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Employer Stock

High Court Kills Presumption of Prudence, Gives Some Hope to ESOP Fiduciaries

By Jacklyn Wille

June 25 — In a partial win for employees who invest in company stock, a unanimous U.S. Supreme Court ruled that fiduciaries of employee stock ownership plans aren't entitled to a presumption of prudence protecting them from liability for declining share price (*Fifth Third Bancorp v. Dudenhoeffer,* 2014 BL 175777, U.S., No. 12-751, 6/25/14).

Calling the judge-made presumption a "defense-friendly standard," Justice Stephen G. Breyer wrote in the court's June 25 opinion that ESOP fiduciaries are subject to the same prudent-person standard that applies to fiduciaries of all plans governed by the Employee Retirement Income Security Act, except for the requirement to diversify plan assets.

Although the court invalidated what has come to be known as the *Moench* presumption, ERISA practitioners agreed that the ruling didn't leave ESOP fiduciaries unable to defend themselves from stock-drop lawsuits.

The court emphasized that, in the absence of "special circumstances," fiduciaries of publicly traded companies can't be liable for failing to act on publicly available information, as that would require them to outsmart the market.

The court also said that fiduciaries can't be found imprudent for failing to act in a way that would violate insider trading laws. ESOP participants bringing claims based on inside information must plausibly allege an alternative action that the fiduciaries could have taken that wouldn't violate securities or other laws and that wouldn't have been likely to harm the plan, the court concluded.

The court's decision left open a number of questions for lower courts to consider, including:

- In the context of publicly traded employer stock, what "special circumstances" are needed to show that an ESOP fiduciary acted imprudently in weighing publicly available information?
- In the context of allegations that an ESOP fiduciary should have taken action based on inside information or disclosed that information to the public, to what extent does the potential imposition of ERISA liability conflict with the requirements or objectives of insider trading and federal securities laws?
- Could a prudent fiduciary in possession of inside information negatively affecting stock price reasonably determine that disclosing such information would "do more harm than good?"

BNA Snapshot

Fifth Third Bancorp v. Dudenhoeffer, 2014 BL 175777, U.S., No. 12-751, 6/25/14

Key Holding: Fiduciaries of employer stock plans aren't protected by an ESOP-specific presumption of prudence; rather, they are subject to the general prudent-person standard applicable to all ERISA fiduciaries.

Key Takeaway: Unanimous U.S. Supreme Court strikes down pro-fiduciary presumption of prudence while articulating new obstacles for ESOP participants bringing stock-drop claims.

Fiduciaries Still Have Options

Scott Macey, president and chief executive of the ERISA Industry Committee in Washington, said that while the opinion looked at first glance like a win for plan participants, the court actually provided many tools for fiduciaries to use in defending meritless stock-drop lawsuits.

"I don't think there are big winners and losers at this point," Macey told Bloomberg BNA on June 25. "If the case gets interpreted by the lower courts in the way I understand it, I think that it's initially a little easier for plaintiffs, because they don't have to deal with the *Moench* presumption at all."

"On the other hand, I don't think the fiduciary defendants should take it on the chin that much, because I think the Supreme Court is saying that there are other ways for them to defend these nonmeritorious cases," Macey said.

He added that plaintiffs will need to show that there is a substantial reason that a fiduciary shouldn't have relied on the market price of the stock, which is considered to be based on publicly available information, or that the fiduciary could have taken some action neither violative of the law—including insider trading laws—nor harmful to participants if the fiduciary had non-public information.

Macey also said that the case gives lower courts a lot to consider in determining whether to dismiss these types of cases in the early stages of litigation.

“The roadmap for defendants and courts becomes somewhat more complex, but I don't think this decision should rule out dismissing a lot of these nonmeritorious cases early on, before they cause years of litigation and costs,” Macey said.

‘Added Teeth.'

Dean J. Schaner, a partner with Haynes and Boone LLP in Houston who represents plan sponsors, said that the court's opinion “offered protection” to ESOP fiduciaries defending stock-drop suits.

“Not surprisingly, the Court interpreted ERISA's plain language and eschewed the adoption of any ‘presumption of prudence' in favor of a ‘careful, context sensitive scrutiny of a Complaint's allegations,' ” Schaner told Bloomberg BNA in a June 25 e-mail.

“Accordingly, while the Court rejected the presumption, it added teeth to the Rule 12(b)(6) motion to dismiss mechanism to ferret out implausible stock drop claims predicated on the plaintiffs' reliance upon public ‘market price' information or insider information,” Schaner said.

According to Schaner, the court's test now appears to be “whether the plaintiff could plausibly allege alternative ‘legal' actions the ESOP could have taken that would not be more likely to harm the fund than to help it.” Schaner called this the “Alternative More Likely to Help than Harm” standard.

However, with the *Moench* presumption now gone, Schaner said that employers “will need to carefully evaluate the risks and benefits of ESOP plans and the possibility of increased litigation expenses and costs to defend stock drop lawsuits beyond the pleadings stage.”

Still ‘Quite Difficult' for Plaintiffs

Richard Siegel, a senior associate with Alston & Bird LLP in Washington who also represents plan sponsors, said that the ruling didn't make it significantly easier for participants bringing stock-drop claims.

“While the Supreme Court's decision today does away with the presumption of prudence, fortunately, the Court did not end its opinion there,” Siegel said in a June 25 e-mail to Bloomberg BNA.

He added that the court provided “helpful guidance” for lower courts weighing stock-drop claims.

“While it will take some time to see how the courts implement this ruling, it appears that the Supreme Court has significantly restricted the types of allegations that plaintiffs may raise in order to state a plausible claim,” Siegel said. “So long as the Supreme Court's instructions are followed, it will likely remain quite difficult for most stock drop cases to survive a motion to dismiss, even in the absence of a presumption.”

Meritorious Cases Can Proceed

Karen L. Handorf, a participant-side attorney and a partner with Cohen Milstein Sellers & Toll PLLC in Washington, praised the court for striking down the presumption.

“The Supreme Court's decision recognizes that ERISA's only purpose is to protect employees' retirement income and that the strict standards of loyalty and prudence are undiluted when applied to employer stock funds—a major source of retirement income for American workers,” Handorf told Bloomberg BNA in a June 25 e-mail.

Handorf said that the presumption was “unsupported by the statutory language and set an unattainable standard that plaintiffs could not meet until it was too late to protect their retirement savings.”

“While the Court recognizes that not every employer stock case will have merit, it allows meritorious ones to go forward under the same standards applicable to all fiduciary decision making,” Handorf said.

‘Substantial Burdens.'

Ellen M. Doyle, a participant-side attorney and a partner with Feinstein Doyle Payne & Kravec LLC in Pittsburgh, told Bloomberg BNA June 25 that the “biggest surprise” from the court's opinion was the fact that the decision was unanimous.

Doyle also said that the ruling benefited plan participants in several ways.

“The elimination of the presumption of prudence for ESOP fiduciaries, the recognition of a duty on the part of ESOP fiduciaries to be concerned with the retirement savings of participants in ESOPs, and the rejection of efforts to make fiduciary duties contingent on plan language in plan documents were all extremely helpful principles for participants in the future hoping to hold their fiduciaries accountable for misconduct,” Doyle said.

She also noted that the opinion placed “substantial burdens” on ESOP participants' ability to plead and prove that plan fiduciaries breached their duties.

“The Court held that where a stock is publicly traded, ‘allegations that a fiduciary should have recognized from publicly available information alone that the market was over-or undervaluing the stock are implausible as a general rule, at least in the absence of special circumstances.' The Court did not provide guidance on what special circumstances could give rise to a claim,” Doyle said.

Similarly, Doyle said that ESOP participants challenging fiduciaries' use of inside information would have difficulty satisfying the court's requirement that they allege an alternative, lawful action that the fiduciary could have taken without harming the plan.

"This will be very difficult for participants to plead," Doyle said.

Doyle added that additional litigation will be necessary to determine the scope of the duty of prudence after this ruling.

"The lesson appears to be that fiduciaries of ESOPs are fiduciaries and they have duties imposed on them by ERISA that plan sponsors in plan documents cannot relieve them from," Doyle said. "But additional litigation will be needed to determine the duties that ESOP fiduciaries do have. Those duties may not be what participants and Department of Labor believed were required of ESOP fiduciaries before this opinion and could be affected by SEC guidance which the Court did not have in issuing its opinion."

Presumption of Prudence

The presumption of prudence struck down by the court was first articulated by the U.S. Court of Appeals for the Third Circuit in *Moench v. Robertson*, 62 F.3d 553, 19 EBC 1713 (3d Cir. 1995). Courts frequently cited the presumption as a grounds for dismissal of employer stock-drop cases.

In general, the *Moench* presumption required plaintiffs to point to a plan sponsor's impending collapse or other dire circumstances to show that a reasonable plan fiduciary would have divested the plan of employer stock.

Several circuits—including the Second, Fifth, Sixth, Seventh, Ninth and Eleventh—adopted some form of the *Moench* presumption in cases involving employer stock.

In its 2012 *Dudenhoeffer* decision, the Sixth Circuit broke from a number of other circuits to hold that the pro-fiduciary presumption didn't apply at the motion-to-dismiss stage of litigation (172 PBD, 9/6/12; 39 BPR 1720, 9/11/12).

The Sixth Circuit also used *Dudenhoeffer* to articulate a weaker presumption than had been used in other circuits. While some courts required a showing of impending collapse or other dire circumstances to overcome the presumption, the Sixth Circuit found that plan participants could overcome the presumption by showing that "a prudent fiduciary acting under similar circumstances would have made a different investment decision."

ESOPs' Special Purpose

The Supreme Court said that its decision to strike down the *Moench* presumption followed from "the pertinent provisions of ERISA," which make no mention of an ESOP-specific presumption.

In particular, the court rejected the argument advanced by petitioner Fifth Third Bancorp, which asserted that the presumption was warranted because ESOPs have an "additional goal" not common to other retirement plans—specifically, the Congress-promoted goal of encouraging employee ownership of company stock.

Looking to ERISA's text, the court said that it "cannot accept the claim that underlies this argument, namely, that the content of ERISA's duty of prudence varies depending upon the specific nonpecuniary goal set out in an ERISA plan."

The court said that ERISA Section 404(a)(1)(B)'s prudent person standard requires fiduciaries to act as a prudent person engaged in "an enterprise of like character and with like aims" would act. This provision "must be understood to refer to the sort of financial benefits (such as retirement income) that trustees who manage investments typically seek," the court reasoned.

'A Rock and a Hard Place.'

The court also addressed Fifth Third's argument that striking down the presumption would put ESOP fiduciaries "between a rock and a hard place." Fifth Third argued that fiduciaries face lawsuits for continuing to invest in declining stock and could also face lawsuits for selling declining stock in violation of plan terms if the stock price later rebounds.

Although it recognized Fifth Third's concern, the court said the presumption wasn't an appropriate way to "weed out meritless lawsuits," because it made it "impossible" for participants to state an imprudence claim "unless the employer is in very bad economic circumstances."

"Such a rule does not readily divide the plausible sheep from the meritless goats," the court said. "That important task can be better accomplished through careful, context-sensitive scrutiny of a complaint's allegations."

Outsmarting the Market

Despite rejecting many of the fiduciaries' arguments, the high court's decision contained a few victories for the defense.

In the context of publicly traded company stock, the court announced a "general rule" that "allegations that a fiduciary should have recognized from publicly available information alone that the market was over- or undervaluing the stock are implausible."

On that point, the court said that a fiduciary usually "is not imprudent to assume that a major stock market…provides the best estimate of the value of the stocks traded on it that is available to him" (quoting *Summers v. State St. Bank & Trust Co.*, 453 F.3d 404, 38 EBC 1065 (7th Cir. 2006) (125 PBD, 6/29/06; 33 BPR 1582, 7/4/06)).

The court added that participants attempting to impose fiduciary liability on the basis of publicly available information must demonstrate the existence of "special circumstances" warranting deviation from that general rule.

Insider Trading Concerns

Turning to the issue that dominated the court's April 2 oral arguments, the court addressed Fifth Third's concern that the imposition of ERISA liability for continuing to hold declining company stock might run afoul of federal insider trading laws.

The court addressed this concern squarely, saying that ERISA "does not require a fiduciary to break the law."

"As every Court of Appeals to address the question has held, ERISA's duty of prudence cannot require an ESOP fiduciary to perform an action—such as divesting the fund's holdings of the employer's stock on the basis of inside information—that would violate the securities laws," the court said.

New Standard, Open Questions

In the context of inside information, the court appeared to articulate a new standard for participants bringing stock-drop claims.

"To state a claim for breach of the duty or prudence on the basis of inside information, a plaintiff must plausibly allege an alternative action that the defendant could have taken that would have been consistent with the securities laws and that a prudent fiduciary in the same circumstances would not have viewed as more likely to harm the fund than to help it," the court said.

In applying this standard, the Supreme Court encouraged lower courts to consider whether imposing ERISA liability on the basis of inside information could conflict with the requirements and objectives of insider trading and securities laws. The court also encouraged the Securities and Exchange Commission to announce its views on this point.

Finally, the court encouraged lower courts to consider another claim raised during oral arguments—namely, the idea that a fiduciary in possession of negative inside information affecting stock price might actually "do more harm than good" to the plan if it stopped buying employer stock. Under that theory, a fiduciary's decision to stop buying employer stock could cause a drop in stock price by signalling to the market that the fiduciary viewed the stock as a bad investment.

Litigation History

The lawsuit was brought by participants in Fifth Third Bancorp's ESOP who challenged the decision by plan fiduciaries to continue offering company stock as an investment option, despite a 74 percent drop in the share price between 2007 and 2009. The participants partially blamed the drop on the company's involvement in subprime mortgage lending.

The U.S. District Court for the Southern District of Ohio dismissed the imprudent investment claim in 2010, finding that the complaint didn't allege circumstances dire enough to overcome the presumption of prudence (227 PBD, 11/30/10; 37 BPR 2639, 12/7/10; 50 EBC 1353).

On appeal, the Sixth Circuit reversed. It clarified that the presumption can be overcome when applied to "a fully developed evidentiary record," if the participants show that a prudent fiduciary under similar circumstances would have made a different investment decision."

The Supreme Court decided to hear the case after asking the U.S. solicitor general to weigh in (240 PBD, 12/16/13; 228 PBD, 11/26/13; 58 PBD, 3/26/13; 40 BPR 2887, 12/17/13; 40 BPR 2782, 12/3/13; 40 BPR 835, 4/2/13).

The case garnered a number of amicus briefs that were largely split on the issues (59 PBD, 3/27/14; 41 BPR 751, 4/1/14).

The justices heard oral arguments on April 2, devoting virtually no attention to whether the presumption could be applied at the pleadings stage of litigation (64 PBD, 4/3/14; 41 BPR 790, 4/8/14).

In its June 25 opinion, the court vacated the Sixth Circuit's decision and remanded the case with instructions for the Sixth Circuit to reconsider whether the participant's stated a plausible claim for breach of the fiduciary duty of prudence.

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Text of the opinion is at http://www.bloomberglaw.com/public/document/Fifth_Third_Bancorp_v_Dudenhoeffer_No_12751_2014_BL_175777_US_Jun.

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