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Outside Counsel

ERISA Presumption of Prudence in 'Stock Drop' Cases Rejected

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On June 23, the U.S. Supreme Court in *Fifth Third Bancorp v. Dudenhoeffer*[1] unanimously rejected the "presumption of prudence" that several courts of appeals had recognized to deal with "stock drop" cases under the Employee Retirement Income Security Act of 1974 (ERISA), as amended.[2] What should trustees of employee stock ownership plans (ESOPs) and §401(k) plans that invest in employer stock do when the price of the company begins to fall sharply? Plan fiduciaries are put on the horns of a dilemma: If they hold onto the stock, they may be accused of not acting in accordance with their duty of prudence, but if they sell the stock, they may face charges of insider trading in violation of the federal securities law.

Some of the lower courts attempted to mitigate this dilemma by recognizing a strong presumption of prudence favoring ESOP fiduciaries. For example, the U.S. Court of Appeals for the Second Circuit required the plaintiff to show that the employer was "in a 'dire situation' that was objectively unforeseeable by the settlor" of the fund.[3] Justice Stephen Breyer's opinion for the court in *Dudenhoeffer* closes off this route: "In our view the law does not create a special presumption favoring ESOP fiduciaries. Rather, the same standard of prudence applies to all ERISA fiduciaries… except that an ESOP fiduciary is under no duty to diversify the ESOP's holdings."[4] The court did, however, offer some concrete suggestions that may facilitate early dismissal of costly "stock drop" litigation.

Background

Fifth Third Bancorp sponsored and acted as trustee for the Fifth Third Bancorp Master Profit Sharing Plan, a defined-contribution employee retirement plan. From July 19, 2007, through Sept. 18, 2009, each plan participant could invest his or her voluntary contributions in employer stock, 17 mutual funds, or two "collective funds." Fifth Third matched each participant's voluntary contributions, up to 4 percent of the participant's total compensation. Although the plan initially invested these matching contributions exclusively in company stock, participants aged 55 or older with at least 10 years at the company could elect that future matching contributions be invested in the fund vehicles that were not connected to company stock.

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According to the complaint, even though the plan did not require investments in company stock, the plan invested significant assets in company stock from July 19, 2007, through Sept. 18, 2009. During that time, the plan lost "tens of millions of dollars" due to a 74 percent drop in the price of the company stock. Over time, the stock made a partial recovery to around half of its July 2007 price.

On Sept. 21, 2008, plaintiffs John Dudenhoeffer and Alireza Partovipanah, former employees of Fifth Third, filed an amended class action complaint against the company, its chief executive officer, and members of the pension committee (collectively, the defendants), alleging breaches of fiduciary duty under ERISA. In particular, they claimed that "all defendants breached their ERISA fiduciary duties by maintaining significant investment in Fifth Third Stock and continuing to offer it as an authorized investment option at a time that they knew or should have known it was imprudent to do so."

On Oct. 5, 2008, the defendants moved to dismiss the amended complaint for failure to state a claim. The U.S. District Court for the Southern District of Ohio granted the defendants' motion on Nov. 24, 2008, reasoning that the plan was an ESOP and that defendants were entitled to a presumption that their "decision to remain invested in employer securities was reasonable." The complaint did not, in the court's view, defeat this presumption because it alleged no facts demonstrating "the type of dire financial predicament sufficient to establish a breach of fiduciary duty" under then-prevailing circuit precedent. In particular, the court highlighted Fifth Third's continued existence as a functional and successful financial services firm, the decision of certain state pension funds to increase their position in company stock, and Fifth Third's enrollment with the Treasury Department's Capital Purchase Program — as evidence that Fifth Third remained viable despite its loss of stock value.[5]

On appeal, the U.S. Court of Appeals for the Sixth Circuit reversed. The appeals court held that ESOP fiduciaries were not generally exempt from the duty of prudence, and that the plaintiffs could overcome any presumption of reasonableness in favor of the defendants "by showing that a prudent fiduciary acting under similar circumstances would

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have made a different investment decision."[6]

The Supreme Court Opinion

On certiorari review, the Supreme Court, per Justice Breyer, unanimously ruled that ERISA does not create a special presumption favoring ESOP fiduciaries. Under §1104(a)(2), an ESOP fiduciary is exempt from the diversification requirement and from the duty of prudence "but only to the extent that it requires diversification." The court also rejected defendants' argument that the scope of the duty of prudence depended on "the specific nonpecuniary goal[s] set out in an ERISA plan." Under §1104(a)(1)(D), the court explained, "the duty of prudence trumps the instructions of a plan document, such as instructions to invest exclusively in employer stock even if financial goals demand the contrary."[7]

Rather than rely on a special presumption that foreclosed all "stock drop" litigation irrespective of the merits, the court suggested the screening task of "divid[ing] the plausible sheep from meritless goats" could be "better accomplished through careful context-sensitive scrutiny of a complaint's allegations."[8] The court proceeded to offer a suggested road map of how lower courts should deal with "stock drop" cases in the future.

1. Are the defendants ERISA fiduciaries? Before discussing the *Dudenhoeffer* road map, the first step is to make sure that the defendants are ERISA fiduciaries. As the Second Circuit recently explained in *Coulter v. Morgan Stanley & Co.*,[9] the decision whether to fund company contribution in stock or cash is a settlor function: "Even assuming that the defendants had full authority and discretion to satisfy company contributions in stock or cash, the exercise of this discretion does not constitute fiduciary conduct under ERISA; the discretionary act must be undertaken with respect to plan management or administration."[10]

2. Has a plausible duty-of-prudence claim been stated? Assuming the defendants are ERISA fiduciaries, the Dudenhoeffer court advised the defendants must state "a plausible duty-of-prudence claim" under the pleading standard announced in *Ashcroft v. Iqbal*[11] and *Bell Atlantic Corp. v. Twombly*.[12] The court then stated it was remanding the case to the lower courts to apply this pleading standard "in light of the following considerations":

a. The prudence of relying on the market price of the stock. In line with its ruling the same week in *Halliburton Co. v. Erica P. John, Inc.*,[13] reaffirming the rebuttable "presumption of reliance" on stock prices set in efficient publicly traded markets, the Dudenhoeffer court stated that ERISA fiduciaries who can "reasonably see 'little hope of outperforming the market…based solely on their analysis of publicly available information,' may, as a general matter, likewise prudently rely on the market price."[14]

> Assuming the defendants are ERISA fiduciaries, the Dudenhoeffer court advised the defendants must state "a plausible duty-of-prudence claim" under the pleading standard announced in 'Iqbal' and 'Twombly.'

b. The need to show "special circumstances" affecting the reliability of the share price. To overcome the presumption that it is prudent to rely on market price in major stock markets, the plaintiff would have to show "special circumstances affecting the reliability of the market price…that would make reliance on the market's valuation imprudent." Pointedly, the Sixth Circuit's reliance on the complaint's allegation that the defendants were imprudent in holding company stock because they were aware of risks of the lending practices Fifth Third was engaged in "appears to have been based on an erroneous understanding of the prudence of relying on market prices."[15]

c. Concerning nonpublic information, was there an alternative action available that would not have caused more harm to the fund than good? With respect to nonpublic information that was available to the defendants only because they were Fifth Third insiders, the court further advised:

> To state a claim for breach of the duty of 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.[16]

"[T]hree points inform the requisite analysis." First, the ERISA duty of prudence "does not require a fiduciary to break the law," including the insider-trading prohibitions. Second, the courts would need to consider whether any asserted fiduciary duty to refrain from continuing to make purchases of employer stock "could conflict with the complex insider trading and corporate disclosure requirements imposed by the federal securities laws or with the objectives of those laws."[17] Finally, the courts would also need to consider whether stopping employer stock purchases "would do more harm than good to the fund by causing a drop in the stock price and a concomitant drop in the value of the stock already held by the fund."[18]

Implications

What the court in *Dudenhoeffer* gives to plaintiffs in "stock drop" litigation with one hand — rejecting the special presumption of prudence favoring ESOP fiduciaries — it appears to take away with the other hand, by offering a road map of suggestions that, if honored by the lower courts, will make it difficult to maintain such litigation in the future.

1. *Fifth Third Bancorp v. Dudenhoeffer,* No. 12-751, 2014 U.S. LEXIS 4495 (U.S. June 25, 2014).
2. 29 U.S.C. §1001 et seq.
3. *In re Citigroup ERISA Litigation*, 662 F.3d 128, 139-140 (2d Cir. 2011).
4. *Fifth Third Bancorp*., 2014 U.S. LEXIS 4495, *16-17.
5. *Dudenhoeffer v. Fifth Third Bancorp*, 757 F.Supp.2d 753 (S.D. Ohio 2010), reversed, 692 F.3d 410 (6th Cir. 2012), vacated & remanded, 2014 U.S. LEXIS 4495 (U.S. June 25, 2014).
6. 692 F.3d at 418.
7. *Fifth Third Bancorp*., 2014 U.S. LEXIS 4495, *20.
8. Id. at *27.
9. 2014 U.S. App. LEIXIS 10027 (2d Cir. May 29. 2014).
10. Id. *5.
11. 556 U.S. 662 (2009).
12. 550 U.S. 544 (2007).
13. No. 13-317, 82 U.S.L.W. 4522 (U.S., June 23, 2014).
14. *Fifth Third Bancorp*., 2014 U.S. LEXIS 4495, *30.
15. Id. at *31.
16. Id. at *32.
17. Id. at *34.
18. Id. at *35.

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