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LITIGATION

New Standards Announced for ERISA Company Stock Cases

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Special to the Legal

In the final week of its term, the U.S. Supreme Court issued the opinion of *Fifth Third Bancorp v. Dudenhoeffer*, --- U.S. --- (June 25, 2014), an important decision defining the standard of care that the Employee Retirement Income Security Act of 1974 (ERISA) imposes on certain plan fiduciaries. While failing to generate the media coverage of other hot-button opinions the court issued that week, the impact of *Fifth Third* to ERISA practitioners cannot be overstated: It fundamentally changed the legal landscape of ERISA company stock cases and will have far-reaching effects on ERISA jurisprudence for years to come.

In *Fifth Third*, a unanimous court held—contrary to every court of appeals that had addressed the issue—that fiduciaries of employee stock ownership plans (ESOPs) are not entitled to a defense-friendly presumption that continuing to purchase and retain company stock is prudent; instead, ESOP fiduciaries must comply with the same stringent duty of prudence (except to the extent it would require diversifying plan assets) that ERISA imposes on all plan fiduciaries. But the decision was far from a one-sided victory for plaintiffs: After rejecting the "presumption of prudence" in its entirety, the court went on to establish extremely stringent pleading requirements for ERISA company stock cases, the application of which will almost certainly result in more dismissals of these types of cases.

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ERISA company stock cases generally allege that 401(k) or ESOP plan fiduciaries (who often are high-ranking corporate officials) breached their fiduciary duties by continuing to allow investment in company stock at a time they knew or should have known that the stock was not a prudent investment. Allegations of imprudence may be based upon publicly available information, the fiduciaries' access to nonpublic (or inside) information, or a combination of the two. In *Fifth Third*, the plaintiffs alleged that public and nonpublic information available to the plan fiduciaries showed that Fifth Third Bancorp stock was overvalued and excessively risky due to the impending collapse of the subprime lending market, which comprised a large portion of Fifth Third's business.

Prior to the Supreme Court issuing its opinion, federal courts around the country had held that ESOP fiduciaries were entitled to a "presumption of prudence" when a participant challenged the fiduciaries' decision to buy or hold company stock. The courts reasoned that a presumption was appropriate given the unique nature of ESOPs, plans that are designed to invest primarily or exclusively in employer stock. In light of an ESOP's singular purpose, courts found that fiduciaries should be presumed to have acted prudently when continuing to purchase and hold employer stock but that a plaintiff could rebut the presumption by showing that the fiduciary had "abused its discretion"—or, put another way, by showing that the fiduciary could not have reasonably believed that continuing to purchase or hold the stock was in keeping with the settlor's expectation of how a prudent fiduciary would act. (See, e.g., *Moench v. Robertson*, 62 F.3d 553, 571 (3d Cir. 1995).)

Although courts generally agreed that a "presumption of prudence" was available to ESOP fiduciaries, they differed substantially on when in the litigation process fiduciaries could invoke the protection. In *Moench*, the first appellate decision to adopt the theory, the court applied the presumption to a developed factual record on summary judgment. Over time, however, other courts had ruled that the doctrine applied from the start of a case and that, to plausibly state a cognizable claim, ERISA plaintiffs must plead facts in their complaint sufficient to overcome the presumption. (See, e.g., *In re Citigroup ERISA Litigation*, 662 F.3d

128, 139-40 (2d Cir. 2011) (presumption of prudence applies at pleadings stage and requires plaintiff to allege that company was in "dire [financial] situation" unforeseen by settlor).)

At the district court level in *Fifth Third—Dudenhoeffer v. Fifth Third Bancorp*, 757 F. Supp. 2d 753 (S.D. Ohio 2010)—the trial judge had dismissed the complaint, concluding that the "presumption of prudence" applied on the pleadings and that the plaintiffs had failed to plead facts sufficient to overcome the presumption. On appeal, however, the U.S. Court of Appeals for the Sixth Circuit reversed, in *Dudenhoeffer v. Fifth Third Bancorp*, 692 F.3d 410 (2012), holding that the "presumption of prudence" is an evidentiary presumption that does not apply until the plaintiffs have had the ability to develop a full evidentiary record—usually on summary judgment or at trial. The Supreme Court subsequently granted Fifth Third's petition for a writ of certiorari to resolve the split among the courts of appeals over when the "presumption of prudence" should apply.

Writing for a unanimous Supreme Court, Justice Stephen Breyer expeditiously rejected application of the presumption in its entirety. Notwithstanding the lower courts' near-universal recognition of the "presumption of prudence," the Supreme Court held that "the law does not create a special presumption favoring ESOP fiduciaries[;] [r]ather, the same standard of prudence applies to all ERISA fiduciaries, including ESOP fiduciaries, except that an ESOP fiduciary is under no duty to diversify the ESOP's holdings." The court reasoned that nothing in ERISA supported the existence of a special presumption for ESOP fiduciaries and that none of the arguments Fifth Third advanced—concerning the special purpose of ESOPs, the avoidance of insider trading prohibitions, or the purported need to "weed out" meritless suits—could trump the plain language of the statute. ERISA imposes stringent obligations, including the duty of prudence, on all fiduciaries, the court stated, and nothing about the special nature of ESOPs modified or reduced the extent of those legal obligations.

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Rather than simply remanding the case for reconsideration of the complaint in the absence of any presumption, however, the court went on to provide broad-ranging guidance to lower courts concerning the sufficiency of allegations in ERISA company stock cases. With respect to allegations that employer stock was imprudent based upon publicly available information, the court stated 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 reasoned that a fiduciary should not be liable for failing to "out-guess" the general market. Regarding allegations that employer stock was imprudent based on nonpublic material information, the court wrote that "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."

In its guidance, the court made three other important points for lower courts to consider in determining the sufficiency of an ERISA complaint: (1) fiduciaries cannot be compelled to violate the law (including the securities laws); (2) these cases implicate complex insider-trading prohibitions and corporate disclosure requirements; and (3) in evaluating whether an ERISA fiduciary should have stopped making additional purchases of employer stock, courts should "consider whether the complaint has plausibly alleged that a prudent fiduciary in the defendant's position could not have concluded that stopping purchases—which the market might take as a sign that insider fiduciaries viewed the employer's stock as a bad investment—or publicly disclosing negative information 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." Taken collectively, these guiding principles provide ERISA defendants with far greater liability protection than the presumption ever offered.

The takeaway from *Fifth Third* is that, notwithstanding the court's surprising rejection of the "presumption of prudence," it will now be even more difficult for ERISA plaintiffs to successfully bring company stock cases in the absence of underlying corporate fraud or an impending corporate bankruptcy. ERISA defendants should not mourn the death of the presumption but, instead, embrace the court's efforts to significantly narrow the viability of ERISA company stock cases in the future. What the court took away in one hand, it more than gave back in the other. •