
employee benefits/ labor and employment lawflash

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Supreme Court Rejects “Presumption of Prudence” in ERISA Employer Stock Cases

The Court’s Dudenhoeffer decision also provides some guidance for scrutinizing such claims at the pleadings stage.

On June 25, the U.S. Supreme Court issued its unanimous decision in *Fifth Third Bancorp v. Dudenhoeffer*,¹ holding that fiduciaries of employee stock ownership plans (ESOPs)² are not entitled to a “presumption of prudence” when their decisions to buy or hold employer stock are challenged as violations of the fiduciary duty of prudence imposed under the Employee Retirement Income Security Act of 1974 (ERISA).³

In rejecting the presumption, the Court disagreed not only with the defendants, but also with all seven U.S. Courts of Appeals that had previously adopted the presumption. The Court reasoned that, while the presumption was created to “reconcile congressional directives that are in some tension with each other,”⁴ it is ultimately unsupported by ERISA’s provisions and is an inappropriate tool for weeding out meritless claims. Thus, the Court held that, while ESOP fiduciaries are exempted from the duty of prudence insofar as that duty would require diversification of ESOP assets, they are otherwise “subject to the duty of prudence just as other ERISA fiduciaries are.”⁵

Nevertheless, the Court recognized the “legitimate” concern that, without the protection of the presumption, ESOP fiduciaries with alleged access to nonpublic information (concerning publicly traded employer stock) will face conflicts between protecting the value of plan assets and the prohibition on insider trading. The Court also recognized the risk that the proliferation of meritless “stock drop” claims will undermine Congress’s desire to encourage the use of ESOPs. The Court reasoned that the best way to address these concerns is “through careful, context-sensitive scrutiny of a complaint’s allegations”⁶ under the rigorous pleading standards established in *Twombly*⁷ and *Iqbal*.⁸ To that end, the Court provided guidance for evaluating the plausibility of stock-drop claims at the pleadings stage.

Background on ERISA Stock-Drop Claims

To date, more than 200 employer “stock drop” class actions have been filed, alleging that plan fiduciaries breached their ERISA duties of prudence and loyalty by allowing participants to invest their plan accounts in

1. No. 12-751 (U.S. June 25, 2014), available at http://www.supremecourt.gov/opinions/13pdf/12-751_d18e.pdf.

2. An ESOP is a qualified defined contribution plan, designed to invest primarily in qualifying employer securities as defined by the IRC and applicable regulations.

3. This holding presumably applies equally to fiduciaries of non-ESOP plans that invest in employer stock.

4. *Dudenhoeffer*, No. 12-751, slip op. at 4.

5. *Id.* at 9.

6. *Id.* at 15.

7. *Bell Atl. Corp. v. Twombly*, 550 U.S. 544 (2007).

8. *Ashcroft v. Iqbal*, 556 U.S. 662 (2009).

employer stock.⁹ Following the Enron and WorldCom scandals and the recent global financial crisis, there was a significant uptick in the filing of these complaints—often as tagalongs to federal securities fraud complaints.

Stock-drop cases generally boil down to two substantive claims: (1) a “prudence” claim, alleging that employer stock became an imprudent investment because of circumstances adversely affecting the company and that the plan fiduciaries breached their fiduciary duties by failing to liquidate the plan’s employer-stock holdings or refrain from purchasing more employer stock and (2) a misrepresentation claim, alleging that the plan fiduciaries knew or should have known about the circumstances adversely affecting the company and that they breached their fiduciary duties by affirmatively misleading or failing to warn participants about the risks.

While these lawsuits typically target publicly held companies, similar claims against fiduciaries of privately held ESOPs have proliferated as well.

“Presumption of Prudence”

Recognizing that federal policy encourages employee ownership of employer stock, as of 2013, all seven federal Courts of Appeals that considered the issue had adopted the “presumption of prudence.” Under this standard, courts generally held that ESOP or other eligible individual account plan (EIAP) fiduciaries are entitled a strong “presumption” that their decisions to permit continued investment in employer stock were prudent under ERISA. Indeed, absent allegations that the employer was on the brink of collapse or facing other “dire” circumstances, many courts held that plaintiffs’ stock-drop claims could not withstand a motion to dismiss.

While the U.S. Courts of Appeals for the Second, Third, Fifth, Sixth, Seventh, Ninth, and Eleventh Circuits all adopted the presumption, in recent years, courts began to diverge on the following issues:

- The type of plan language (mandatory, permissive, or something in between) regarding the plan’s investment in employer stock that was needed to trigger the presumption
- The type of factual circumstances needed to overcome the presumption (e.g., “dire financial circumstances,” “impending collapse,” or something less severe)
- Whether the presumption was properly applied on a motion to dismiss

Despite these differences, the presumption remained a potent defense successfully asserted by defendants in cases across the United States.

Lower Court Proceedings in *Dudenhoeffer*

The *Dudenhoeffer* plaintiffs were former participants in Fifth Third Bank’s 401(k) plan. The plan provided participants with 20 different investment funds from which to choose, including an ESOP designed to be “invested primarily in shares” of Fifth Third common stock. The plaintiffs invested a portion of their accounts in the stock fund and suffered losses when the price of Fifth Third stock declined during the recent global financial crisis. Seeking to recover those losses, plaintiffs sued Fifth Third and other defendants in the Southern District of Ohio, alleging breaches of fiduciary duty under ERISA.

Among other things, the plaintiffs alleged that the plan fiduciaries breached their fiduciary duty of prudence by allowing the ESOP to remain invested in Fifth Third stock. According to the plaintiffs, both public information concerning the risks associated with subprime lending and nonpublic information regarding the company’s financial prospects rendered Fifth Third stock an “imprudent” investment.

The defendants moved to dismiss, arguing that the plaintiffs had failed to plausibly allege facts sufficient to overcome the presumption of prudence. The district court agreed and dismissed the plaintiffs’ imprudent

9. For more information on ERISA stock-drop claims, see our December 2013 White Paper, “Supreme Court to Decide Applicability of the ‘Prudence Presumption’ in ERISA Stock Cases: ESOP and 401(k) Plan Sponsors and Fiduciaries, Take Note,” available at www.morganlewis.com/pubs/WhitePaper_ApplicabilityPrudencePresumptionInERISAStockCases_20dec13.pdf.

investment claims for failure to state a claim.

The Sixth Circuit reversed. Although the court agreed that the presumption of prudence applied to the plaintiffs' imprudent investment claim, it held that the presumption was evidentiary, rather than substantive, and thus inapplicable at the pleadings stage. The court concluded that, ignoring the presumption, the plaintiffs' allegations were sufficient to state a claim for breach of the fiduciary duty of prudence with respect to continued investment in Fifth Third stock. Thereafter, the defendants filed a petition for certiorari with the Supreme Court, which was granted on December 13, 2013.

Supreme Court's Opinion

Rejection of the Presumption of Prudence

The Court began its opinion by holding that ESOP fiduciaries are not entitled to a presumption of prudence. "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."¹⁰

First, the Court acknowledged that the presumption was born out of the lower courts' desire to "reconcile" competing congressional directives that both impose a "prudent man standard of care" on all pension plan fiduciaries **and** strongly encourage the use of ESOPs which, by definition, "are *not* prudently diversified."¹¹ The Court reasoned, however, that ERISA's text does not support a "special presumption favoring ESOP fiduciaries."¹² As the Court explained, ERISA's fiduciary provisions make "no reference to a special 'presumption'" and do "not require plaintiffs to allege that the employer was on the 'brink of collapse,' under 'extraordinary circumstances,' or the like."¹³ Rather, ERISA provides that fiduciary duties in the ESOP context are modified "in a precisely delineated" way: It exempts ESOP fiduciaries from the ordinary duty to diversify plan assets and from the duty of prudence, "but '*only to the extent it requires diversification.*'"¹⁴

Next, the Court addressed a number of the defendants' arguments in support of the presumption. The Court first rejected the statutory argument that the "special purpose" of an ESOP—allowing employees to invest in their employer—warranted application of the presumption. The defendants argued that, because of this special purpose, investment in employer stock may remain prudent for nonpecuniary reasons (e.g., promoting employee ownership), even when the stock might otherwise be deemed an imprudent means of providing certain financial benefits (e.g., retirement savings). The Court explained that, although ERISA defines the duty of prudence in terms of what a reasonable person would do "in the conduct of an enterprise of a like character and with like aims,"¹⁵ this language refers only "to the sort of *financial* benefits (such as retirement income) that trustees who manage investments typically seek to secure for the trust's beneficiaries."¹⁶

The Court also rejected the defendants' related trust-law argument. The defendants argued that "by commanding the ESOP fiduciaries to invest primarily in Fifth Third stock, the plan documents waived the duty of prudence to the extent that it comes into conflict with investment in Fifth Third stock—at least unless 'extraordinary circumstances' arise that so threaten the goal of employee ownership of Fifth Third stock that the fiduciaries must assume that the settlor would want them to depart from that goal under the common-law 'deviation doctrine.'"¹⁷ The Court reasoned that this argument was doomed under prior precedent holding that plan documents cannot supplant a fiduciary's duties under ERISA.

10. *Dudenhoeffer*, No. 12-751, slip op. at 1–2.

11. *Id.* at 4–5 (emphasis in original).

12. *Id.* at 8.

13. *Id.* at 9.

14. *Id.* (emphasis in original).

15. ERISA, § 1104(a)(1)(B).

16. *Dudenhoeffer*, No. 12-751, slip op. at 10 (emphasis in original).

17. *Id.* at 12.

By contrast, the Court agreed with the defendants that the nature of the plaintiffs' claims posed a "legitimate" concern that, without the presumption, ESOP fiduciaries with alleged access to nonpublic information concerning the employer would face "conflicts with the legal prohibition on insider trading."¹⁸ The Court reasoned, however, that the presumption ultimately "is an ill-fitting means of addressing" this concern in light of various "alternative[s]" discussed below.¹⁹

Finally, the Court concluded that the presumption is an inappropriate means to "weed out" meritless claims.²⁰ The Court acknowledged that "in many cases an ESOP fiduciary who fears that continuing to invest in company stock may be imprudent finds himself between a rock and a hard place: If he keeps investing and the stock goes down he may be sued for acting imprudently . . . , but if he stops investing and the stock goes up he may be sued for disobeying the plan documents."²¹ Nevertheless, while the Court recognized that this conundrum threatened to upset the "careful balancing" between enforcing ERISA's requirements and Congress's goal of encouraging the use of ESOPs, it reasoned that the presumption is too blunt a tool for distinguishing between plausible and meritless claims.²² The Court held that this "important task can be better accomplished through careful, context-sensitive scrutiny of a complaint's allegations" under Federal Rule of Civil Procedure 12(b)(6).²³

Guidance for Evaluating Plausibility of ERISA Stock-Drop Claims at the Pleadings Stage

After rejecting the presumption of prudence, the Court set out to provide guidance to district courts for evaluating the plausibility of stock-drop claims at the pleadings stage. Significantly, the Court vacated the Sixth Circuit's conclusion that, absent the prudence presumption, plaintiffs had stated a plausible imprudent investment claim. The Court ordered the Sixth Circuit, on remand, to reevaluate the plaintiffs' claim in light of a number of specific considerations.

To begin, the Court held that, at least where company stock is publicly traded, any claim that a fiduciary should have concluded that employer stock was over- or under-valued based on publicly available information is "implausible as a general rule."²⁴ The Court based this reasoning on Judge Posner's oft-repeated statement that it "is not imprudent to assume that a major stock market . . . provides the best estimate of value of the stocks traded on it that is available to him."²⁵ The Court expressly did not consider whether a plaintiff could avoid this "general rule" of implausibility by alleging a "special circumstance" undermining the reliability of a stock's market price as an "unbiased assessment of the security's value in light of all public information."²⁶

The Court then turned to the issue of **nonpublic** information. First, the Court rejected as implausible any claim that fiduciaries violate their duty of prudence by failing to **sell** company stock based on nonpublic information. The Court explained that, "[a]s every Court of Appeals to address the question has held, 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."²⁷

The Court also addressed claims alleging that fiduciaries were required to **refrain** from buying additional shares of employer stock based on nonpublic information or to **disclose** that information publicly. The Court observed

18. *Id.* at 13.

19. *Id.*

20. *Id.* at 15.

21. *Id.* at 14.

22. *Id.*

23. *Id.* at 15.

24. *Id.* at 16.

25. *Id.* at 17 (quoting *Summers v. State Street Bank & Trust Co.*, 453 F. 3d 404, 408 (7th Cir. 2006)).

26. *Id.* (internal quotations omitted). As a practical matter, such an allegation could well prove to be self-defeating because the plaintiffs might then need to prove reliance without resorting to a "fraud on the market" theory. *Cf. Halliburton Co. v. Erica P. John Fund, Inc.*, No. 13-317, slip op. at 20 (U.S. June 23, 2014), available at http://www.supremecourt.gov/opinions/13pdf/13-317_mh0.pdf ("[a]ny showing that severs the link between the alleged misrepresentation and . . . the price received (or paid) by the plaintiff . . . will be sufficient to rebut the presumption of reliance' because 'the basis for finding that the fraud had been transmitted through the market price would be gone.'").

27. *Dudenhoeffer*, No. 12-751, slip op. at 19.

that, in evaluating these claims, district courts “should consider the extent to which an ERISA-based obligation” to “refrain” or “disclose” may “conflict with the complex insider trading and corporate disclosure requirements imposed by the federal securities laws or with the objectives of those laws.”²⁸ The Court further invited the Securities and Exchange Commission to provide guidance in this regard.

In addition, the Court admonished that lower courts evaluating such “refrain” or “disclose” claims must “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.”²⁹ However, the Court provided no additional guidance for how best to apply this “more harm than good” analysis at the pleadings stage.

Implications

What Stock-Drop Claims and Defenses May Look Like at the Pleadings Stage

The Court’s decision may, at least in the short term, lead to an increase in the number of stock-drop cases filed across the United States. At the same time, stock-drop plaintiffs will be forced to narrow and otherwise refine stock-drop claims in a manner that may diminish the potential liability they engender. At least with respect to publicly traded employer stock, plaintiffs will no longer be able to plausibly allege that fiduciaries imprudently failed to sell off employer stock based on nonpublic information.³⁰ Plaintiffs instead will need to allege sufficient facts that fiduciaries imprudently failed to “refrain” from purchasing additional employer stock based on nonpublic information or that they imprudently failed to disclose that information (and could have done so consistent with securities laws and regulations). In addition, plaintiffs must allege that a reasonable fiduciary could not have concluded that “refraining” or “disclosing” would have done the plan more harm than good.

Importantly, ERISA imposes a duty of prudence—not prescience—and these inquiries must focus on what the fiduciaries reasonably could have done based on the information available at the time and without the benefit of hindsight.

The Court’s opinion makes it clear that district courts should closely scrutinize stock-drop claims and be prepared to weed out those that are implausible in light of the considerations outlined above. The opinion also leaves the door open for defense arguments—available at the pleadings stage and beyond—that any claimed failure to “refrain” or “disclose” conflicts with applicable securities laws.

Considerations for Public Company Plan Sponsors

Plan sponsors already have adopted a number of different strategies and structures for their company stock funds. Some plan sponsors have imposed specific limits on participant investments in employer stock or revised their fiduciary governance structure, while others have appointed an independent fiduciary for the fund. Still others have tailored plan provisions to incorporate prior court decisions. Plan sponsors will want to review their current structures and strategies in light of *the Dudenhofer* decision to consider whether they should revisit their plan design with respect to employer stock. Considerations may include revising the plan’s fiduciary governance and committee structures, adopting additional policies and procedures, reviewing and updating plan documents and participant disclosures, and obtaining advice as appropriate from the plan’s advisor and, as applicable, independent fiduciaries to support the ongoing prudence of employer stock investments and fiduciary decisionmaking, with an eye toward risk mitigation and the Court’s guidance from this decision. Plan sponsors and fiduciaries may want to recognize the limits the Court’s decision may have applied to their reliance on plan provisions to circumscribe their statutory responsibilities.

28. *Id.*

29. *Id.* at 20.

30. The Court’s reasoning focused on ESOPs involving publicly traded employer stock, and much of its reasoning creates unique concerns for sponsors and fiduciaries of privately held ESOPs.

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