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Commentary

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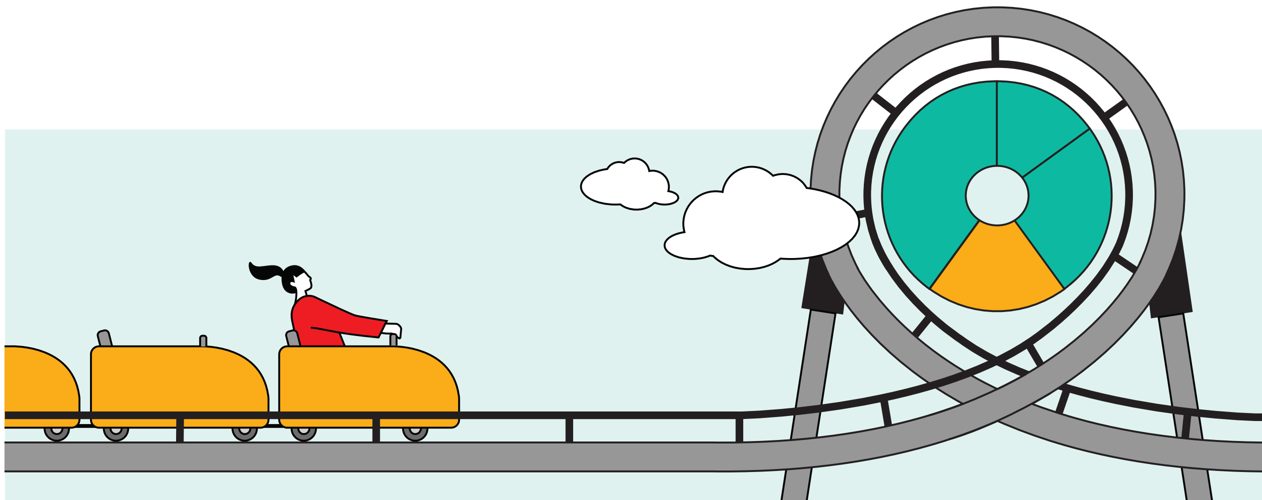
Mitigating the risk of company stock in defined contribution plans



Introduction

Over the years, employers have encouraged employee ownership in their company by offering company stock as an investment option in their defined contribution (DC) plans. This option provides a tax-efficient, convenient way for employees to establish an ownership position in the company.

Historically, employers have often matched employee-elective deferrals with company contributions invested in stock.

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In fact, Congress encouraged investment in company stock by offering tax benefits on company stock holdings and by not placing any limits on the amount or percentage of company stock that a participant could hold in their DC retirement plan.

However, despite the interest in encouraging employee ownership, company stock in a retirement plan is one of the biggest sources of fiduciary risk and has been the basis for a large number of lawsuits brought against DC plan sponsors. And participant portfolios overly concentrated in company stock are subject to large losses if the value of the company stock declines rapidly.

The Pension Protection Act of 2006 (PPA) required employers to offer certain diversification rights with respect to company stock. In times of heightened market volatility, many companies have become the targets of "stock drop" class action lawsuits. These lawsuits often allege that it is imprudent to offer company stock in a retirement plan and are usually filed after a precipitous drop in the company's stock price.

The significant number of lawsuits has led plan sponsors to take a closer look at company stock as an investment option in DC retirement plans. Unfortunately, what actions a sponsor should take (or not take) are not always clear. Plan sponsors have faced lawsuits in situations where the stock price has dropped following a major event, but in some circumstances a lawsuit has been filed when the fiduciary removed stock from a DC plan and the stock saw a subsequent rise in value.

This uncertainty can leave sponsors feeling as if they are in a no-win situation. However, there are strategies employed by many companies to mitigate the risk of company stock in order to continue to offer the benefits of company stock ownership.

Risks associated with company stock

Two court cases highlight the company stock quandary for plan sponsors. *Fifth Third Bancorp v. Dudenhoeffer*,[1] decided by the Supreme Court, is an example of a typical company stock drop case where participants sued over a decline in the value of company stock.

In *Dudenhoeffer*, the plaintiffs alleged that plan fiduciaries imprudently maintained the plan's investment in company stock even though the stock value suffered a 74% decline because of the company's exposure to subprime mortgages. Plaintiffs alleged the plan fiduciaries breached their duty of prudence because they should have known, based on both publicly available and inside information, that the stock was overpriced and excessively risky. In its defense, the company claimed it was not responsible for the investment losses due to the presumption that employer stock is a prudent investment if the plan document states that the plan is designed to invest in employer stock (the so-called *Moench*[2] presumption).

In a 2014 ruling, the Supreme Court unanimously held in *Dudenhoeffer* that employers offering company stock in their plan are not entitled to a presumption of prudence, regardless of language in the plan document. It also noted that ERISA requires that plan fiduciaries evaluate and monitor company stock just like any other investment in the plan, even if the plan document requires that company stock be offered as an option (commonly referred to as "hardwiring").

While these findings were considered unfriendly to plan sponsors, there were additional findings that were beneficial to them. The Supreme Court ruled that with regard to public information, a plan sponsor should not be expected to second-guess a stock's price as reported on its principal exchange. As to nonpublic information, a plaintiff must be able to show that there was a plausible alternative action the plan fiduciaries could have taken that would not have violated securities insider-trading laws (that is, the duty of prudence does not require a fiduciary to break the law) or would have not done more harm than good to the stock price.

Not all company stock cases stem from a decline in employer stock value. For example, in *Tatum v. RJR Pension Investment Committee*,[3] participants sued because the employer stock rose in value after it was removed from the plan. In *Tatum*, the plaintiffs alleged that the plan fiduciaries breached their fiduciary duty by eliminating the company stock from the plan (even though the plan terms specifically allowed for it as an investment option) without following a rigorous, prudent process and, therefore, were liable for participants' losses because the stock was sold when it was trading at an all-time low. To compound matters, the company stock's value rose after the stock fund was liquidated in the plan.

1 *Fifth Third Bancorp v. Dudenhoeffer*, 573 U.S. 409 (2014).

2 *Moench v. Robertson*, 62 F.3d 553 (3rd Cir. 1995).

3 *Tatum v. RJR Pension Investment*, No. 16-1293 (4th Cir. 2017); *Tatum v. R.J. Reynolds Tobacco Co.*, 2016 U.S. Dist. Lexis 19536 (M.D.N.C. 2016); *Tatum v. RJR Pension Investment Committee*, 761 F.3d 346 (4th Cir. 2014); and *Tatum v. R.J. Reynolds Tobacco Co.*, 926 F. Supp. 2d 648 (M.D.N.C. 2013).

In 2013, the district court found that no valid plan amendment had been adopted requiring liquidation over the six-month period. (The court reasoned that had an amendment existed, the decision to remove company stock would have been a settlor function.) It also found a lack of procedural prudence in the decision to liquidate the funds. Nevertheless, the lower court held the defendants' decision was objectively prudent because a reasonable and prudent fiduciary could have made the same decision after proper investigation.

The Fourth Circuit Court of Appeals upheld the district court's holding that the fiduciaries breached the duty of procedural prudence, but it found that the lower court applied the wrong legal standard in determining objective prudence. Specifically, the circuit court maintained that the standard for objective prudence was whether a hypothetical prudent fiduciary would have made the same decision. This is a more difficult standard for the plan fiduciary to prove because it asks whether a prudent fiduciary *would have* made—and not *could have* made—the same decision.

In June 2015, the Supreme Court declined to hear an appeal of *Tatum*, leaving the Court of Appeals decision in place. Upon remand, the district court in 2016 found that a prudent fiduciary would have eliminated the company stock fund from the plan, and thus the RJR defendants were not liable for any losses incurred. In 2017, the Court of Appeals agreed, relying on the efficient market theory, whereby the market prices a publicly traded stock by considering all available known information. Therefore, the fiduciaries can look at the company's stock price and not second-guess the true value of the stock.

Company stock trends

Since 2005, Vanguard has seen a decline in the number of plans offering company stock.

Decline in company stock, 2005 vs. 2023

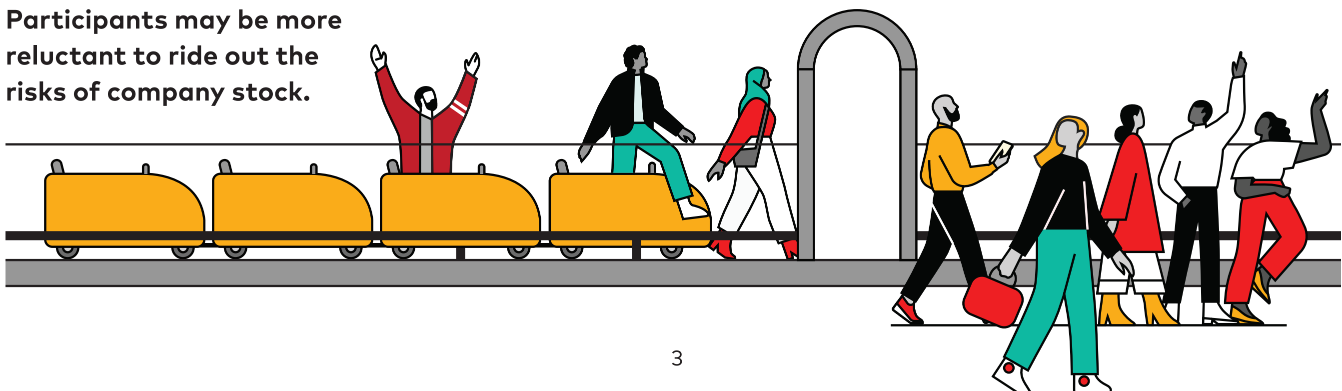
	2005	2023
Percentage of employers offering company stock	11%	8%
Percentage of participants choosing to hold company stock when offered	54%	23%
Percentage of all participants using company stock	24%	7%
Percentage of all participants with a company stock concentration of greater than 20%	14%	2%

Sources: *Company Stock in DC Plans*, Vanguard. December 2020. *How America Saves 2024*, Vanguard. June 2024.

This decline is likely attributable to the increased awareness brought about by company stock litigation and the enactment of the PPA.

The PPA included provisions intended to mitigate risks associated with overly concentrated company stock portfolios by adding company stock diversification requirements. For example, participants with employee contributions invested in publicly traded company stock (other than employee stock ownership plans) must be able to diversify these investments immediately. Similarly, company stock investments attributed to employer matching and nonelective contributions must be able to be diversified after three years. Finally, the PPA required that within 30 days a notice be provided to participants of their ability to diversify out of company stock.

Participants may be more reluctant to ride out the risks of company stock.



Best practices to mitigate risks

Recognizing that it's difficult to eliminate the risks associated with company stock in their plans, plan sponsors employ multiple approaches to mitigate the risks of a lawsuit. Approaches include complying with Section 404(c) of ERISA; having a well-documented process for evaluating company stock; educating their participants on the benefits of diversification, including the risks associated with company stock; developing plan design alternatives for company stock; and hiring an independent fiduciary to make decisions regarding company stock.

Section 404(c) compliance

Section 404(c) of ERISA relieves plan sponsors of liability for the investment decisions made by participants if certain requirements are met: The plan must offer a broad range of investment alternatives; provide participants with the opportunity to exercise control of their investments; and provide participants with sufficient information to make informed investment decisions. Section 404(c) adds several additional requirements for plans with company stock. These include:

- The employer security must be publicly traded on a national exchange or other generally recognized market.
- It must be traded with sufficient frequency and in sufficient volume to ensure that participant and beneficiary directions to buy or sell the security may be acted upon promptly and efficiently.
- Information provided to shareholders of such securities must be provided to participants and beneficiaries with accounts holding such securities.
- Voting, tender, and similar rights with respect to such securities must be passed through to participants and beneficiaries.
- Information relating to the purchase, holding, and sale of securities, and the exercise of voting, tender, and similar rights with respect to such securities by participants and beneficiaries must be maintained in accordance with procedures designed to safeguard the confidentiality of such information.
- The plan must designate a fiduciary to ensure the confidentiality of the participants' actions regarding company stock and a process to appoint an independent fiduciary if a conflict exists.

Process

Many company stock-related lawsuits have been permitted to proceed despite the employer's Section 404(c) defense, since Section 404(c) does not insulate a company from liability if the company stock was an imprudent option included in the plan's investment lineup. To address this, the company should document its process to demonstrate it was prudent to continue to offer company stock in the plan. The committee should establish clear goals and objectives related to the plan's investments, including company stock. Because of potential conflicts of interest, plan sponsors of DC plans with company stock should consider keeping company insiders out of the decision-making process for this investment.

Also, the committee should have a process to evaluate company stock against appropriate benchmarks. Typically, the investment policy statement (IPS) documents the committee's approach and should be reviewed on a regular basis. The IPS should also include the criteria for measuring performance and should address when to remove or freeze the company stock.

Committees should review the company stock on a regular basis as well as have a process for review during times of extreme volatility and corporate events, such as the merger with, or the acquisition of, another company.

The review of company stock should be based on publicly available information and the guidance provided by the IPS. Generally, the procedural due diligence of fiduciaries is more important than the results obtained. It is critical that all reviews, discussions, and decisions are well documented to show that a prudent process was followed regarding company stock.

In light of *Dudenhoeffer* and *Tatum*, organizations that hardwired company stock into their plan document should work with their legal counsel to determine whether it makes sense to remove the provisions mandating company stock as a plan investment. Post-*Dudenhoeffer*, such company stock mandates provide no additional protection to plan sponsors against a stock drop case. Furthermore, retaining the requirement that company stock be offered as a plan investment could make it easier for plan participants to bring a cause of action when the plan is changed to limit access to company stock and the value of stock rises in the future.

Education

The PPA requires certain notices be sent to participants to inform them of their right to diversify out of company stock. In addition to providing legally required disclosures, sponsors should regularly communicate with their participants and explain both the benefits and substantial downside risks of holding concentrated positions in company stock in an effort to mitigate risk.

Plan design

Unfortunately, education does not always have the desired effect of reducing overly concentrated stock positions. Plan design changes, however, can have a greater impact. Plan sponsors have used various plan design changes to limit investment in company stock, such as setting limitations on company stock, closing the stock fund to new money, or removing company stock as an option altogether.

Setting company stock limitations—The majority of Vanguard plan sponsors offering company stock have some type of restriction on the investment of contributions in company stock or have a restriction on exchanges into company stock.

For those who want to keep company stock in the plan while limiting exposure to risk, setting company stock limits could accomplish this with the least impact on participants currently invested in company stock. This plan design option can allow for new contributions into the company stock fund, but it mitigates a participant's overall exposure by placing limits on how much can be invested in company stock. This is the most common plan change during the past 15 years in Vanguard-administered plans. Sponsors can restrict new contributions to a certain percentage or redirect new contributions to a different investment when the company stock fund exceeds the restriction limit.

Plan sponsors must decide what the restriction limit will be, such as 20% or 25%, and how to apply it—whether to exchanges, contribution allocations, future contributions, and/or the rebalancing of participant accounts. For exchanges, participants could be prevented from making any exchanges that would cause the company stock fund to exceed the restriction limit. Alternatively, participants could be prevented from making any exchanges into the company stock. For contribution allocations, participants could be prevented from electing more than the restriction limit for future allocations.

A plan sponsor could also decide that contributions directed to the company stock fund would not be invested in stock if, at the time of deposit, it would cause the company stock fund to exceed the restriction limit. This would trigger a fiduciary decision on where these contributions should be invested, such as in the plan's qualified default investment alternative (QDIA). Finally, regarding rebalancing, a sponsor could decide that company stock investments above the limit will be sold down to the limit, which would also trigger a fiduciary decision on where these funds should be invested.Rebalancing is not typical, and participants already invested above the limits are generally "grandfathered" (that is, they are not required to sell off company stock assets to bring their overall company stock concentration down to the limit). A process must be established to map assets if contributions are redirected or rebalancing occurs.

Providing employer contributions in "cash"—An additional way to mitigate the risk of concentrated positions in company stock is to direct all employer contributions to cash (that is, participants can choose where to invest). In 2023, plans offering company stock as an investment option but making employer contributions in cash had an average of 8% of plan assets invested in company stock. Meanwhile, plans offering company stock as an investment option and making employer contributions in the stock had an average of 27% of plan assets in company stock.[4]

Closing the company stock fund to new money—Another option that keeps company stock in the plan, while mitigating risk, is to close the fund to new money. This is a more desirable option if the goal is to see a quicker decline in company stock concentrations within the plan. The downside is that it will also be a bigger change for participants currently directing contributions to company stock. Implementation considerations for this option are very similar to when restriction limits are established, except that existing assets and new contributions would not need to be mapped or defaulted in certain situations. Often this change is made as the first step in the process of completely removing company stock fund from the plan.

Removing company stock from the plan—The most drastic step a plan sponsor can take is the elimination of company stock fund from the plan. This can be very time-consuming, depending on the stock's liquidity and the plan sponsor's desire to give participants adequate time to decide where to move their company stock investments.

There are additional factors to consider when implementing this option. As with other options, participant communications, mapping and/or defaulting assets for those who do not proactively move money out of company stock, and updating plan documentation will be required. When updating plan documentation, it should be made clear that company stock will no longer be an investment option in the plan.

When closing the stock fund, it's important to establish a "sunset" period that will give participants time to make decisions regarding their company stock investments. Finally, when removing the company stock fund from the plan, securities counsel should be engaged in the process because there will be potential insider-trading safeguards, SEC filings, and blackout impacts that will have to be dealt with carefully during the process.

Additional implementation considerations—Regardless of the reason for the change or which change is implemented, employers should have a well-documented, thoughtful process before making any changes. This process should support the plan sponsor's conclusions regarding the company stock fund, and it should be defensible in situations where the value of company stock drops (or increases). Plan sponsors should work closely with ERISA and securities counsel during this process. For example, ERISA counsel can provide assistance dealing with issues such as how to address company stock that is "hardwired" into the plan document. Likewise, securities counsel can help identify and manage company stock requirements that apply to either an ongoing fund or one that is being eliminated.

Once a decision is made, there are considerations for the plan sponsor to be aware of when implementing the change. Plan materials such as the plan document and summary plan description will need to be updated to reflect changes. Additionally, communications will need to be drafted to explain why the change is happening and how it will impact the participant. The communications must also contain the legally required information for participant fee disclosure, QDIA notices, and possibly Sarbanes-Oxley (SOX) blackout notices for periods where no action is allowed on certain funds. Finally, applicable securities laws must be considered both for the ongoing fund, assuming the company stock fund is not eliminated, and for the plan change.

4 How America Saves 2024. Vanguard.

Independent fiduciary

Finally, some companies hire an independent fiduciary to determine the prudence of offering (or continuing to offer) company stock in the plan, to manage the sunset period for plans eliminating company stock from the plan, or to make other decisions related to the company stock. An independent fiduciary can relieve plan fiduciaries of the conflict of interest that arises when the committee is privy to inside information but is also tasked as fiduciaries to act in the best interest of participants. This is especially important in times of uncertainty, such as extreme and sudden volatility, or against the backdrop of impending corporate events, such as mergers or takeovers. However, hiring a third-party fiduciary is itself a fiduciary act that must be initially evaluated and monitored on an ongoing basis.

Conclusion

Court decisions, especially *Dudenhoeffer* and *Tatum*, have made it imperative that plan sponsors take a closer look at company stock investments in their DC plans. While there are many plans that continue to offer company stock, the trend over the past 15 years has been to eliminate or, at a minimum, to limit the exposure to concentrated holdings through plan design changes. Plan sponsors should regularly evaluate whether company stock continues to be an important benefit and a prudent investment to offer to employees in the retirement plan. Although it may not be possible to eliminate all risk, by following a consistent documented process combined with an effective plan design, participants can still benefit from employee ownership with reduced risk for the employer.

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