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Supreme Court Axes "Presumption of Prudence" in ESOP Stock-Drop Cases

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On June 25, 2014, the U.S. Supreme Court issued a decision that gives comfort to "stock-drop" plaintiffs and may cause shockwaves among employee stock ownership plan (ESOP) fiduciary committees. In *Fifth Third Bancorp v. Dudenhoeffer*,[1] the Court held that ESOP fiduciaries are not entitled to any "presumption of prudence" in lawsuits challenging their decision to invest plan assets in company stock. Instead, ESOP fiduciaries "are subject to the same duty of prudence that applies to ERISA fiduciaries in general, except that they need not diversify the fund's assets."

In *Dudenhoeffer*, the plaintiffs were Fifth Third (hereinafter "Company") employees and participants in a defined contribution individual account plan that offered, among its 20 investment options, a company stock fund designated as an ESOP. The plaintiffs alleged that the defendants violated ERISA's duty of prudence by continuing to hold substantial investments in Company stock, and continuing to offer Company stock as an investment option, even though they knew that it was overvalued and excessively risky.

The plaintiffs claimed the defendant fiduciaries were aware of this for two reasons: *First*, publicly available information, such as newspaper articles, allegedly provided early warning signs that the stock was inflated due to the Company's significant lending to subprime lenders; and *second*, the defendants were allegedly aware of *nonpublic (i.e., insider) information*, that the Company had, allegedly, deceived the market by making material misstatements about its financial prospects.

The plaintiffs claimed that a prudent fiduciary in the defendants' shoes would have done one or more of the following: (1) sold the ESOP's holdings of company stock before its value declined; (2) refrained from purchasing any more company stock; (3) canceled the pension plan's ESOP option; or (4) disclosed the insider information so that the market would adjust its valuation of the company's stock downward, and the ESOP would no longer be overpaying for it.

Instead of doing these things, the defendants continued to hold and buy company stock. When the market crashed, its value fell by 74% between July 2007 and September 2009, when the plaintiffs filed their lawsuit.

Consistent with every federal appellate court that had previously decided the issue, the U.S. Court of Appeals for the Sixth Circuit held that ESOP fiduciaries are entitled to a "presumption of prudence." There were, however, differences among the federal appellate courts as to whether

1 ___U.S. ___, No. 12-751 (June 25, 2014).

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this presumption applies at the pleading stage (and thus could result in dismissal of the complaint if there was inadequate pleading of facts sufficient to overcome the presumption) or at trial (and was thus an evidentiary issue). As a consequence, the Supreme Court decided to hear the case. Its holding eviscerated the presumption entirely.

ERISA subjects all pension plan fiduciaries to a duty of prudence. Section 404 provides, in part, that "a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries … for the exclusive purpose of … providing benefits to participants and their beneficiaries; and … defraying reasonable expenses of administering the plan…."

The statute further requires fiduciaries to discharge these duties "with the care, skill, prudence and diligence under the circumstances then prevailing that a reasonably prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims …."

Further, the statute normally requires fiduciaries to *diversify* investments "so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so …."

However, Congress exempted fiduciaries of ESOPs, to some degree, from the diversification and prudence requirements. ERISA holds that its diversification and prudence requirements (only to the extent that the latter requires diversification) *are not violated by acquiring or holding company stock*. Thus, an ESOP fiduciary need not diversify the investments of the plan so as to minimize the risk of large losses, or to act "with the care, skill, prudence and diligence" of a "prudent man," insofar as that duty "requires diversification."

The Court noted that federal courts of appeals had gone beyond this express provision of ERISA by giving ESOP fiduciaries a "presumption of prudence" when their decisions to hold or buy employer stock are challenged as imprudent.

Thus, for example, the Ninth Circuit has held that a beneficiary must "make allegations that clearly implicate the company's viability as an ongoing concern or show a precipitous decline in the employer's stock … combined with evidence that the company is on the brink of collapse or is undergoing serious mismanagement."[2]

And the Seventh Circuit has described the presumption as requiring plaintiffs to "allege and ultimately prove that the company faced 'impending collapse' or 'dire circumstances' that could not have been foreseen by the founder of the plan."[3]

But the Supreme Court rejected this notion, stating, "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, including ESOP fiduciaries, except that an ESOP fiduciary is under no duty to diversify the ESOP's holdings."

The Court rejected the defendants' argument that an ESOP's explicit requirement to invest assets primarily in shares of company stock should trump the duty of prudence—to the contrary, the Court held, the opposite is true. The Court also held that a plan sponsor may not reduce or waive the prudent man standard of care by specific language in the plan document.

Notwithstanding these rejections of the defendant fiduciaries' position, the Court rejected the *plaintiffs'* argument that mere fluctuations in stock price should have alerted the fiduciaries to the danger of investing in company stock. The Court stated: "In our view, 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 agreed that normally, it is prudent for fiduciaries to rely on the stock price as a reasonable estimate of its value, and not expect to outperform the market based solely on their analysis of publicly available information—absent "publicly available information … pointing to a special circumstance affecting the reliability of the market price as an unbiased assessment of the security's value … that would make reliance on the market's valuation imprudent." (Internal quotations omitted)

Perhaps the most troublesome aspect of the case involved the participants' argument that the defendants imprudently failed to act on the basis of *nonpublic, inside information* indicating that the market was overvaluing company stock. For their part, the fiduciary defendants pointed out that the participants' position would lead to conflicts with the legal prohibition of insider trading, insofar as ESOP fiduciaries, who are often company insiders, might be *compelled* to use insider information in making ESOP investment decisions.

2 *Quan v. Computer Sciences Corp.*, 623 F. 3d 870, 882 (9th Cir. 2010).

3 *White v. Marshall & Ilsley Corp.*, 714 F. 3d 980, 989 (7th Cir. 2013).

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The Court disposed, to some degree, of both arguments. The Court first ruled that, in order for a beneficiary to state a claim for breach of the duty of prudence based on 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 recognized, though, that the duty of prudence under ERISA "does not require a fiduciary to break the law." Consistent with this, the Court ruled that "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 also ruled that when beneficiaries claim that fiduciaries have failed to take into account insider information in making ESOP investment decisions, a court "should" (read as, "must") consider whether doing so "could conflict with the complex insider trading and corporate disclosure requirements imposed by the federal securities laws or with the objectives of those laws."[4]

And finally, on this point, the Court expressed additional concern—lower courts, it ruled, need to consider whether a prudent fiduciary, faced with a consideration to trade on insider information, might not appropriately decide that doing so would do more harm than good to the value of the stock, insofar as the market might consider this as a sign "that insider fiduciaries viewed the employer's stock as a bad investment" or even cause a drop in the stock price and in the value of the ESOP funds.

Thus, the Court undoubtedly lessened the burden on plaintiffs in ESOP stock-drop cases, and made clear that ESOP fiduciaries must be vigilant in making investment decisions, and do not have a free pass to invest in company stock when doing so is not prudent. However, the Court also made clear that fiduciaries need not trade based on material insider information, nor do they ordinarily need to second-guess whether the market price of a publicly traded stock accurately reflects its value.

Based on the decision, ESOP fiduciary committees may want to rethink whether their members should possess non-public information concerning the company's finances. Perhaps the result of the decision will be to give a permanent "pass" to C-level executives' serving on these committees.

Further, in the absence of the presumption of prudence on the part of the fiduciary committee, participants in non-public company ESOPs in particular may have a better chance of prevailing in stock-drop cases. Public information creates a stock price that is presumed to be a valid reflection of its market value. ESOP fiduciaries of privately held companies, on the other hand, have no such basis to defend stock valuations and are more likely to be vulnerable to challenges without a clear (and, ideally, independently determined) valuation.

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4 The Court pointedly noted that the SEC "has not advised us of its views on these matters, and we believe those views may well be relevant."

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