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"Companies that allegedly backdated stock options now have a companion concern."

BACKDATED OPTIONS: THE TAG-ALONG QUALIFIED PLAN CLAIMS

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Well, it should come as no surprise. Companies that allegedly backdated stock options now have a companion concern. Fiduciaries of their 401(k) plans are facing ERISA fiduciary claims where their plans have maintained company stock funds. In one such case, a federal district court has permitted a former employee to proceed with a claim against the employer and certain of its officers for breaches of ERISA fiduciary duties relating to alleged backdating. *Bendaoud v. Hodgson*, 2008 U.S. Dist. LEXIS 72788 (D. Mass. 2008).

Although the plaintiff was not invested in company stock at any time on or after the date the market learned of backdating allegations, the court held that he nevertheless had standing to prosecute his claim that during a prior period in which he was so invested, the price of the company's stock was inflated beyond its real value because the backdated options constituted a type of undisclosed liability, and the defendant fiduciaries knew of this. The plaintiff argued that the defendant fiduciaries knew or should have known that the disclosure of the backdating practice would cause the company's stock price to fall, harming participants holding company stock, and that as a result the fiduciaries exposed him to an unacceptable level of risk by offering the stock fund as an investment under the defined contribution plan.

The court found that the plaintiff also had standing to bring a claim for a second alleged breach of fiduciary duty. This was the fiduciaries' alleged failure to disclose material information regarding the plan's employer stock fund – namely, the backdating practice. The court concluded that the plaintiff had standing even though it might be difficult to assess the relief to which the plaintiff would be entitled. As to that relief, the court stated that the plaintiff would only be able to recover if he could show that if the fiduciaries had acted in a fashion that did not constitute a breach of fiduciary duty, the value of the participant's investments would have been greater. Presumably, this would be the case if the plaintiff were successful in establishing that it was a fiduciary breach to offer the company stock fund, and if the alternative investments in which the plaintiff would then have directed his plan account outperformed the company stock fund.

Importantly, the court suggested that the defendants may have been acting in their ERISA fiduciary capacity when they made affirmative statements about the company's executive compensation practices, including statements about the issuance of options at fair market value found in 11-K Annual Reports and proxy statements. The defendants had argued that these were not statements made in a fiduciary capacity, but instead that the "public filings and press releases amounted to disclosures by Defendants in their capacity as

corporate fiduciaries to the entire market in general, and *not* as some exercise of authority or control with respect to the management or disposition of plan assets." The court agreed that merely signing a securities filing, even one that the signer knows will be incorporated into an ERISA document, does not make one an ERISA fiduciary. But, a person who is already an ERISA fiduciary may, the court concluded, make a misstatement in his or her fiduciary capacity by incorporating a false document into materials distributed to plan participants. The court cited for support of its position the following cases: *In re WorldComm, Inc. ERISA Litigation*, 263 F.Supp.2d 745, 766 (S.D.N.Y. 2003) (an ERISA fiduciary could be held liable for material false statements made in securities filings incorporated into prospectus); *In re Schering-Plough Corp. ERISA Litigation*, 2007 WL 2374989, at *5-6 (D.N.J. 2007) (same); and *Kirschbaum v. Reliant Energy, Inc.*, 526 F.3d 243, 257 (5th Cir. 2008) (SEC filings that were distributed to plan participants as holders of the company's common stock, but which were not incorporated into plan documents, did not give rise to ERISA fiduciary liability).

Importantly in this regard, the plan incorporated by reference "any future filings made with the SEC under Sections 13(a), 13(c), 14 and 15(d) of the Exchange Act." These filings included the Form 11-K Annual Reports made pursuant to Section 15(d) and proxy statements made under Section 14, both of which the complaint alleged included material misstatements. The court concluded that by incorporating the Annual Reports and the proxy statements into the plan materials, the company's ERISA fiduciaries took responsibility for the content of those documents, and that this was an act taken in their capacity as plan fiduciaries.

In response to the defendants' arguments that the court's position would effectively require plan fiduciaries to violate laws forbidding insider trading, the court noted with seeming approval the response of the Department of Labor to defendants making similar arguments in other cases. Specifically, although an ERISA trustee cannot trade on inside information, even to benefit the plan, the Secretary of Labor has "identified three possible courses of action: disclose the relevant information to the plan beneficiaries and the public at large; eliminate the company stock as an investment option; and (sic) notify the appropriate regulatory authorities."

Lesson. *Bendaoud* is a reminder of the substantial dangers and difficulties associated with maintaining a company stock fund in a 401(k) (or other ERISA) plan that is subject to participant investment direction. These same challenges apply, though to a lesser degree, with ESOPs or other ERISA plans holding company stock. The risk is particularly acute for publicly traded companies, where any circumstances triggering securities litigation may result in tag-along suits against plan fiduciaries. Many companies have, since the initial wave of "stock drop" class actions gained attention several years ago, engaged in a vigorous reassessment of the advantages of company stock funds, in light of the very difficult ERISA fiduciary issues they raise. These new cases involving allegations of backdated options add yet another ingredient to that conversation.

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