The first class action salvo? Breach of duty claim filed against trustees of coal company pension fund

Sarah Barker and Maged Girgis report on a recent breach of duty claim against the trustees of a coal company pension plan … for continuing to invest in the sponsoring company's stock. This case demonstrates the potential legal exposure of trustees who fail to proactively engage with the evolving risk/return landscape, and sounds an ominous warning of beneficiaries' preparedness to litigate on point.

A recent case filing in the United States illustrates the potential exposures of trustees and their directors, as beneficiaries (and their class action attorneys) turn to fiduciary and securities laws to recover pension fund losses.

Members of the employee pension plan (**Plan**) of the world's fifth largest producer of thermal and coking coal, Arch Coal, have filed representative proceedings in the United States District Court against Plan fiduciaries (including both the independent trustee and individual directors and officers of the Plan's sponsoring employer) [1]. The plaintiffs are seeking compensation for a drop in the value of pension funds invested in company stock, which is alleged to have plummeted in value by 96% over the three and a half-year claim period. The complaint alleges that Plan fiduciaries breached their duties of prudence and loyalty under the Employee Retirement Income Security Act (**ERISA**), by allowing the Plan to continue to invest in the sponsoring coal company's stock when it was imprudent to do so:

> *An adequate (or even cursory) investigation by the Defendants would have revealed to a reasonable fiduciary that investment by the Plan in Arch Stock during the Relevant Period was clearly imprudent…Either Defendants did not conduct such an adequate investigation (in violation of their duty of prudence) or they did conduct an adequate investigation and ignored the results thereof (in violation of the duty of loyalty).*[2]

The complaint also alleges that the fiduciaries breached their statutory duties to:

- disclose and inform (encompassing a negative duty not to misinform, and a positive duty to convey complete and accurate information to Plan participants); and to
- monitor appointees – by failing to properly evaluate the performance of other Plan fiduciaries (eg. services providers), or to have a proper system in place for doing so.

Arch Coal

The Arch Coal Inc Employee Thrift Plan has over 6,900 active participants and over US$546.7M in plan assets[3], with an average account balance of approximately US$83,000. Participants can direct their contributions to be

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[1] *Roe v Arch Coal Inc et al*, Case: 4:15-cv-00910-NAB, United States District Court, Eastern District of Missouri, 9 June 2015 (**'Arch Coal Complaint'**).
[2] Arch Coal Complaint, paragraph 272.
[3] Arch Coal 11-K for the fiscal year ended 31 December 2014, page 2.

invested across 27 options[4], including a company stock fund (which represented 5.4% of total Plan assets at the commencement of the claim period)[5].

The complaint asserts that, by the start of the claim period on 1 January 2012, the defendant fiduciaries knew or ought to have known that the Plan's holdings of the sponsoring company's stock was '*unduly risky and…unreasonably likely to result in substantial losses*', and therefore was clearly an imprudent investment as a retirement vehicle. Specifically it is alleged that:

a) there was evidence that the US coal industry was in 'structural' decline, with coal prices diving due to weakening demand from thermal and coking coal export markets, intense competition from domestic natural gas and renewable energy sources, and stricter regulations on environmental oversight and emissions controls; and
b) the sponsoring company's financial prospects were dire and that it was inevitable that its stock price would continue to deteriorate, as evidenced by:
    i) its Altman-Z scores ('**Z-score**') collapsing into the 'distressed zone' below 1.88 (falling from 1.95 in December 2008 to 1.57 in December 2009, to less than 1 by December 2011), indicating a likelihood of bankruptcy within two years;
    ii) excessive increases in the company's debt to equity ratio;
    iii) mine closures, production cuts, declining revenue forecasts and liquidity pressures; and
    iv) negative outlooks by independent analysts and ratings agencies.

On that basis, the claim alleges that the '*Defendants knew or should have known that…the Company Stock was imprudent no matter what its price….There was absolutely no objective evidence that the Company stock price would or could recover. Yet, Defendants failed to protect the Plans and their Participants from these foreseeable losses.*'

As at the date of this Alert, the defendants' responses to the claim were yet to be filed with the District Court.

Does such a claim translate under Australian law?

Of course, the duties of pension fund trustees and their directors under ERISA (including sole purpose, best interests, avoidance of conflicts and prudent conduct) are not identical to those prescribed under Australian general and statutory law (including under the *Corporations Act 2001* and *Superannuation Industry (Supervision) Act 1993*). However, they are not dissimilar. For example, under section 52 of the *SIS Act*, Australian superannuation fund trustees are held to the duty of care, skill and diligence expected of a prudent 'professional superannuation trustee', while under ERISA the Arch Coal Plan fiduciaries are subject to a duty to exercise the '*care, skill, prudence and diligence…that a prudent man acting in a like capacity and familiar with such matters would use*'.[6]

Jurisdictional specificities aside, the Arch Coal claim provides a stark illustration of the application of fiduciary laws in a dynamic modern economy. In particular, as we have reported in a number of recent Client Alerts: *From 'ethical crusade' to financial mainstream – is climate change reaching a tipping point for institutional investors?* [see here], *Trustee liability…but not as you know it*) [see here], trustees who fail to consider the material financial risks (irrespective of whether they arise out of 'financial' factors such as market or economic change or 'non-financial' factors such as political or societal factors, or other environmental, social and

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[4] Statistics as at 31 December 2013 - http://www.brightscope.com/401k-rating/225704/Arch-Coal-Inc/229464/Arch-Coal-Inc-Employee-Thrift-Plan/

[5] The Arch Coal Plan is alleged to have held approximately 2 million shares in company stock at the commencement of the Claim Period, with a market value of $27,824,221 (Arch Coal Complaint, 39) against total Plan assets of $515.7 million (Arch Coal 2012 11-K, p. 2) – or approximately 5.4% of total Plan assets. Its company stock holdings (of more than four and a half million shares) had fallen to $8,169,449 by the end of 2014 (Arch Coal 2014 11-K, p.9), against total Plan assets of approximately $567.8m (Arch Coal 2014 11-K, p.2).

[6] ERISA section 404(a)(1), 29 U.S.C. § 1104(a)(1).

governance (ESG) drivers) may open themselves to claims of failure to act in the fund's best interests, and a failure to govern with the requisite care, skill and diligence.

The complaint illustrates that:

a) It is no longer safe for fiduciaries to make an unreflective assumption that ESG issues are inherently 'non-financial'. Nor can they allow personal convictions or extraneous interests to drive their governance decisions, rather than dispassionate judgment based on robust information and assessment.

The Arch Coal claim argues that there is a 'structural' decline in the US coal industry due to shifts in international regulatory policies around environmental standards and emission controls, and competition from natural gas and renewable energy. It is these market pressures, and the risk of asset 'stranding' that they raise, that it is alleged the Arch Coal plan fiduciaries should have considered in deciding whether to invest the plan in Arch Coal stock. Such pressures are squarely framed as 'economic'. However, they demonstrate the way in which factors that were once considered 'ethical' or 'non-financial' have evolved to potentially have a material impact on a fund's financial risk and return.

An examination of the *drivers* behind the financial and economic pressures cited in the claim reveals that many regulatory and market outcomes are being driven by government and stakeholder concerns associated with *environmental* issues – and climate change in particular. Of course, the degree to which climate change has contributed to any alleged 'structural' decline of the coal industry, and any associated financial woes of Arch Coal, is a matter of debate. For example, a significant contributor to the collapse in the price of coking coal in recent years has been a decline in demand from Chinese steel producers (itself a product of Chinese economic conditions), and miners' 'take-or-pay' haulage and port contracts which compound over-supply by dis-incentivising cuts to production. Determination of the relative materiality of these factors versus those of 'environmentally-driven' regulatory, market or stakeholder actions, is a task that may challenge the most experienced economist.

The claim relies on purely economic arguments. In fact, it does not use the terms 'global warming' or 'climate change' at all. The claim has been filed by a representative plaintiff who is *not* associated with any environmental interest group, but the US plaintiff bar. But this is where it is of such potential significance. The manner in which this claim has been brought about illustrates the way in which beneficiaries may seek to frame claims that trustees and their directors have breached their duties by failing to consider the material *financial* risks associated with climate change.

This is not to suggest that trustee directors have to start 'picking stocks'. But it does reinforce the need to regularly interrogate investment beliefs and assumptions, and to actively and dispassionately consider the impacts of material market trends on portfolio risk management and investment strategy – whatever the underlying drivers of those trends may be.

b) The duty of prudence (or, in Australia, the equivalent duty of due care and diligence) is not primarily concerned with performance outcomes, but the robustness of the reasoning processes on which they sit.

It is a fundamental precept of corporate and trust law that the courts should not intrude into the commercial realm by 'second-guessing' commercial judgments with the perfect wisdom of hindsight. The Arch Coal complaint does not seek to upset this established principle. It does *not* allege that the defendants have breached their duty of prudence because of the fall in the value of their investment in the sponsoring company's stock, *in and of itself*. Rather, the claim alleges *'procedural imprudence'* – a failure to adequately (or even cursorily) investigate whether the company stock option was a prudent retirement investment vehicle, or to *monitor* the on-going prudence of that investment in response to dynamic market developments. The failing is squarely framed as one of process, rather than to achieve a particular outcome.

A new frontier in pension fund claims?

Of course, claims by aggrieved beneficiaries against pension fund trustees are not a new phenomenon. In the United States, damages claims against fiduciaries of employee benefit plans are resurgent in the wake of the Supreme Court's 2014 *Dudenhoeffer* decision (which held that ERISA fiduciaries are *not* entitled to a presumption of prudence when investing in the sponsoring employer's stock).

However, the Arch Coal claim has distinguishing features that makes it particularly significant for pension fund fiduciaries – in the US and beyond.

First, unlike many other employee benefit plan claims (including claims against the fiduciaries of the Lehman Bros and Eastman Kodak plans)[7], the complaints has been filed at a time when the sponsoring company remains *solvent*.

Secondly, the claim demonstrates the inherent risks of failing to proactively manage trustee conflicts of interest. In the Arch Coal case, the alleged conflict is particularly intractable, with the fund fiduciaries also serving as directors of the sponsoring company. However, it is instructive of the broader conflict management issues faced by superannuation fund directors – and the over-riding need to exercise unfettered, independent judgment in a single-minded pursuit of the fund's best interests.

Thirdly, plaintiffs in employee benefit plan claims often fail to establish that the operative cause of their loss was the trustee directors' lack of prudence (as compared to, for example, a general softening of the global economy reducing portfolio-wide returns, or an abrupt market event such as the Global Financial Crisis). This was in fact a significant factor in the dismissal of a claim against the fiduciaries of the Lehman Bros employee pension plan on 10 July 2015. However, in the Arch Coal case the drop in the market value is alleged to have been significant, sustained and consistent with the weight of independent analysis.

Finally, unlike many other employee benefit plan claims, the Arch Coal claim also alleges a breach of the duty to inform the beneficiaries – misleading or deceptive conduct – in making statements to suggest that the companies had positive commercial prospects when this was not the case. This reinforces the importance of ensuring that statements made by the fund in relation to its investments (including the role of ESG considerations in their investment processes) are clear and accurate, and that trustees can verify that commitments are effectively implemented by the fund and their managers.

In short, these developments have the potential to significantly impact the way in which trustees and their directors approach the governance of their funds – far beyond the United States. Regardless of a trustee's personal, moral or ideological views, the financial risks (and opportunities) associated with the response of other market stakeholders cannot be ignored. Trustees and their directors must remain informed, proactive and engaged on the issues that may materially impact on portfolio risk management and strategy. And there is now a case filing to demonstrate the consequences if they don't.

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[7] The claim against the Eastman Kodak plan fiduciaries survived a motion to dismiss in December 2014, and awaits trial – see *Gedek v Perez et al* 66 F.Supp.3d 368. That against the Lehman Bros plan fiduciaries was dismissed by the Southern New York District Court in July 2015 – see *In re Lehman Brothers Securities and 09-md-2017 (LAK) ERISA Litigation 2015* WL 4139978 (S.D.N.Y.).