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Supreme Court Strikes Down ESOP Presumption of Prudence and Imposes New Limits and Standards for Stock Drop Claims

In the July issue of *The Investment Lawyer*, we stated that the Supreme Court may eliminate the once settled presumption of prudence that applied to fiduciaries of Employee Stock Ownership Plans (ESOPs) covered by the Employee Retirement Income Security Act of 1974, as amended (ERISA).[1] In that column, which was drafted after the Supreme Court heard oral arguments, we suggested that plan fiduciaries and their advisers consider rethinking their approach with respect to ESOPs. That time has come. Earlier this summer, the Supreme Court announced that it was striking down the presumption of prudence in a unanimous opinion.[2] The background of the case, the Supreme Court's opinion and our views of what this means for plan fiduciaries, plan sponsors and their advisers is set forth below.

Background

Until somewhat recently, the legal landscape for "stock drop" lawsuits brought by plan participants was somewhat settled as a number of US Circuit Courts of Appeals adopted some form of the *Moench* presumption, in an effort to balance the need to protect participants against imprudent investments with what was interpreted from legislative history to be Congress' intent to encourage the sponsorship of ESOPs. The *Moench* presumption provided that a plan fiduciary's decision to continue offering company stock as an investment option was considered prudent under ERISA unless the plaintiff could show that the employer abused its discretion by continuing to offer the stock.[3] 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 a going concern was threatened, that it was facing impending financial collapse, or that similar "dire circumstances" existed.[4] Further, many plan fiduciaries base their procedures, related to the review of employer stock as a plan investment, based upon the availability of the *Moench* presumption.

This once settled area of the law was shaken by the US Court of Appeals for the Sixth Circuit in its *Dudenhoeffer* decision, which departed from

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the majority of courts on its application of the presumption.[5] Specifically, the Sixth Circuit applied the presumption of prudence at the merits/evidentiary stage of the litigation rather than at the pleading stage like a majority of courts.[6] Further, the Sixth Circuit restated its plaintiff-friendly "presumption of prudence" test, rather than the "dire circumstances" test that was followed by most circuit courts, that only requires a plaintiff to prove that "a prudent fiduciary acting under similar circumstances would have made a different investment decision."[7]

Supreme Court Decision

The issue before the Court was whether ESOP fiduciaries are entitled to a presumption that the ESOP's investment in employer stock or other securities is in accordance with the requirements of ERISA except in very limited circumstances, and if so, whether the presumption applies at the pleading stage or evidentiary stage of the litigation.

The Supreme Court eliminated the presumption entirely, holding that ESOP fiduciaries are subject to ERISA's prudent expert standard and that ERISA only provides a statutory exception from the duty of prudence as to the duty to diversify plan investments.[8] 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)[9] The statute makes no reference to any special presumption of prudence.[10] 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," at the motion to dismiss stage.[11]

While the Court's decision in *Dudenhoeffer* may in fact turn out to be helpful to plan fiduciaries who offer employer stock as an investment option, there is much more work to be done in the lower courts, which are charged with interpreting the nuances of the Court's opinion. In its opinion, the Court adhered to the efficient market theory in holding that an ERISA fiduciary "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."[12] 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, "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.[13] In our view, the "special circumstances" exception may affect less watched, thinly traded companies, where public information is not as readily available more so than large companies that are closely watched by analysts, with large trading volumes.

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 also cautioned that ERISA's duty of prudence could never require a fiduciary to break securities laws (that is, require the fiduciary to remove the company stock fund based on insider information). The Court held that lower courts should consider a fiduciary's decision not to stop additional purchases of company stock or publicly disclose insider information in light of securities laws and objectives. The Court also determined that lower courts should weigh

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whether no prudent fiduciary could conclude that limiting additional purchases or disclosing insider information would do more harm than good (that is, trigger a drop in the stock's value).[14]

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.

What *Dudenhoeffer* Means for Plan Sponsors and Fiduciaries

Over almost twenty years, many plan fiduciaries and their advisers 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 and their advisers 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.

Difficult to State a Claim Based on Public Information

The Supreme Court's opinion indicates that, with respect to publicly traded employer stock, plan fiduciaries who do not possess insider information may rely on the market price of the stock absent "special circumstances." This may mostly foreclose plaintiffs' challenges that the plan fiduciaries purchased overvalued stock. This is good news. Nevertheless, fiduciaries and their advisers 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. It appears that "special circumstances" is 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.

ERISA Fiduciaries Still Face Difficulties with Insider Information

Where plan fiduciaries of publicly traded companies 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 (that is, removing the company stock fund). However, the opinion suggests that fiduciaries may need to evaluate whether to freeze investment in employer stock or to publicly disclose material, non-public information (provided that such disclosure does not violate applicable securities laws) and whether taking either action would cause more harm to the plan than good.

In light of the Court's ruling related to insider 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 potential benefit of engaging an independent fiduciary to manage employer stock investments. While an independent fiduciary could help to alleviate some of the litigation risk associated with the Court's new stock drop framework, consideration should be given to whether shielding decision-making fiduciaries from insider information is necessarily a decision consistent with fiduciary obligations under ERISA.

Stock Drop Cases Are Not Going Away

We think it is likely that the plaintiffs bar will test the limits of the *Dudenhoeffer* decision quickly. We think that the plaintiffs bar could explore claims that offering company stock was imprudent regardless of the market price due to dim future prospects, participation in a dying industry, or other examples of why investment in such a company may not be a prudent long term investment. The plaintiffs bar has already started exploring the contours of a fiduciary's duty of loyalty to the plan when they have insider information. How these claims are drafted, and what degree of success they have, in light of

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the *Dudenhoeffer* decision, are yet to be seen. Given ERISA's six-year statute of limitations, we expect that there will be new lawsuits relating to the 2008 market decline. There is definitely more to come in this area.

NOTES

1 Please note that we also refer to ESOPs as company stock funds throughout this column.

2 Fifth Third Bancorp v. Dudenhoeffer, 134 S. Ct. 2459 (2014).

3 Moench v. Robertson, 62 F.3d 553 (3d Cir. 1995)

4 *See, e.g.*, Kopp v. Klein, 722 F.3d 327 (5th Cir. 2013); *Moench*, 62 F.3d at 572.

5 Dudenhoeffer v. Fifth Third Bancorp, 692 F.3d 410 (6th Cir. 2012).

6 *Id.* at 418.

7 *Id.*; *citing* Pfeil v. State St. Bank & Trust Co., 671 F.3d 585, 592–93 (6th Cir. 2012).

8 *Dudenhoeffer*, 134 S. Ct. at 2467.

9 ERISA § 404(a)(2).

10 *Id.* at 2468–69.

11 *Id*. at 2470.

12 *Id*. at 2471; *citing* Summers v. State St. Bank & Trust Co., 453 F.3d 404, 408 (7th Cir. 2006).

13 *Dudenhoeffer*, 134 S. Ct. at 2472.

14 *Id*.

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