BENEFITS LAW BRIEFING:

Eliminating the Company Stock Fund From Your Public Company's 401(k) Plan – Navigating the Securities and ERISA Fiduciary Issues

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The Jenner & Block LLP Panel

- Matt Renaud – Employee Benefits and Executive Compensation
- Jessie Amunson – Litigation
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Agenda

- Introduction to sunsetting a company stock fund
- ERISA Issues – the impact of *Dudenhoeffer* and *Tatum*
- Securities issues
- Best Practices

What are we talking about here?

- Company stock held as an investment option in a publicly traded company's 401(k) plan
- Getting the genie back in the bottle – someone wants to eliminate that fund
- Appropriate platitudes
  - "Easier said than done"
  - "No good deed goes unpunished"

How/when does this come up?

- Settlor decision to shut down the company stock fund
  - Reduce risk to the company – stock may be performing well (or not)
  - Paternalistically force greater diversification of participant accounts
- Fiduciary override of plan terms
  - Fiduciary determines that it is imprudent to hold company stock despite plan terms
  - Special circumstances exist to justify the sunset?
  - Governed in part by *Dudenhoeffer* – see below
- Parent spins off a subsidiary and the subsidiary stock is eliminated from the parent's plan
  - Settlor action (hopefully)
  - No reason to have someone else's stock in your plan
  - Certain prudence and diversification protections for company stock not available to unrelated company's stock
  - This is the *Tatum v. RJ Reynolds* case

Types of sunsetting?

- Limit purchases to a certain percentage of account balance
- Freeze any new purchases
- Eliminate stock fund but permit trading of company stock in a brokerage window
- Total elimination of company stock from the plan

Why it can be problematic?

- A fiduciary overriding plan terms must justify its actions
- Reverse stock drop
  - Sued by participants when stock increases in price after sale
  - Imprudent implementation of the sunset provisions?
  - Stock poised to increase in price
    - Fiduciary acted imprudently in implementing the terms of the plan
    - Should have ignored plan terms to benefit participants
- Insider trading
  - If material, non-public information is held by the company
  - When it amends the plan, it could have Rule 10b-5 exposure

Process

- You want to/have to eliminate your company stock fund
- What's next?
  - Plan amendments
  - Engage (or amend engagement) of independent fiduciary
  - Mapping of proceeds
  - Employee communications (including ERISA and maybe SOX blackout notices)

Process

- Amend the plan
  - Settlor action – company acting in its own interests
  - Provide end-of-trading date after which stock will be liquidated
  - **How the stock is liquidated remains a fiduciary function**
  - Consider securities issues when making the amendment
    - May affect timing
    - Consider disclosure and insider trading issues
    - See discussion below

Process

- Independent fiduciary
  - If not already engaged, consider an independent fiduciary to manage the sunset process
  - Hardwired into the plan makes the appointment a settlor action
  - They are experienced and can guide you through the process

Process

- Mapping liquidation proceeds
  - QDIA?
  - Equity fund using mapping safe-harbor?
- Engage manager/broker who can liquidate efficiently and without driving stock price down
- Communication with employees
  - SPD/SMM – recall, this is a plan amendment!
  - Fee disclosure, if any – 30 to 90 days
  - ERISA blackout notice – 30 days in advance
  - SOX blackout notice and 8-K requirement?

SOX Blackout?

- Regulation BTR governs SOX blackouts
  - SOX blackout applies where there is a “temporary” restriction in trading in company stock
  - Note: SOX blackout applies to restrictions on buying as well as selling company stock
  - Query: is a sunset “temporary” for these purposes?
- SOX blackout 8-Ks most often seen where restrictions are due to tender offers or change in recordkeeper
- Reg. BTR applies to brokerage window where company stock may be purchased, even if none is actually held
- Some recordkeepers may be able to avoid restrictions on trading if the stock fund is unitized
- Form 8-K disclosure is required if there is a SOX blackout
- No Form 8-K disclosure required if no SOX blackout – see below

Company Stock Via Brokerage Window?

- Alternative to sunsetting
- Shut down company stock fund
- Permit purchases of company stock through brokerage window
- Could offer election to transfer stock from company stock fund to brokerage window
- The SEC takes the position that if Company stock could be purchased through a brokerage window, the company would have to:
  - Maintain a Form S-8 registration statement on the plan and the shares
  - File an annual Form 11-K with respect to the 401(k) plan; and
  - Give employees a prospectus
  - Apply SOX blackout rules to any blackout affecting the brokerage window
- Thus, most employers prohibit purchases of employer securities through a brokerage window

Impact of *Dudenhoeffer* and *Tatum*

- Two recent cases have greatly affected the ERISA stock drop world
- In *Dudenhoeffer,* the Supreme Court addressed the validity of a presumption of prudence for fiduciaries holding company stock and struck it down
  - The court replaced that presumption with a pleading standard and guidance that plan fiduciaries cannot violate the securities laws
- The 4th Circuit's *Tatum* is a reverse stock drop case that highlights some of the problems a company can encounter when it tries to sunset a stock fund

Impact of *Dudenhoeffer*

- *Fifth-Third Bancorp v. Dudenhoeffer,* Supreme Court (2014)
  - Eliminated the *Moench* presumption that a fiduciary acts prudently when holding company stock unless the company is facing dire circumstances or imminent economic collapse
  - Pleading standard for ERISA prudence claims:
    - A fiduciary can ordinarily establish that it acted prudently in not selling publicly-traded stock unless “special circumstances” exist that distort the market price
    - What’s a “special circumstance”?
  - Pleading standard for ERISA claims related to securities non-disclosure:
    - To state a claim for breach of duty related to non-public, material information, the plaintiffs "must plausibly allege an alternative action that the defendant could have taken that would have been consistent with the securities law and that a prudent fiduciary in the same circumstances would not have viewed as more likely to harm the fund than to help it."

Impact of *Tatum*

- *Tatum v. R.J. Reynolds Tobacco Co.* 4th Circuit, (2014)
  - RJR thought it had amended its plan to eliminate Nabisco stock fund following the spin-off of Nabisco
  - RJR plan fiduciaries failed in their procedural prudence
    - They thought they were acting under a plan amendment
    - Fiduciaries failed to consider whether it was prudent to sell Nabisco shares
  - A fiduciary is required to investigate and analyze the future value of stock held in its 401(k) plan where it has discretion to hold such shares

ERISA Considerations

- Decision to sunset is a "settlor" act if done pursuant to plan amendment
- Implementing the sunset is a fiduciary act
- Under *Dudenhoeffer*, absent special circumstances, sale of company stock into the market should be prudent if no "special circumstances" exist
- But, under *Tatum*, a fiduciary has a duty to investigate and analyze the future value of company stock to the extent it has discretion to hold such shares
  - Implementing the sale is a fiduciary act
  - A fiduciary's duty to follow plan terms is always subject to compliance with ERISA (ERISA override)

Fiduciary Override

- Consider getting company to amend the plan
- Justify overriding plan terms
  - Complying with engagement letter, plan terms, prior communications to participants?
  - What special circumstances exist to justify the override?
  - Consider the old *Moench* standard of dire circumstances and imminent economic collapse?
  - Apply procedural prudence
- Procedural prudence
  - Investigation and analysis of future prospects of the stock
  - Opportunity for gain and risk of loss?
  - Availability of other investment alternatives to structure a diversified portfolio
  - Participants getting accurate and timely information
- Make sure no insider trading or other securities violations

Settlor Action By The Company

- Limit discretion via plan amendment
  - Prohibit stock being held in the plan
  - Provide an end date for the stock fund in the amendment
  - An open-ended period to sunset the stock gives the fiduciary too much discretion over how quickly to sell
- Fiduciary must implement the plan amendments
- Sale of stock must be done prudently and to mitigate effects of front-running and impact of block selling
- *Tatum* should have limited applicability, but as a precaution, the fiduciary implementing the sunset might consider investigating
  - Near-term prospects for the stock
  - Are there special circumstances that could distort the value the market is placing on the shares?
  - Is timing/method of sale prudent in light of that investigation?
- ERISA override always a possibility in extreme circumstances

Securities Disclosure - Materiality

- If the sunset of the Company stock fund in the 401(k) plan is not considered "material" information, then Company has no disclosure obligation (absent a SOX blackout)

- Note, however, the information will be in the public domain in other ways:
  - All of the plan participants will be given detailed written notices about the action
  - There will be some low level SEC and DOL disclosure, including:
    - The plan's annual report on Form 5500 will reflect that it no longer holds company stock
    - The plan will stop filing 11-Ks and the final 11-K will disclose the sale of the company stock
    - The current Form S-8 for the plan may have a copy of the plan attached to it, which plan may need to be updated when the plan is amended to sunset the stock
    - The Form S-8s will be taken down once all of the shares are sold

- PR consideration
  - Sunsetting may become public from employee disclosure if nothing else
  - Company management may be questioned about why it didn't disclose and what are they trying to hide?

Securities Disclosure - Materiality

- Is it material? No one knows or can know, but here's a few reasons to consider treating it as material
  - Materiality will be judged in hindsight
  - Other external factors may impact the price of company stock during the liquidation period and such changes in price could be alleged to have been caused by the sunsetting of the stock fund

Securities Disclosure - Materiality

- Is it material?
  - Material information is generally anything that could move the stock price – viewed either quantitatively or qualitatively
    - Quantitatively, one could argue that selling what is likely around 5% of the company's outstanding shares (or less) should not move the stock price if sold over a period of six to eight weeks
      - If the price does drop during the sale period, it would be easy to argue the sunsetting was material
    - Qualitatively, a plaintiff or the government could argue that the sunset is material because the market might view it as indicative of management's view on the long-term viability of the stock

Securities Disclosure - Materiality

- Is it material?
  - In any event, because this is a factual determination, a claim could survive a motion to dismiss
  - Arguments against materiality include that (i) the stock is freely tradable already, (ii) the action is not going to impact EPS or otherwise dilute current outstanding shares, and (iii) a better indicator of management's views on the stock are their holdings outside of the plan

Potential Dangers of Non-Disclosure

- Why do we care whether it's material if there is no 8-K requirement (absent a SOX blackout)?
  - If material, those trading while knowing about the sunsetting could be in violation of Rule 10b-5
  - Who knows? Officers, directors, and all plan participants!
  - Company runs risk of a Reg. FD violation by disclosing material non-public information to some shareholders (plan participants) and not others
  - Insider trading if the company is in the market (stock buybacks, issuing securities, etc.)
    - Cannot occur while Company is in possession of material, non-public information
  - Also implicates insider trading issues as to employees who participate in the plan
    - The company has sent participants official notifications telling them they should trade out of the company stock fund if they want before it is shut down
    - The company has, in effect, potentially shared material non-public information with employees and authorized them to trade in the company's securities

Potential Dangers of Non-Disclosure

- As an issuer, Company can only be “in the market” if it has disclosed all material non-public information
  - Because Company is amending the plan to sunset the stock, it could be deemed to be “in the market” with respect to those shares being liquidated
  - This could trigger securities non-disclosure litigation by shareholders or, stated another way, could be a hook plaintiffs hang their hat on in the event of an increase in the Company stock price due to other factors
  - There is the potential for SEC or Department of Justice pursuing civil or criminal enforcement actions

Securities Implementation

- Mechanics of selling the shares
  - Adopt 10b5-1 and 10b-18 plan to sell into the market. If properly implemented and proper disclosures made, this provides a safe harbor against allegations of insider trading and market manipulation
  - Even if the company uses a third-party (such as a trustee or broker) there is still the potential for control person liability under Section 20 of the Exchange Act
    - The company is the entity that initiates the decision to sunset its stock and may influence time and manner in which stock is sunset
  - Front-running problem – if publicly disclosed, others know you are selling significant amount of shares; brokers think they can handle this, but it's something you need to be concerned about

Best Practices

- Take care with amendment process
- Use an independent fiduciary to manage the sunset
- Involve securities counsel as well as ERISA counsel
- Consider public disclosure of sunset
  - If trading restrictions, consider treating as a SOX blackout even though it may not be
  - Use Reg. FD/Form 8-K disclosure if not SOX blackout
  - Consider what material non-public information the company has when it amends the plan and how that may affect timing of the adoption of the amendment

Best Practices

- Fiduciary should be aware of its ERISA obligations during any sunset
  - Plan terms/prudence/ERISA override
  - Apply *Tatum* out of an abundance of caution: analyze and investigate stock's near-term prospects during any implementation period
- Avoid sunsetting the stock fund when you think the price may be ready for a significant increase or the company is sitting on material, non-public information
  - Consider alternatives, such as limiting or freezing the stock fund
  - No securities violation for not purchasing
- Be ready to react during a sunset period to a tender offer or other unforeseen third-party action that might affect the stock
  - Consider amending the plan to react
  - ERISA override appropriate?

QUESTIONS?

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