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Employers: Time to Take Stock of Your 401(k) Plans

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With market volatility and precipitous declines in stock prices, a company may face liability for securities laws violations from a source close to home—its own employees.

Many public companies offer an employer stock fund as an investment option under 401(k) savings plans. But as the balances of employees' retirement accounts have declined in recent months, so have the values of employer stock funds. Yet employees may have an often overlooked (and unintended) right to regain a portion of their lost investments in employer stock—if the employer failed to comply, however innocently, with the federal securities laws. In today's economic environment, recouping the stock values of a year ago, with interest, may look attractive to even the most loyal employee. Employers would do well to examine their stock funds and, if out of compliance, take quick action, via several possible routes, to remedy the situation.

Registration

Generally, if an employee makes a plan contribution to purchase shares in an employer stock fund, that constitutes a "sale" of a security. The transaction must be either registered under the Securities Act of 1933 or exempted from registration. As a practical matter, most transactions involving employee investments in an employer stock fund will not qualify for an exemption, and the registration requirements will apply. Registration is necessary even for a "unitized plan" in which employees purchase units representing an indirect interest in the shares of stock plus a varying amount of liquid short term investments.

In the ordinary course, registration is straightforward. Using a Form S-8, the registration statement incorporates most of the required information by reference from other SEC filings and becomes automatically effective. It does not include a prospectus. Instead, the employer can provide employees with the information they need to make an investment choice through a prospectus that is not filed with the SEC or several alternative means.

So, what can go wrong?

Common Mistakes

In some cases, employers simply are unaware of the potential registration requirements. The 401(k) plan may be administered by someone in the HR or benefits department who is not familiar with securities laws. Employers mistakenly may assume that employer shares acquired in the open market or from treasury and then sold under the plan already have been registered under the securities laws. They do not realize that the 1933 Act requires the registration of transactions, not of securities.

Even if a registration statement has been filed, keeping track of transactions and the number of shares sold can be a daunting task. There are two basic methods that companies use for counting the shares that remain available on a Form S-8—net and gross. Some companies apply the "net" method under which the employer does not register additional shares until the trustee cannot match purchase and sale requests among participant accounts; the trustee must then acquire additional shares from outside the 401(k) plan. The risk of this approach is that registration applies to transactions, not shares. The SEC staff may not agree that this is the appropriate method for securities laws purposes, even though it may suffice for tracking the number of shares issued or sold under board authorization for state corporate law or stock exchange listing purposes (additional considerations to keep in mind that are beyond the scope of this article).

A more conservative approach is to apply the "gross" method of counting. With this approach, every transaction is counted against the number of shares available on the registration statement. If the plan trustee allocates 10 shares to a participant's account, 10 shares are counted against the number of shares subject to registration. If that participant subsequently rebalances his or her account and the trustee allocates those shares to other purchasing accounts, there is a second transaction. As a result, another 10 shares are deducted from the number of shares registered.

Counting for "unitized" stock funds is more confusing. In a unitized stock fund, each unit represents an interest in a share of the employer's stock, plus a varying amount of liquid short-term investments. As a result, an employee's investment in stock units does not correlate to the same number of shares.

Regardless of the reasons, the consequences of failing to register the 401(k) plan transactions are potentially significant. A purchaser of a security issued in violation of the registration requirements, including an employee, has the right to receive the amount he or she paid for the security (minus any dividends)—plus interest. If the purchaser no longer owns the security, he or she is entitled to damages based on the prices at which he or she bought and sold the securities. Under either scenario, the employer's liability is absolute. The employee has the right to be made whole, without demonstrating reliance on any false or misleading statements in connection with the offering (which might create independent claims). With stock prices declining significantly over the last several months, it is understandable that an employee may have an interest in pursuing this right.

The statute of limitations for bringing a claim for an unregistered sale of a security typically is one year. Even if an employer corrects the problem going forward, it will take a year until the potential liability ends.

In addition to the federal securities laws, issues can arise under the Employee Retirement Income Security Act (ERISA) and for financial statement reporting purposes. Moreover, even an innocent, but repeated, pattern of missed registration statements or miscounting can call into question the adequacy of the employer's controls and procedures.

ERISA Considerations

Although allowing employees to select among investment alternatives for employee contributions may help to limit the liability of the employer and others responsible for the administration of a 401(k) plan, the plan trustees still are fiduciaries to the participants. Trustees must exercise their duties prudently and solely in the interests of the plan's participants and beneficiaries. If the trustees learn of a failure to register employer stock under the 1933 Act, they likely will evaluate the consequences of that failure. Although it may be unfair to trace a deterioration in stock price to a failure to register, plan trustees may struggle with this idea in the face of a significant recovery potential by the employees. Members of management who serve as plan trustees are in a particularly conflicted position. These ERISA concerns are in addition to duties that the trustees may have in the face of an employer's deteriorating financial performance.

Financial Reporting

Upon discovering a failure to register sales of securities in the 401(k) plan, an employer must consider the effect of that failure on its financial statements. As noted above, employee purchasers have a right to rescind those purchases. Because the redemption right is not within the employer's control, the shares may have to be classified outside of equity on the balance sheet. In addition, the employer will have to consider carefully the potential exposure to liability—and determine what reserves may be necessary. In any case, the employer will have to consult with its independent accountants.

Controls and Procedures

Public companies must maintain effective internal controls over financial reporting. An internal control over financial reporting is designed to provide reasonable assurance of the reliability of financial reporting and the preparation of financial statements for external purposes. Together with its accountants, the employer will have to evaluate the adequacy of those controls and identify possible weaknesses. The employer's chief executive officer and chief financial officer then must certify the adequacy of the controls and report on any changes. On an annual basis, the independent accountant must attest to management's assessment and report. A failure to maintain adequate controls of securities compliance for employee benefit plans, with the potential for significant financial exposure, may call internal controls into question.

An Imperfect Fix

Like many solutions to uncomfortable problems, the cure often seems worse than the disease. In general, a complete "fix" for unregistered sales of under a 401(k) plan can include public disclosure, possible financial statements changes, a new registration statement, a rescission offer to employees, and improved controls and procedures. Other issues to consider include suspending current sales under the employer stock fund and determining whether a blackout period is necessary while the situation is addressed.

Upon discovering a failure to register securities under a 401(k), an employer should file as soon as possible a registration statement for future sales. This prevents continued unregistered sales and allows ongoing selling in the employer stock fund. The filing can be made using a registration statement on Form S-8. Of course, preparing a registration statement requires the employer to confront uncomfortable questions, such as: "What do I tell my board of directors and the audit committee?," "How will the accountants react?," and "How much do I have to say now about the problem?" These questions and others must be answered before filing the new registration statement. At the same time, the employer has to consider changes to internal controls and procedures, evaluate the weaknesses, educate employees involved with the operation of the 401(k) plan, and take steps to prevent the problem from recurring.

Past mistakes are more difficult to rectify. The most effective, but still imperfect, solution may be to offer employees a chance to rescind their unregistered purchases of securities. In light of the statute of limitations, employees who purchased securities within the last year are offered an opportunity to keep those securities or to sell them back to the employer for what they paid, plus interest. From a federal securities laws perspective, a rescission offer involves yet another offer and sale of a security because the employees now are being given the choice of keeping or "buying" the securities or tendering them back to the employer. Registration on Form S-8 is not available. As a result, the registration statement will not become effective on filing, and it will have to include a prospectus describing the reasons for and consequences of the rescission offer and explaining the tender procedures.

The rationale for the rescission offer is to give employees a choice of accepting the statutory remedy or keeping the securities. In theory, if upon completion of the offer an employee keeps the security, he or she has "purchased" that security in a transaction registered under the 1933 Act. If the employee accepts the offer and tenders the securities, he or she is made whole. If the employee keeps the securities, the employer should be able to assert that he or she is stopped from asserting further claims.

Unfortunately, this outcome may not be that clearly delineated under the federal securities laws. Section 14 of the 1933 Act provides that "any condition, stipulation, or provision binding any person to waive compliance with any provision of the Act or rule thereunder shall be void." Similarly, in a 1975 letter to Steiger Tractor Co., the SEC staff declined to express a view about the effect of a rescission offer on potential liability for unregistered sales of securities. The staff went on to "underscore its previously-expressed view that liabilities under the Federal securities laws, including the civil liabilities arising under Section 12 of the [1933 Act], are not terminated merely because potentially liable persons make a registered rescission offer. . . ."

Whether a rescission offer terminates liability depends on whether an employee's acceptance or rejection of that offer is a prohibited waiver. If the employee accepts the offer, receipt of the consideration paid, plus interest should eliminate the damages element of the federal claim. With respect to the remaining rights of an employee who rejects the offer, the few federal courts that have addressed this issue in the past have suggested that, at least in certain circumstances, a person who rejects or fails to accept a rescission offer may be precluded from later seeking similar relief. Equitable considerations also will come into play.

An employer making a rescission offer must take into account these and other complexities when drafting the registration statement and prospectus. Clear disclosure is essential. The prospectus must carefully explain the background and reasons for the offer, describe possible effects on recipients and the company, and highlight risks to employees of accepting or rejecting the offer. For planning purposes, the employer also should assume that the registration statement, which will be publicly available on filing with the SEC, will be selected by the SEC staff for review.

First Steps

Not knowing whether it has a problem with its 401(k) plan is not an attractive option for an employer in today's regulatory, governance, and economic environment. If there is any doubt about the need for registration, an employer might consider the following steps:

- Confirm that the 401(k) plan permits an employee to invest in employer stock and that no exemption from registration is available;
- Identify all registration statements covering shares under the 401(k) plan;
- Total the numbers of shares registered, taking into account stock splits and shares carried forward from prior Form S-8 registration statements;
- Identify the appropriate counting method and match the transactions in the employer stock fund against the amounts registered;
- Calculate the surplus or shortfall; and
- Review controls and enhance them as appropriate.

Only after gathering the facts can the employer begin to plan its next steps. Those steps will vary among employers, the type of plan, and the nature of the mistake. Undoubtedly, the employer will assess the potential exposure to liability, review the significance of the errors, and consult with outside professionals.

Other Plans

While this article has focused on issues associated with 401(k) plans, similar problems may arise in connection with other types of compensatory and noncompensatory stock plans. These include stock option, restricted stock, stock purchase, deferred compensation, and dividend reinvestment plans. For companies that have not done so, this would be a good time to assess the state of compliance and control and take "stock" of all stock-based plans.

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