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401(k) Plan Sponsor ERISA Fiduciary Litigation Update: Sequoia Fund Litigation

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While much of the 401(k) fiduciary litigation in recent years has focused on investment and recordkeeping expenses, a large number of claims filed against 401(k) fiduciaries have alleged that fiduciaries simply made a bad investment decision. Most of these claims are related to employer stock and fall into a niche area of 401(k) fiduciary litigation often referred to as "stock drop" litigation. But occasionally, a claim is filed against 401(k) plan fiduciaries that alleges a poor investment decision regarding one or more of a plan's core investment funds.

Recently, breach of fiduciary duty claims were filed against fiduciaries of the Walt Disney Company and FMC Corporation 401(k) plans regarding the inclusion of the Sequoia Fund (a mutual fund) in their plans' investment lineups. Both of the claims allege that the plan fiduciaries breached their fiduciary duties under the Employee Retirement Income Security Act of 1974 (ERISA) by failing to remove the Sequoia Fund from the plan's investment lineup prior to a precipitous drop in the fund's value. The decline in value was largely attributable to the Sequoia Fund's significant investment in Valeant Pharmaceuticals, Inc., the value of which declined by more than 88% between October 2015 and June 2016. Almost 30% of the Sequoia Fund's assets were invested in Valeant in mid-2015, just prior to the drop in price.

The Disney and FMC Corporation complaints make a number of arguments that the plans' continued investments in the Sequoia Fund were imprudent and, therefore, caused the plan fiduciaries to breach their fiduciary duties under ERISA:

- The investment was inconsistent with the plan document, which requires that all investment options be diversified (and the Sequoia Fund was, by its own admission, not diversified).
- The Sequoia Fund's sizeable investment in Valeant violated the fund's policies against overconcentrating fund investments in any one industry and investing in undervalued securities and was too high by acceptable standards for investing a retirement plan investment option in any single security.
- Public information called into question whether Valeant stock was overvalued by the market.
- Plan fiduciaries failed to conduct an appropriate investigation into the plans' continued investments in the Sequoia Fund in light of the foregoing.

The FMC Corporation claim, which was filed with the U.S. District Court for the Eastern District of Pennsylvania, is, of course, still pending as that claim was only filed very recently. However, on November 14th, the U.S. District Court for the Central District of California dismissed the claim against Disney. [1] The District Court's opinion is instructive regarding the difficult procedural hurdles that employees must clear in order to survive a motion to dismiss.

Taking its cue from *Fifth Third Bancorp v. Dudenhoeffer*, __U.S. __, 134 S. Ct. 2459, 189 L. Ed 2s 457 (2014), in which the U.S. Supreme Court established the standard for evaluating breach of fiduciary duty claims in employer stock drop claims, the District Court stated that "an allegation that an investment's price dropped, even precipitously, does not alone suffice to state a claim under ERISA." Rather, as required by *Dudenhoeffer*, because plan fiduciaries are not expected to second guess market valuations, employees must allege that "special circumstances" existed that at least support an inference that fiduciaries should have questioned the reliability of the market valuation of the investment in question. While post-*Dudenhoeffer* decisions have not yet established when "special circumstances" exist, whatever they are, the District Court stated that the employees had not alleged any such "special circumstances."

The District Court noted specifically that the Sequoia Fund appears to have been included in the Disney plan's investment lineup to satisfy the plan fiduciaries' objective of including a fund that offered a higher growth potential in exchange for greater risk. The employees alleged no facts that the inclusion of the Sequoia Fund in the plan's investment lineup was unreasonable or inappropriate in light of that particular goal. Further, the District Court stated that under those circumstances, plan fiduciaries do not have an obligation under ERISA to monitor (1) the market and publicly available information about every holding maintained by every mutual fund in the plan's investment lineup, (2) the concentration of all stocks held by each mutual fund, or (3) whether that concentration was the result of an imprudent acquisition of additional shares or the dramatic appreciation in value of any particular mutual fund's original investment.

The District Court's commentary regarding a plan fiduciary's obligation to monitor the investment holdings of funds in the plan's investment lineup should not be misunderstood. The District Court does not appear to be saying that plan fiduciaries never have a duty to monitor an investment fund's holdings. While plan fiduciaries should not be required to monitor each individual investment decision made by the plan's investment funds, or the appropriateness of any particular security within a fund's portfolio, fiduciaries presumably do have at least some obligation to monitor the fund's overall holdings if, for no other reason, than to ensure that the fund continues to satisfy the diversification, risk/reward and investment style characteristics that led the plan fiduciaries to select the fund in the first place. Here, what the District Court appears to be saying is that when a plan fiduciary selects a fund that is intended have a higher risk/return profile, including through less diversification, the plan fiduciary should not have an obligation to monitor whether that fund is, in fact, diversified. In other words, as the court stated, "*in the context within which the Plan operated during the relevant time period*", plan fiduciaries had no duty to monitor the concentration of any particular investment in the Sequoia Fund.

Setting aside the District Court's approach to the question of the duty to monitor a fund's investment holdings, the District Court's procedural approach to investment-related ERISA fiduciary claims is consistent with that of other courts. Like *White v. Chevron Corporation*, [2] *Disney* reaffirms the principle that it is insufficient for employees to make summary allegations of breach of fiduciary duty based solely upon investment results. No matter how poorly an investment performs, in order to survive a motion to dismiss, employees must allege a failure in the fiduciary process for selecting and retaining that investment. Claims directed to hindsight analysis of investment results rather than to the adequacy of fiduciary decision-making activity will likely fail and will likely not survive a motion to dismiss.

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[1] In re Disney ERISA Litigation, Case No. CV-16-2551 PA (JCx) (C.D. Cal. Nov. 24, 2016).

[2] White v. Chevron Corporation, Case No. 16-cv-00793-PJH (N.D. Cal. March 9, 2016).