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Supreme Court Rejects Presumption of Prudence; Identifies New Considerations to "Divide the Plausible Sheep from the Meritless Goats" in the Context of ERISA Stock Drop Claims

On June 25, the Supreme Court handed down its decision in *Fifth Third Bancorp v. Dudenhoeffer*, No. 12-751, concluding that ERISA fiduciaries are no longer entitled to a presumption that they acted prudently in investing in employer stock. While the Supreme Court struck the presumption entirely, the Court provided new guidance regarding the duties of plan fiduciaries, particularly those of publicly traded companies.

Genesis and Prior Application of the Presumption

Previously, nearly every Circuit Court adopted some form of a presumption of prudence in an effort to establish a standard that balanced the need to protect participants against imprudent investments with Congress's desire to encourage ESOPs. In 1976, congressional interest in encouraging ESOPs was so strong that Senator Russell Long (D-LA), then Chair of the Senate Finance Committee and the Joint Tax Committee, announced his intention to exempt ESOPs from all ERISA fiduciary requirements. Senator Harrison Williams (D-NJ), then chair of the Senate Labor Committee, and Ian Lanoff, then Benefits Counsel to the Committee (and now a principal at Groom Law Group) spoke with Senator Long on the Senate floor about the issue. After negotiation, a final agreement was reached under which ESOPs would be exempt from ERISA's diversification requirement, but the prudence requirement would apply. Ian notes that, at the time of the agreement, he could not have predicted that courts would struggle for so long to interpret the meaning of prudence without diversification.

The presumption of prudence has been the primary basis on which ERISA "stock drop" lawsuits have been dismissed in recent years. Most courts have required plaintiffs seeking to overcome the presumption to allege facts in their complaint indicating that the company's viability as an ongoing concern was threatened, that it was facing impending financial collapse or that similar "dire circumstances" existed. *See, e.g.*, *Kopp v. Klein*, 722 F.3d 327 (5th Cir. 2013).

In *Dudenhoeffer*, the Sixth Circuit had departed from the majority of courts on its application of the presumption. *Fifth Third Bancorp v. Dudenhoeffer*, 692 F.3d 410 (6th Cir. 2012). Specifically, the Sixth Circuit refused to apply the presumption of prudence at the pleading stage, reserving it instead for the merits/evidentiary stage of the litigation. Further the Sixth Circuit only required a plaintiff to prove that "a prudent fiduciary acting under similar

circumstances would have made a different investment decision"—a much less stringent standard than most courts' dire circumstances (or similar) test. *Pfeil v. State Street Bank & Trust Co.*, 671 F.3d 585, 592–93 (6th Cir. 2012).

Supreme Court Decision

As highlighted above, the Supreme Court eliminated the presumption entirely, holding that ESOP fiduciaries are subject to ERISA's prudent expert standard and that the statutory exception related to ESOPs only relieves fiduciaries from the fiduciary duty to diversify plan investments. *Dudenhoeffer*, No. 12-751, slip op. at 2. The Court reasoned that the statutory exemption from the duty of prudence explicitly states that it only applies "to the extent that it requires diversification," ERISA § 404(a)(2), and it makes no reference to any special presumption of prudence more generally. *Dudenhoeffer*, No. 12-751, slip op. at 9.

While the elimination of the presumption of prudence was unwelcome news for plan fiduciaries, the Court recognized the need for meaningful protections for fiduciaries against frequent participant suits. In order to address such concerns, the Court outlined a framework for sorting the "plausible sheep from the meritless goats," *Dudenhoeffer*, No. 12-751, slip op. at 15, at the motion to dismiss stage.

The Court's analysis of typical "stock drop" claims may ultimately be very helpful to fiduciaries. For example, claims alleging that a fiduciary should have removed or stopped additional investments in the company stock fund because the fiduciary should have recognized *based on publicly available information* that the stock was improperly valued on the market are generally considered implausible, absent some "special circumstances." While it did not identify any examples of "special circumstances," the Court found that the significant decline in the price of Fifth Third stock as a result of the housing market collapse, and the Fifth Third fiduciaries' knowledge of Fifth Third's exposure to risk from sub-prime loans did not result in "special circumstances" that would render reliance on the market price of Fifth Third stock imprudent. *Dudenhoeffer*, No. 12-751, slip op. at 16-17.

The Court left open the possibility that plaintiffs could proceed with limited claims based on allegations that a fiduciary should have acted based on *non-public information*. However, the Court noted that plaintiffs must be able to (1) articulate what course of action the fiduciary legally could have taken to avoid incurring losses, and (2) show that a prudent fiduciary in like circumstances could not have believed that such an action would be more likely to harm rather than help the plan. The Court cautioned that ERISA's fiduciary duties could never require a fiduciary to break securities laws (*i.e.*, require the fiduciary to remove the company stock fund based on insider information), that a decision not to stop additional purchases of company stock or publicly disclose insider information should be considered in light of securities laws and objectives, and that it is important to weigh whether no prudent fiduciary could conclude that limiting additional purchases or disclosing insider information would do more harm than good (*i.e.*, trigger a drop in the stock's value). *Dudenhoeffer*, No. 12-751, slip op. at 18-20. The Court also encouraged the Securities and Exchange Commission to express its views on whether an "ERISA-based obligation either to refrain on the basis of inside information from making a planned trade or to disclose inside information to the public could conflict with the complex insider trading and corporate disclosure requirements imposed by the federal securities laws or with the objectives of those laws." *Dudenhoeffer*, No. 12-751, slip op. at 18-20.

Because the Court eliminated the presumption of prudence for investment in company stock, plan fiduciaries of plans holding company stock now must look to the *Dudenhoeffer* opinion for guidance as to the best approach for satisfying ERISA's prudence requirement with respect to company stock.

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What *Dudenhoeffer* Means for Plan Sponsors and Fiduciaries

Many plan fiduciaries have taken comfort in the presumption of prudence and have adopted plan language requiring that a plan maintain a company stock fund and that the assets within such a fund be exclusively invested in company stock (other than as required for liquidity). In our view plan fiduciaries must now identify an approach to monitoring the plan's investment in company stock designed to fulfill ERISA's prudence requirement while recognizing that ERISA's diversification requirement does not apply. The Supreme Court's opinion indicates that, with respect to publicly traded employer stock, plan fiduciaries who do not possess inside information may rely solely on the market price to ensure that company stock is properly valued. Thus, fiduciaries may want to consider, on a periodic basis, whether any "special circumstances" exist that could cause the market price for the stock to be inaccurate. We consider "special circumstances" a very narrow category, but could potentially include, for example, situations where company stock is thinly traded and, therefore, the market may not be able to establish an accurate value.

Where plan fiduciaries have knowledge of material, non-public information, the Supreme Court's opinion makes clear that ERISA does not require the fiduciaries to violate securities laws by trading on such information (*i.e.*, removing the company stock fund). However, the opinion counsels that fiduciaries could have a process in place for evaluating whether to freeze investment in employer stock or to publicly disclose material, non-public information. Importantly, such a process may be aimed at determining whether no prudent fiduciary could conclude that doing so would cause more harm to the plan than good.

In light of the Court's ruling related to inside information, plan sponsors could consider the pros and cons of continuing to appoint members to investment committees who routinely are in possession of material, non-public information. Similarly plan sponsors might also consider the benefit of engaging an independent fiduciary to manage employer stock investments. Without the burden of possessing material, non-public information, an independent fiduciary could help to alleviate some of the litigation risk associated with the Court's new stock drop framework.

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