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Seventh Circuit Affirms Trial Judgment for Defendants in Indianapolis Power & Light 401(k) Stock-Drop Case

On January 2, 2008, the Court of Appeals for the Seventh Circuit upheld a defense judgment in a 401(k) employer stock case following a bench trial on breach of fiduciary claims. *Nelson v. Hodowal*, ___ F.3d ___, 2008 WL 90057 (7th Cir. Jan. 2, 2008). The Seventh Circuit's decision is undoubtedly significant as only the second appellate decision following a trial on the merits of fiduciary breach claims arising out of the decline of employer stock in a defined contribution plan.¹

But *Nelson* may prove to be of limited precedential value. Trial of the plaintiffs' numerous theories of liability resulted in a 111-page decision from the Southern District of Indiana. *Nelson v. IPALCO Enterprises, Inc.*, 480 F. Supp. 2d 1061 (S.D. Ind. 2007), *aff'd*, ___ F.3d ___, 2008 WL 90057 (7th Cir. 2008). On appeal, however, the *Nelson* plaintiffs abandoned most of their claims. Consequently, the Seventh Circuit confined its analysis of the facts and law to the only claim argued on appeal: breach of fiduciary disclosure obligations. Moreover, even though the law governing fiduciary disclosure obligations is dynamic and hotly contested (such that any judicial decision — especially one from an appellate court — discussing fiduciary disclosure issues is noteworthy), the Seventh Circuit's analysis of the plaintiffs' disclosure theory is opaque and fact-specific. Accordingly, plan sponsors, fiduciaries, and defendants in similar lawsuits may ultimately draw little more from *Nelson* than the basic fact that a defense verdict was upheld on appeal.

Factual Background and the District Court's Verdict

In March 2001, AES Corporation ("AES") acquired IPALCO Holdings, Inc. ("IPALCO"), the parent company of Indianapolis area utility Indianapolis Power & Light Company, in a stock-for-stock exchange. As a result of the deal, all IPALCO shares in a defined contribution pension plan maintained by Indianapolis Power & Light were replaced with shares of AES. In the year and a half after the deal closed, AES stock lost more than 90 percent of its market value.

A group of participants in the IPALCO 401(k) plan sued former officers, directors, and fiduciary committee members (all of whom lost their jobs through the acquisition), claiming the defendants: should have removed IPALCO and then AES stock as a plan investment; failed to disclose their own sales of nearly all of their own IPALCO and AES stock; and should not have allowed employer matching contributions (made in IPALCO stock) to be converted to AES stock upon the deal's closing. The Southern District of Indiana denied the defendants' motion to dismiss, certified a plaintiff class, denied both sides' motions for summary judgment on liability, and granted the plaintiffs' summary judgment motion on the

¹ The Fourth Circuit issued the first such decision on August 1, 2007. *DiFelice v. US Airways, Inc.*, 497 F.3d 410 (4th Cir. 2007). An *ERISA Litigation Advisory* discussing in detail the *DiFelice* decision is available at www.alston.com/resources/advisories

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defendants' release defense. On March 28, 2007, after a six day bench trial in February, the district court issued its 111-page decision finding in favor of the defendants as to all claims.

The Southern District of Indiana reached five general conclusions for finding in favor of the defendants as to all claims, emphasizing that it was evaluating the facts and the plaintiffs' claims "[w]ithout the benefit of hindsight": (1) the transaction and investments in AES stock appeared "reasonable, prudent and consistent with the Thrift Plan itself at the time"; (2) the defendants did not have any "negative inside information" about AES or the prospects of AES stock; (3) the defendants "made competent and appropriate investment advice readily available" to plan participants; (4) the defendants complied with all disclosure obligations under the federal securities laws regarding their own sales of IPALCO stock and the risks associated with investments in AES stock; and (5) ERISA did not require the defendants to make additional or special disclosures to plan participants. 480 F. Supp. 2d at 1064.

Regarding the plaintiffs' imprudent investment claim, the Southern District of Indiana held that even though the plan fiduciaries never considered the possibility of prohibiting participants from investing in IPALCO or AES, the fiduciaries reasonably and prudently allowed the plan to continue to invest in IPALCO and AES. The district court reasoned that the plan fiduciaries "were thoroughly familiar with IPALCO and had learned a great deal about AES" through deal negotiations and due diligence, and that AES appeared to be a "promising investment, and one that seemed less risky than IPALCO stock in the absence of the acquisition." *Id.* at 1099-1100. Thus, the district court concluded that the fiduciaries would not have decided to terminate investment in IPALCO and AES if they had considered the issue. The court explained: "There was no apparent reason for the Pension Committee to act contrary to the terms of the written plan either by forcing Thrift Plan members to sell their IPALCO stock before closing or by prohibiting Thrift Plan members from continuing to purchase additional shares with each paycheck." *Id.* at 1100. The court explained further: "The evidence shows that AES, at least without the benefit of hindsight, appeared to be a prudent investment option for Thrift Plan participants." *Id.* at 1103.

Turning to the plaintiffs' fiduciary misrepresentation and disclosure claim, the Southern District of Indiana rejected the plaintiffs' argument that one defendant "wrongfully promoted investment in IPALCO and then AES" by telling shareholders "the best is yet to come" as a result of the transaction. The court effectively decided that the defendant was stating a truthfully held belief, concluding that no one had any reason to expect the future drop in AES's stock price.

The district court also rejected the plaintiffs' contention that the defendants should have disclosed specifically to the plan participants their pre-acquisition sales of IPALCO stock and the reasons for those sales. The court gave three reasons for that conclusion: (1) the defendants did not have material negative inside information about AES and its future prospects; (2) the fiduciaries made available to plan participants "ample information to make their own decisions about how to invest their accounts"; and (3) the defendants disclosed their sales of IPALCO stock in accordance with the securities laws, and "ERISA should not be interpreted to give some shareholders, those in ERISA plans, special access to information not presented to other shareholders in the publicly traded corporation." *Id.* at 1108. The court also criticized the plaintiffs for seeking to impose a "very vague" duty on plan fiduciaries

in terms of who would need to disclose what information to whom, when, and how. In such a scheme, the devil is in the details. . . . Without well-defined obligations for such disclosures, the temptation will be powerful for investors who lost money, and perhaps even for judges who decide their cases,

to use hindsight to decide whether more information should have been disclosed sooner, more clearly, and more personally to the plaintiffs. Along these lines, it is important to remember that ERISA is a compromise between competing concerns. The law was written to protect employees' interests, but without creating a system that would be so complex or burdensome as to discourage employers from even offering benefit plans.

Id.

The Seventh Circuit's Decision

The plaintiffs appealed the judgment to the Seventh Circuit. The Seventh Circuit explained that the plaintiffs were pursuing on appeal only one of the various theories they had advanced in the district court, characterizing the issue on appeal as:

whether the defendants had to tell the participants that the defendants were selling most of their own stock in IPALCO — not only stock held through the Thrift Plan, but also stock that the defendants were able to acquire by exercising vested options that they had received in their roles as managers or directors of Indianapolis Power & Light. Plaintiffs accuse the defendants of promoting AES as a good prospective employer (and implicitly as a good investment), while by divesting their own holdings they demonstrated that their true beliefs were otherwise.

Nelson, 2008 WL 90057, at *2. The appellate court noted, however, the district court's factual findings — not challenged by the plaintiffs on appeal — that the defendants legitimately believed everything they told to participants, and that the defendants had sold their IPALCO stock and cashed out options because they were going to lose their jobs as a result of the acquisition. Moreover, the Seventh Circuit highlighted that the defendants had disclosed their stock sales via public securities filings, but these sales (known to the market "long before the closing") had not affected the price of AES stock.

Given the absence of any market reaction, the appellate court concluded that the sales could not have been material to decisions by investors. The Seventh Circuit therefore reasoned, "the case boils down to an argument that an ERISA fiduciary has a duty to disclose, directly to a pension plan's participants, even non-material information that may affect the participants for reasons unrelated to the value of the investment." 2008 WL 90057, at *3. The appellate court was highly skeptical about this theory, observing:

no regulation or decision requires ERISA fiduciaries to disclose facts that might lead to idiosyncratic reactions. *Any* tidbit might cause such a reaction; the materiality requirement entitles fiduciaries to limit their disclosures and advice to those facts that concern real economic values.

Id.

This criticism suggests that the plaintiffs' non-disclosure claim should fail because the defendants were not under any duty of disclosure under the circumstances. But the Seventh Circuit did not explicitly so hold. Instead of affirming judgment for the defendants based on the absence of a disclosure obligation (the logical conclusion following the Seventh Circuit's criticism of the plaintiffs' disclosure theory), the Seventh Circuit concluded — somewhat abruptly — that the defendants *satisfied* any disclosure duty by retaining Merrill Lynch to provide investment advice to plan participants.

The Seventh Circuit reasoned that the defendants had “diversified their own portfolios” by selling shares of IPALCO and AES, “and might have done more to promote diversification by other participants.” *Id.* at *4. According to the appellate court, by retaining Merrill Lynch — which would have been aware of the defendants’ publicly-disclosed stock sales — to advise participants and “to promote intelligent diversification,” the defendants satisfied their fiduciary obligations. *Id.* at *4. The Seventh Circuit explained:

Plaintiffs have not referred us to any regulation or judicial decision obliging fiduciaries to disclose directly to participants rather than through professional investment counselors. Sometimes trust law *requires* delegation to a professional trust such as Merrill Lynch. . . . ERISA does not hold a fiduciary responsible for the decline in an investment’s value, when an informed and independent investment adviser has been furnished without charge to all beneficiaries, who exercise full control over which investments their accounts will hold.

Id. With those concluding remarks, the Seventh Circuit affirmed the district court’s trial judgment for the defendants.

Applications to Similar Pending Cases

The *Nelson* decision raises more questions than it resolves and ultimately provides little guidance for similar cases. Although the Seventh Circuit came quite close to holding that plan fiduciaries do not have any duty to disclose “non-material information that may affect the participants for reasons unrelated to the value of the investment,” the court shifted gears at effectively the last second and never explicitly stated that conclusion.

Under the narrow, specific circumstances of this appeal — focusing on fiduciary disclosure obligations arising out of *publicly*-disclosed sales of stock, with no evidence of insider knowledge of bad news or wrongdoing — the Seventh Circuit’s decision may make some sense. But it would read too much into *Nelson* to conclude that fiduciaries can absolve themselves of all liability by retaining investment professionals (such as Merrill Lynch in the case of the Indianapolis Power & Light plan) to advise participants. Relying on professionals such as Merrill Lynch to interact with and advise plan participants can implicate fiduciary monitoring obligations, the parameters of which are still developing in the case law. The Seventh Circuit did not face a monitoring duty claim (or any claim other than non-disclosure), so there is no way to know whether the appellate court would have found that defendants’ retention of Merrill Lynch fulfilled monitoring and other fiduciary responsibilities.

Despite the fact-specific and somewhat arbitrary reasoning of the Seventh Circuit in *Nelson*, the decision remains important in that it affirms a trial verdict for defendants on breach of fiduciary duty claims pertaining to employer stock in a defined contribution plan. Thus far, both district courts and both appellate courts addressing such claims after full trials on the merits have sided with defendants. It may be a bit premature to declare this series of four decisions as signifying a trend, particularly given that trials are rare and unlikely in this area. But if courts find ways to apply *Nelson* and the *US Airways* decisions at other stages of litigation – on motions to dismiss, class certification, or on summary judgment – then the tide of 401(k) employer stock actions could recede substantially.

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