence of uncompensated risk has been demonstrated by the fiduciary's prudent process. The decision can be easily communicated to participants and investors alike, as one based in concerns about diversification, rather than concerns about the viability of the company and its stock.

Alternatively, the fiduciary might want to consider mixed strategies for dealing with this dilemma. Under a staged decision, for example, the fiduciary decides on the basis of its prudent process the fund should be terminate; the company then amends the plan to direct the fiduciary to do just that. This might or might not add a layer of protection for the fiduciary, and might or might not reduce the possibility the amendment itself is viewed as a fiduciary act. Alternatively, the plan amendment could be preceded by a settlor-driven process, ready to be produced in the event of litigation.

(h) Retaining an Independent Fiduciary. It is not uncommon to retain an independent fiduciary to handle the liquidation of the employer stock fund. This yields significant benefits when the independent fiduciary brings to the table key experience and expertise, including for example, expertise on the technical question of how rapidly to sell the stock without affecting its market price.

Whether the appointment relieves the in-house fiduciary from its duty to consider halting the sales on the basis of inside information—or directing the independent fiduciary to halt the liquidation on the same information—is another issue. This uncertainty arises even if the independent fiduciary is named in the plan document rather than appointed by the named fiduciary. These issues are discussed in Section I(2)(b) of this article.

Another potential role for the independent fiduciary is to act as a nonconflicted decision maker about the entire termination. Under this approach, the company amends the plan to command the fund's termination. The independent fiduciary carries out the amendment, unless it first decides the termination would be imprudent. This approach forestalls claims the implementing fiduciary violated its duty of loyalty by acting under a structural conflict of interest—a risk the *Tatum* decision highlights. And it secures experience and expertise. It

a plan investment option, be made only after a thorough and impartial investigation and analysis.").

does not address the nontrivial risk raised by Labor Department guidance and case law that the amendment (or the accompanying company decision) itself is a fiduciary act, and thus subject to ERISA's duty of procedural prudence and loyalty. It thus creates vulnerability to a *Tatum*-like finding that a fiduciary decision was made unsupported by a fiduciary process. And it short circuits the fiduciary process we have proposed that allows both the fiduciary and management to explain the termination without the risk of simultaneously signaling that management has lost faith in the stock, that the fiduciary was imprudent not to close it earlier, or that the fiduciary terminated the fund for inappropriate and disloyal reasons. The fiduciary must balance competing goals guided by conflicting authorities.

III. Supplementing Fiduciary's Section 404(c) Protections

As we have noted, the Labor Department takes the position that ERISA Section 404(c) protects the fiduciary only from participant investment elections, but leaves the fiduciary responsible for the prudence of each fund offering. The case law on this point is conflicted. Some courts disagree with the Labor Department.¹⁰⁶ Other courts, however, appear to agree with the Labor Department's narrow reading of the statute.¹⁰⁷ There are a couple of steps the fiduciary might wish to consider to buttress or supplement its possibly limited protection under Section 404(c). While somewhat speculative, these suggestions might be seen as one additional line of protection for the fiduciary.

(a) Require Participant Consent to Company Stock Fund Offering. A possible way to avoid the conflicting statutory interpretations of ERISA Section 404(c) might be to draw on the underlying common law of trusts, and obtain participant consent to the offering of the company stock fund. This could involve a consent every time a participant moves amounts into a fund, or it could be applied more aggressively by requiring consent in order to keep funds in the stock fund.

Under the common law of trusts, a fiduciary is not liable for an action if a beneficiary consented to the action in advance.¹⁰⁸ The only exceptions to that rule are if (1) the beneficiary is under an incapacity at the time of the consent, (2) to the knowledge of the fiduciary the beneficiary does not know the material facts, or (3) the consent is induced by improper conduct of the fiduciary. The common law of trusts and the Restatement (Trusts) serve as an important starting point for the interpretation of the ERISA fiduciary rules.¹⁰⁹ At least one district court has stated that the doctrine of consent

as expressed in the *Restatement (Trusts)* Section 216 may present a cognizable affirmative defense to an ERISA fiduciary breach claim.¹¹⁰ And citing the doctrine of participant consent under the common law of trusts and Section 216 of the *Restatement (Trusts)*, the Seventh Circuit has held that an IRA beneficiary could not sue an IRA bank trustee for implementing an investment decision made by the IRA beneficiary.¹¹¹ IRAs are not ERISA plans subject to Title I of ERISA, but they closely resemble participant-directed 401(k) plans and they share a common heritage.

One question is whether the participant's consent is barred as a valid defense by the prohibition against exculpatory clauses under ERISA Section 410. Arguably not. The common law doctrine of participant consent differs from the concept of a release. Participant consent requires concurrence with an action before it occurs, whereas a release is a legal forgiveness of a possible wrong after an event has transpired. Accordingly, the consenting participant is not forgiving the fiduciary who selected the company stock fund, but merely agreeing with the selection before the participant invests in the fund. Further, the statute prohibits exculpatory provisions in "an agreement or instrument" and participant consent does not fall into either category; there is no legal agreement before or after the event and there is no wording in any plan instrument deeming the participant to have consented.

Obtaining participant consent does not protect the fiduciary from claims it should have acted with respect to inside information—either by announcing the information to the public, or by closing off the stock fund to new participant investments. It also offers no protection against claims of participant coercion, which could arise in *Enron*-type situations, where plan fiduciaries tout the company stock fund while knowing the company is failing. (These same limitations also apply under ERISA Section 404(c) itself.¹¹²) It would only serve to shore up the fiduciary's position against claims based on public information (if participants successfully override the *Dudenhoeffer* fair market-price presumption) or the stock's volatility.

(b) Make Participant the Named Fiduciary for Company Stock Investments. This is a step beyond the participant consent idea and would have the participants who elect to invest in the company stock fund denominated as "named fiduciaries" with respect to the company stock fund offering. The idea would be that the investing participants would be "directing" the company to offer the company stock fund, thereby insulating the "directed" individuals from liability under ERISA. It is similar to what happens under a brokerage window, where the plan participant has full authority over all aspects of the investment choice.

¹⁰⁶ *Meinhardt (In re Unisys Sav. Plan Litig)*, 74 F.3d at 445 (plain language of ERISA § 404(c) suggests that fiduciary breach of duty of prudence in selecting investment alternative does not bar ERISA § 404(c) defense as long as participant exercise of control is a contribution factor in the loss); *Langbecker*, 476 F.3d at 311 (noting that participants' position would render 404(c) defense applicable only where fiduciary breach no duty and thus only were unnecessary).

¹⁰⁷ *DiFelice*, 497 F.3d 410 (fiduciary must determine the prudence of each investment option).

¹⁰⁸ Restatement (Second) of Trusts, Section 216 (1959).

¹⁰⁹ *Varity*, 516 U.S. at 511 (The common law of trusts "will inform, but will not necessarily determine the outcome of an effort to interpret ERISA fiduciary duties."); accord *LaRue v.*

DeWolff, Boberg & Assocs., 128 S. Ct. 1020, 2024 n.4, 42 EBC 2857 (2008) (34 PBD, 2/21/08).

¹¹⁰ *Local 464A United Food and Commercial Workers Union Pension Fund v. Wachovia Bank*, No. 09-668 (WJM), 47 EBC 1553 (D. N.J. July 14, 2009) (134 PBD, 7/16/09) (suit by trustee of union pension fund and union over investment strategy of investment manager).

¹¹¹ *Metz v. Indep. Tr. Corp.*, 994 F.2d 395, 16 EBC 2379 (7th Cir. 1993).

¹¹² 29 CFR § 2550.404c-1(c)(2)(i), (ii) and (iii) (improper influence, concealment of material non-public facts, legal incompetence).

The named fiduciary approach makes the participant a fiduciary at the fund selection stage. Under Section 404(c), a participant cannot become a fiduciary by virtue of his “exercise of control over assets in the plan,” defined by regulations as his investment decisions with regard to investment alternatives available under the plan.¹¹³ According to the Labor Department the investment alternatives available under the plan are selected by a fiduciary. Under the named fiduciary approach, the participant becomes the selecting fiduciary with respect to the employer stock fund; the investment fiduciary would still select the plan’s other investment funds.

The idea that participants can be “named fiduciaries” is firmly rooted in ERISA. In *Herman v. NationsBank Trust Co.*, 126 F.3d 1354, 21 EBC 2061 (11th Cir. 1997), the Eleventh Circuit held that plan participants could be denominated as “named fiduciaries” for purposes of voting company stock held for their account under an ERISA plan. The court’s opinion upheld the Labor Department’s long held position to the same effect.¹¹⁴ The only other caveat given by the Eleventh Circuit was that they were not sure that “named fiduciary” status could be forced on a plan participant without sufficient notice and that an opt-out opportunity might have to be given.¹¹⁵ In ERISA Opinion Letter 80-30A (May 21, 1980) the Labor Department provides the participant can be a named fiduciary.

As with participant consent, one question is how to implement the named fiduciary approach. One method would have the participant acknowledge named fiduciary status only as new amounts are allocated to the company stock fund. The approach would be to require that participants acknowledge named fiduciary status as a broader condition of keeping existing amounts in the company stock fund.

IV. Conclusions and Executive Summary

Our article has described a process by which the fiduciary can prudently decide to keep the employer stock fund open to new investment and a process by which the fiduciary can prudently decide to terminate the fund. Both are based on *Dudenhoeffer* and the case law and financial market theory on which it is based. We also set forth some additional thoughts for possibly shoring up the fiduciary’s 404(c) protection by transferring some of the decision from the fiduciary to participants.

(1) Keeping the Fund Open. We have outlined a process allowing the fiduciary to conclude it may prudently keep the employer stock fund open to new investments. The process we propose allows the fiduciary to evaluate the prudence of its decision on the basis of its three sources of challenge: public information, inside information, and the stock’s risk.

¹¹³ 29 CFR § 2550.404c-1(c)(1).

¹¹⁴ *Olena Berg Letter to Ian Lanoff*, September 28, 1995, reprinted in 22 Pens. Rep. (BNA) pp. 2249–51 (October 9, 1995); *Letter from Department of Labor to Citizens and Southern Trust Company* (February 23, 1989), reprinted in 16 Pens. & Ben. Rep. (BNA) 390 (March 6, 1989).

¹¹⁵ *Accord* Department of Labor Opinion Letter on Profit-Sharing Retirement Income Plan for the Employees of Carter Hawley Hale Stores, Inc., 11 Pens. & Ben. Rptr. (BNA) at 2 (“[I]n our view, an affirmative direction from a participant is necessary for section 403(a)(1) to apply.”).

(a) The fiduciary first applies a well-established and routine test proving the stock trades in an efficient market. This test is long accepted by the federal courts in securities fraud litigation as establishing the stock’s market price accurately reflects all public information. This same securities case law is the precedent for the identical *Dudenhoeffer* presumption. The test comprises eight or 10 “Cammer/Krogman factors.” By showing the stock successfully satisfies some or all Cammer/Krogman factors, the fiduciary shows that the stock trades in an efficient market and that no “special circumstances” make it imprudent to rely on the stock’s market price as the best available estimate of its value. By its careful process, the fiduciary may prudently conclude it has no ability and no duty to predict future stock price, and it may prudently buy hold or sell the stock at the market price, notwithstanding recent price declines, no matter how precipitous.

The fiduciary is probably able to evaluate eight of these factors with in-house help alone. A more robust process, using all ten factors, would need the services of a consulting economist. An example of a study applying all 10 Cammer/Krogman factors to the employer stock fund in the plan of an unnamed company can be found on the website of NERA Economic Consultants.¹¹⁶

(b) To create a process to handle inside information, the fiduciary can take a conservative approach based on the Ninth Circuit’s decision in *Harris v. Amgen*. Under this narrow reading of *Dudenhoeffer*, the fiduciary would decide it will not close the fund to new investments based on inside information unless it knows or has reason to know the company’s concealment of the information has violated federal securities laws. At this point its duty to close is triggered. Before this point, closing the fund to new investment would do more harm than good (in contravention of *Dudenhoeffer*). Under a more broadly defined *Dudenhoeffer* standard, the fiduciary could determine it will not close the fund to new investment if this would violate the “spirit” or “objectives” of the securities laws. This more flexible standard allows more fiduciary discretion, and has some case law support outside of the Ninth Circuit.

(c) Another possible way to handle inside information is to appoint an uninformed proxy fiduciary, such as an independent fiduciary, to handle the employer stock fund. ERISA’s unsettled standards on the appointing fiduciary’s duty to inform the appointed fiduciary, and open questions on what constitutes appointment, make this strategy less than perfectly assured of success.

(d) On handling risk the fiduciary has a couple of prudent choices. Applying *Dudenhoeffer*, its underlying financial theory and a handful of helpful cases (both before and after *Dudenhoeffer*), the fiduciary could prudently decide that any stock fairly priced by the market is conclusively not excessively risky for the employer stock fund. Under this approach, the fiduciary’s process would establish the stock trades in an efficient market, but the fiduciary would not further investigate its riskiness. Or the fiduciary might determine not to rely on

¹¹⁶ See “NERA’s Review of Fortune 500 Company’s Employee Stock Ownership Plan” <http://www.nera.com/publications/archive/case-project-experience/nera-s-review-of-fortune-500-company-s-employee-stock-ownership-.html>.

this approach, no matter how sound, given the still sparse and inconsistent case law. Applying its permitted discretion to draw lines, the fiduciary can, with the assistance of a financial consultant, investigate whether the stock's degree of volatility falls below some upper limit, selected by the fiduciary.

(e) The fiduciary's duty of prudence is somewhat ill defined on key points. And while a process can establish a decision is prudent, possibly no process can help the fiduciary with respect to all its ERISA duties, all supplying multiple potential claims of breach, and all somewhat shifting and imprecisely defined.

(2) Terminating the Fund. The fiduciary might accordingly prefer to terminate the fund and liquidate the stock. We have proposed a process allowing the fiduciary to establish that the termination is prudent and solely in the participants' interests—even if the stock price later goes up—without simultaneously signaling that management has lost faith in the stock, that the fiduciary was imprudent not to close it earlier, or that the fiduciary terminated the fund for inappropriate and disloyal reasons.

(a) The fiduciary's starting point when terminating the fund is the same as when deciding to hold it open. By applying a test based on the Cammer/Krogman factors, the fiduciary can show the stock trades in an efficient market. The fiduciary thus establishes by a prudent process that no special circumstances make it imprudent to rely on the stock's market price as the best available estimate of its value. No matter how good (or bad) the stock's recent price performance, optimistic the press or bullish the analysts, the fiduciary can prudently conclude it has no ability to outguess the market, and so no duty to predict or even try to predict the stock's future price. It is not imprudent to sell at the market price.

(b) The fiduciary's next step is to show the termination promotes the plan's purpose of enabling retirement savings, by showing the termination eliminates uncompensated risk—risk participants assume without being paid more to do so—created by the nondiversified employer stock fund. To do this, the fiduciary may commission a “volatility study,” which should show the employer stock fund is more volatile than the plan's other, diversified funds. Based on this study, the fiduciary may conclude that the single-stock fund contributes to uncompensated risk and frustrates the plan's purpose of providing adequate retirement savings relative to the plan's other funds.

(c) This volatility study also provides several permitted incidental benefits to the fiduciary and the company. The process allows the company to explain the fund's termination to its employees and shareholders in a way clearly showing that management has not lost faith in the company's stock, or acted on the basis of concealed business troubles. The company can explain, and the fiduciary record will show, the decision was made by the fiduciary based solely on the fiduciary's concerns about the uncompensated risk created by the nondiversified employer stock fund, and the fiduciary's

conclusion the fund was less appropriate for a retirement plan than the plan's other, diversified funds.

(d) The volatility study also allows the fiduciary to terminate the fund without admitting or supplying evidence it was imprudent to keep it open before. Under ERISA, the fiduciary is permitted to ignore the employer stock fund's lack of diversification in evaluating its prudence. But it is not required to do so. And under ERISA the fiduciary enjoys flexibility in determining the plan's prudent investment strategy. The fiduciary should not be held imprudent for using its discretion to investigate a potential impediment to the plan's purpose that by law the fiduciary was permitted to ignore. And by demonstrating the decision promotes the plan's purpose of retirement savings, the fiduciary demonstrates the decision is both prudent and consistent with its duty of loyalty to act solely in participants' interests. If any internal evidence is revealed showing the fiduciary also wished to eliminate an ongoing source of liability, the process should show this objective is merely a permitted incidental benefit.

An example of a volatility study conducted for the employer stock fund of an unnamed company can be found on the website of NERA Economic Consultants.¹¹⁷

(e) Whether a plan amendment commanding termination of the fund helps or hurts is a close call. After *Dudenhoeffer*, it is an open question whether an amendment places a thumb on the “prudence” side of the scale. There is a non-trivial risk the plan amendment will itself be viewed as a fiduciary rather than settlor act, meaning the need for process is not avoided. And both employer and fiduciary might prefer a process establishing a prudent basis for the termination and allowing a true and credible public explanation unrelated to the company's health or the fiduciary's concerns about its own liability.

(f) The appropriate role of any independent fiduciary is also an issue. An independent fiduciary accustomed to handling employer stock sales can bring valuable expertise to a complex process. But it is very unclear whether the independent fiduciary relieves corporate insider fiduciaries from the hazards of holding inside information.

(3) Shoring Up Fiduciary's 404(c) Protection.

In addition, the fiduciary who wants to keep the fund open may wish participants who choose to invest in the employer stock fund assume at least some responsibility for the decision. The fiduciary could obtain express participant consent for each stock fund purchase. Another idea would have the participants who elect to invest in the company stock fund denominated as “named fiduciaries” with respect to the company stock fund offering. While rather speculative, these could be used as ancillary strategies.

¹¹⁷ See “NERA's Review of Fortune 500 Company's Employee Stock Ownership Plan” <http://www.nera.com/publications/archive/case-project-experience/nera-s-review-of-fortune-500-company-s-employee-stock-ownership-.html>.