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ERISA Litigation

The Subprime Crisis

Craig C. Martin and William L. Scogland

The subprime lending crisis is the business story of the day, and perhaps of the year. You need only pick up the newspaper to read all about it, or go online to one of your favorite news sites, and the subprime lending crisis will be there. No doubt that much ink has already been spilled on the subprime crisis, but not much about how it relates to ERISA litigation.

As many recognize, pension investments are playing an increasing role in the capital markets. And, unfortunately, many pension funds have been negatively impacted by the subprime crisis. For example, several public pension funds have invested significant amounts into subprime mortgages. The Ohio Public Employees Retirement System has invested approximately $530 million in subprime mortgages, about one percent of its total investments.[1] Similarly, the California Public Employees' Retirement System has invested close to $2.5 billion in subprime mortgages—out of $250 billion total invested.[2]

Moreover, many private and public pension funds have invested significant resources in hedge funds and other mutual funds, which in turn may be negatively impacted by the downturn in the subprime mortgage industry. For example, the Massachusetts state pension system

Craig C. Martin, a partner in Jenner & Block LLP's Chicago office, is chair of the firm's ERISA Litigation Practice. William L. Scogland, who also is a partner in the firm's Chicago office, is chair of the firm's Employee Benefits and Executive Compensation Practice and co-chair of the ERISA Litigation Practice. The authors, who have represented and continue to represent ERISA fiduciaries in ERISA fiduciary litigation, can be reached at *cmartin@jenner.com* and *wscogland@jenner.com*, respectively. The authors wish to thank Melissa L. Dickey, an associate at the firm, for her assistance on this column.

announced on August 2, 2007, that it had lost $30 million after the hedge fund Sowood Capital Management L.P. collapsed for reasons that have been attributed to losses in the subprime mortgage industry.

All of this just shows that you don't have to look very far to find the connection between pension investments and the subprime crisis. But, what if anything does that connection have to do with ERISA litigation? The short answer is: a lot. The subprime crisis underscores one of the very fundamental dilemmas in which an ERISA fiduciary will often find itself. On the one hand, the fiduciary has a set of fiduciary duties, for example, to invest prudently. So, faced with losses in a pension plan, the ERISA fiduciary must, of course, be concerned about the potential litigation from participants in its plan arising out of not only the poor investment in the first instance, but the process by which the fiduciary proceeds to determine if the fiduciary should lead the charge against the hedge fund or other fund that the fiduciary invested in—or not. So, the bottom line is that the fiduciary might find itself defending its investment, or suing the investment, or both.

Certain pension funds are leading the way with regard to litigation arising out of the subprime crisis. The typical claims of these pension funds are truly no different than the claims that most investors may pursue. Claims for violations of the securities laws, including securities fraud, and common-law claims such as fraud, negligent misrepresentation, breach of fiduciary duty, and civil conspiracy, are all fair game.

Pension funds have already begun to file civil lawsuits. In one example, the New York State Teachers Retirement Fund is the lead plaintiff in a class action against failed subprime lender, New Century Financial Corporation.[3] The action alleges that the company and its executives issued false and misleading statements that artificially inflated the value of the company's stock. In another example, the Arkansas Teacher Retirement System has been named the lead plaintiff in a securities fraud class action against defendant Accredited Home Lending Holding Company, a mortgage banking company that offers subprime mortgages.[4] In another case, the former employees of New Century Financial Corp., a subprime lender, filed suit to prevent the bankrupt company from paying creditors with funds from the employees' retirement plans.[5] The former employees alleged that the retirement plan had largely been funded through deductions in their salaries.[6]

The lawsuits with pension funds as defendants for making a poor investment choice, however, *have not* begun in earnest. As is well settled, an ERISA fiduciary is anyone who:

1. Exercises discretionary authority with respect to the management and/or administration of the plan;

2. Renders investment advice for a fee or other compensation, direct or direct, with respect to any moneys or property of such plan; and

3. Exercises any authority or control respecting management of disposition of the plan assets.[7]

Although the definition is highly fact specific, the following types of parties have been found to be plan fiduciaries:

- Private companies offering applicable pension plans;
- Pension plan committees;
- Directors and officers;
- Investment managers of the plans;
- Attorneys and accountants; and
- Brokers.

ERISA fiduciaries owe the following duties to pension fund plan participants:

1. To disclose complete and accurate information about plan benefits;
2. To be loyal and prudent;
3. To diversify plan assets; and
4. To follow the terms of plan documents.[8]

Nor has there yet been a number of publicly reported claims against hedge funds with investments affected by the subprime lending crisis. Under ERISA, hedge fund managers are ERISA fiduciaries if 25 or more percent of the hedge fund is comprised of pension plan monies, unless other exceptions to the "plan asset" rules apply, which they frequently do not in the hedge fund context.[9]

In practice, many hedge funds and their managers actively monitor and limit equity participants in the fund by pension plans to avoid ERISA liability. Any hedge fund that qualifies as an ERISA fiduciary and has investments adversely affected by the subprime lending crisis faces potential fiduciary litigation. The extent to which that fiduciary litigation may be successful depends in part on whether subprime mortgage investments by hedge funds are inherently "risky," or as the Department of Labor's ERISA Advisory Councils' Working Group on Prudent Investment Processes has reported, are not "per se" imprudent investments for pension plans. Regardless, however, any hedge fund with fiduciary status and subprime investments would be wise to gather information sufficient to understand the investment and the risks through a well-thought-out and documented process.

The claims against pension funds, however, are potentially very broad and wide ranging. Perhaps the most obvious and the most frequent claim is one for breach of fiduciary duty. A second related claim would be for failure to adequately diversify funds;[10] a third for investing in funds due to improper relationship or other conflict of interest;[11] and a fourth claim would be for causing retirement plans to invest in employer securities.[12] Subject to ERISA limitations, in general, fiduciaries may cause a pension plan to invest in employer securities, but such investments must be prudent. Other potential claims may include investment into imprudent securities in violation of duty of loyalty.[13] In order to fulfill its duty to prudently and loyally manage plan assets, ERISA fiduciaries must not cause the pension plan to invest into a security the fiduciary knew or should have known was imprudent or improper.

Few lawsuits have begun to be filed against companies whose stock has fallen in response to the growing subprime crises. For example, Countrywide Financial Corporation has been sued by a class of employee participants in its 401(k) plan.[14] The complaint alleges in part that the defendants violated their fiduciary duty to the plan participants because the fiduciaries knew or should have known that a sharp decline in the stock's price was inevitable because Countrywide was engaged in a "fraudulent and highly-risky business plan" and failed to disclose this information to plan participants.[15] The complaint further alleges that the defendant fiduciaries violated their duty to loyally and prudently manage the 401(k) plan because Countrywide stock was offered as an investment option to plan participants while the fraudulent conduct allegedly was ongoing.[16]

Similarly, investors in the employee retirement plans of Fremont General Corporation, a financial services holding corporation engaged in subprime lending, have filed suit against the corporation under ERISA Sections 404 and 405 for knowingly causing the plan to invest in what the corporation and the other plan fiduciaries should have been aware was an imprudent investment.[17]

The course of these cases will likely follow the developments in other stock drop cases such as *Schering-Plough* and *Diebold*. For example, the participants in a defined contribution pension plan sponsored by Schering-Plough Corporation recently sued Schering-Plough, its board of directors, and the plan's administrative committee.[18] The plaintiffs alleged that the defendants breached their ERISA fiduciary duty by making material misrepresentations about Schering-Plough's financial health in its SEC S-8 filings.[19] When the fraud became known, Schering-Plough's common stock plummeted from $60 a share to $20 a share. The class contended that defendants should have stopped offering investments in the company stock during the period in question.

Defendants' motion to dismiss was denied. The defendants contended that the complaint should be denied because the allegedly fraudulent statements were contained in SEC filings, and not in the ERISA Plan

Documents. The court disagreed, noting that unlike general corporate communications to the public, the Plan Documents included a reference to the company prospectus and financial reports. The court found that while the defendants were not required to provide plan participants with investment advice, once they released information about the investments, they had the duty to give complete information so as to "paint the full picture of the company's financial health."[20]

In yet another case, the participants in Diebold's 401(k) savings plan filed suit against Diebold Inc. and its current and former officers and directors.[21] Plaintiffs alleged that defendants violated their fiduciary duty by artificially inflating its stock prices in order to mislead employees into investing their pensions in the company stock.[22] In July 2007, defendants moved to dismiss the action, alleging that plaintiffs' are improperly attempting to bring a securities fraud claim under ERISA, a completely separate statute with different terms and obligations.[23] The court has yet to rule on the motion to dismiss.

In Summary

In summary, the subprime lending crisis may well be the source for the next wave of ERISA litigation. The litigation appears, however, to involve traditional areas where other pension fund and ERISA litigation has already paved the way. While pension funds, in their capacity as investors, may initiate legal actions, those legal actions will likely turn on time honored legal principals. Likewise, the new wave of stock drop cases will fall into the growing body of case law in that area. What remains to be seen is whether pension funds face scrutiny by their own stakeholders for investing the subprime area unwisely and imprudently, and whether hedge funds in which pension funds place money become scrutinized as well.

Notes

1. *See, e.g.*, Mark Rollenhagen, "State Pension Funds Fear Sub-Prime Mortgage Falldown," *Cleveland Plain Dealer*, Aug. 13, 2007, at B1.

2. *See, e.g.*, Jennifer Vigil, "Pensions Avoid Suprime Meltdown," *San Diego Union Tribune*, Aug. 16, 2007, at 1.

3. Gold v. New Century Financial Corp., 07-cv-00931 (C.D. Cal., consolidated complaint filed Sept. 14, 2007).

4. Atlas v. Home Lenders Holding Co., 3:07-cv-00488 (S.D. Cal., complaint filed 2007).

5. Schroeder v. New Century Holdings, Inc., No. 07-51598-KJC (Bankr. D. Del., complaint filed June 20, 2007).

6. *Id.*

7. 29 U.S.C. § 1102(a)(1).

8. 29 U.S.C. §§ 1104, 1105.

9. 29 U.S.C. § 1002(42).

10. 29 U.S.C. §§ 1104, 1105.

11. *Id.*

12. 29 U.S.C. § 1106.

13. 29 U.S.C. §§ 1104, 1105.

14. Brockmeyer v. Countrywide Financial Corp., No. 07-cv-05906 (C.D. Cal., complaint filed Sept. 11, 2007).

15. *Id.* at 30–32.

16. *Id.* at 23–28.

17. McCoy v. Plan Comm., No. 2:07-cv-02693 (C.D. Cal., complaint filed Apr. 24, 2007).

18. In re Schering-Plough Corp. ERISA Litigation, No. 03-1204, 2007 WL 2374989, *3–*9 (D.N.J. Aug. 15, 2007).

19. *Id.* at *3.

20. *Id.* at *9.

21. In re Diebold ERISA Litigation, No. 5:06-CV-0170 (N.D. Ohio, complaint filed Jan. 24, 2006.)

22. Defendant's Motion to Dismiss, In re Diebold ERISA Litigation, No. 5:06-CV-0170 (N.D. Ohio June 4, 2004.)

23. *Id.*

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