LEGAL UPDATE

Duty to Investigate

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The two fundamental duties of a fiduciary under the common law of trusts were the duty of loyalty and the duty of prudence. With respect to the latter, a plan fiduciary under ERISA must act with "the care, skill, prudence and diligence under the circumstances then prevailing that prudent man acting in like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." Obviously, that is a flexible standard and is context-specific, but some recent cases have drilled down a bit further as to whether a prudent fiduciary would have taken a specific action. For example, because ERISA's prudence requirement focuses upon process, rather than results, courts have uniformly held that there is a duty to investigate, research, and review a plan's investment options (and, as ERISA counsel will advise, to document such investigation), and, in a context such as an ESOP in which it is possible to question a fiduciary's loyalty, fiduciaries are obligated "to engage in an intensive and scrupulous independent investigation of their options to ensure they act in the best interest of their clients." Such a standard still leaves open, however, what specific actions may be required, an issue discussed in the following cases.

In the ERISA securities litigation involving Lehman Bros. stock, plaintiffs alleged that plan fiduciaries had breached their fiduciary duty by failing to pursue inside information held by others. According to plaintiffs, had the plan committee honored its fiduciary obligation to conduct an independent investigation into the riskiness of Lehman stock, they would have uncovered non-public information about the imprudence of continuing to invest in the stock. As the District Court elaborated on this theory, plaintiff's premise was that there was a quantum of negative information about Lehman Bros. stock which by itself might be insufficient to render continued investment imprudent, but such information would be troubling enough so that a prudent person would have made further inquiries of corporate insiders.

Whether such a duty exists will, however, need to be decided at some future date, because the District Court held, and the Court of Appeals for the Second Circuit affirmed, that even if such a duty existed, plaintiff could not establish a breach of fiduciary duty. To establish a breach of the duty of prudence in this context, a plaintiff would need to establish that an adequate investigation would have revealed to a reasonable fiduciary that the investment was improvident. In this case, plaintiff failed to explain in a non-conclusory fashion how the defendant's hypothetical investigation would have uncovered the alleged inside information. There were no specific allegations about what lines of inquiry would have revealed the information or who, in fact, if pressed, would have disclosed the information to the defendants.

In Dudenhoeffer v. Fifth Third Bank, the Supreme Court held that absent "special circumstances," a fiduciary "is not imprudent to assume that a major stock market provides the best estimate of the stocks traded upon it." To attempt to avoid the strict pleading standards of Dudenhoeffer, plaintiffs in Saumer v. Cliffs Natural Resources Inc. alleged that the fiduciaries failure "to engage in a reasoned decision-making process regarding the prudence of Cliffs stock" constituted a "special circumstance." The Court of Appeals for the Sixth Circuit disagreed, holding that a fiduciary's failure to investigate the merits of investing in a publicly traded company does not count as a "special circumstance." In explaining why a fiduciary's failure to independently verify the accuracy of the market's pricing was not a special circumstance, the Sixth Circuit indicated that the Supreme Court had specifically stated that an ERISA fiduciary could assume that stock markets provide the best estimate of a security's value. Furthermore, Dudenhoeffer had reasoned that an investor's inquiry into a publicly traded company is unlikely to reveal a company's true value, much less the future course of its stock price. Finally, plaintiff's theory suffered from the same type of pleading deficiencies as were present in the ERISA securities litigation. As the Sixth Circuit explained, while a fiduciary generally must investigate the merits of an investment, its failure to investigate an investment decision alone is not sufficient to show that the decision was not reasonable. That is, there must be a causal link between the failure to investigate and the harm suffered by the plan. In Saumer, the plaintiffs had not pled anything that the fiduciaries might have gleaned from the publicly available information that would have undermined reliance upon the market price.

The above cases are interesting, but they are outliers to the general importance of conducting investigations with respect to investment decisions, as well as other fiduciary decisions. While the case law provides that a failure to investigate will not necessarily lead to the imposition of fiduciary liability, failure to take such action increases the likelihood of being named as a defendant in an ERISA civil litigation.

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