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Employee Stock Option Plans

US Supreme Court Rejects 'Presumption of Prudence' in ERISA Stock-Drop Cases and Adopts New Pleading Standards in *Fifth Third Bancorp v. Dudenhoeffer*

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On June 25, 2014, the US Supreme Court issued its highly anticipated decision in *Fifth Third Bancorp v. Dudenhoeffer*,[1] eliminating the "presumption of prudence" in so-called "stock-drop" cases. Although the elimination of the presumption of prudence is a loss for plan fiduciaries, the Court's opinion contains several positive elements for plan sponsors and fiduciaries: an emphasis on the pleading standard for plaintiffs to avoid a motion to dismiss, a new focus on the reliability of stock market prices, and a recognition of the practical problems of fiduciaries with negative inside information. The decision provides significant alternative grounds to defend these cases and puts a high burden on plaintiffs to plead specific facts to avoid early dismissal of cases about public company stock funds. The decision also raises important questions for plan sponsors, such as whether to change language

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> requiring that certain contributions be invested in a company stock fund and whether to engage an independent fiduciary to manage the company stock fund. These issues are even more critical for fiduciaries of plans sponsored by nonpublic companies that cannot rely on the Court's emphasis of the market price of a publicly traded stock as a defense.

In a unanimous opinion written by Justice Breyer, the Supreme Court held that:

1. Employee stock ownership plan (ESOP) fiduciaries are not entitled to a "presumption of prudence" in connection with their decisions to buy, hold or sell the employer's securities under the Employee Retirement Income Security Act of 1974 (ERISA);

2. Absent "special circumstances," a fiduciary is entitled to rely on a stock's market price and "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;" and

3. To state a claim for breach of fiduciary duty on the basis of nonpublic 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."

Background

Fifth Third Bancorp (Fifth Third) sponsored a 401(k) plan for its employees. It permitted participants of the plan to make contributions into an individual account and direct the plan to invest those contributions in a menu of 20 investment options. The plan required one of the investment funds offered to participants to be invested primarily in Fifth Third publicly traded stock. Fifth Third matched the first 4 percent of a participant's contribution with Fifth Third stock, although, once received, the participant could move the contribution to any of the other investment options.

Plaintiffs' consolidated putative class action complaint alleged that as Fifth Third became engaged in subprime lending, its loan portfolio became increasingly exposed to defaults putting the company at risk, and its stock became "overvalued and excessively risky." Plaintiffs alleged that:

1. Publicly available information provided "early warning signs" that the subprime lending was heading toward a collapse; and

2. The fiduciaries (who were bank insiders) deceived the market by making material misrepresentations about the company's prospects.

As the mortgage market collapsed, Fifth Third's stock price declined almost 75 percent, and plan participants invested in the Fifth Third stock fund collectively lost millions of dollars. Plaintiffs' complaint alleged that defendants violated their fiduciary duties under ERISA by continuing to offer Fifth Third stock as a plan investment option when it was imprudent to do so and failing to provide participants with accurate and complete information about the Fifth Third stock fund.

The "presumption of prudence" was a defense that many courts had granted to ERISA ESOP fiduciaries and that was first recognized by the US Court of Appeals for the Third Circuit in *Moench v. Robertson*.[2] In *Moench*, the Third Circuit held that a precipitous decline in an employer stock over a short period of time (such as from $18.25 per share to around $0.25 per share) was not by itself sufficient to state a claim that the fiduciaries of an ESOP plan breached their fiduciary duties by continuing to invest in or maintain the employer stock fund. The Court's application of the presumption of prudence required something more to overcome the presumption of prudence—such as allegations that in addition to a precipitous decline in stock price, the company was on the verge of collapse or call into question the company's viability as an ongoing concern.

District Court and Sixth Circuit Decision

In Fifth Third, the district court held that the ESOP fiduciaries' decision to invest in employer stock was entitled to a "presumption of prudence" at the pleading stage and granted defendants' motion to dismiss, finding that plaintiffs failed to overcome the presumption of prudence by plausibly alleging that Fifth Third's viability as a going concern was in jeopardy.

The US Court of Appeals for the Sixth Circuit reversed, holding that the presumption was an evidentiary rule that did not apply at the pleading stage and that plaintiffs were not required to plausibly allege that the employer faced a "dire situation," an "impending collapse" or "the brink of bankruptcy" to overcome the "presumption of prudence," only that "a prudent fiduciary acting under similar circumstances would have made a different investment decision."[3]

Unanimous Supreme Court Rejects Presumption of Prudence, but Suggests New Pleading Standards for Company Stock Cases

The Supreme Court granted *certiorari* to "consider whether, when an ESOP fiduciary's decision to buy or hold the employer's stock is challenged in court, the fiduciary is entitled to a . . . 'presumption of prudence.' "

The Court held that "no such presumption applies" because there is no basis for the "presumption of prudence" in ERISA, which "makes no reference to a special 'presumption' in favor of ESOP fiduciaries." Rather, although ERISA exempts ESOP fiduciaries from the duty to diversify the investments of the plan to minimize the risk of large losses, "aside from that distinction, because ESOP fiduciaries are ERISA fiduciaries and because Section 1104(a)(1)(B)'s duty of prudence applies to all ERISA fiduciaries, ESOP fiduciaries are subject to the duty of prudence just as other ERISA fiduciaries are." The Court concluded that the "Courts of Appeals have gone beyond ERISA's express" provisions in applying the "presumption of prudence."

Although the Court rejected the presumption of prudence, it nonetheless recognized the legitimate problems that could ensue without the presumption, such as when "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 under Section 1104(a)(1)(B), but if he stops investing and the stock goes up he may be sued for disobeying the plan documents in violation of Section 1104(a)(1)(D)."

In response to the argument that "without some sort of special presumption, the threat of costly duty-of-prudence lawsuits will deter companies from offering ESOPs to their employees, contrary to the stated intent of Congress," the Court reiterated that the "presumption of prudence" is not an appropriate way to "weed out" "meritless, economically burdensome lawsuits." Rather, that "important task can be better accomplished through careful, context-sensitive scrutiny of a complaint's allegations" at the pleading stage through a motion to dismiss. This "important mechanism for weeding out meritless claims," the Court instructed, "requires careful judicial consideration of whether the complaint states a claim that the defendant has acted imprudently" under the pleading standard set forth in *Ashcroft v. Iqbal*[4] and *Bell Atlantic Corp. v. Twombly*.[5] The Court then directed the Sixth Circuit to apply this pleading standard "in light of the following considerations."

Allegations of Fiduciary Breaches Based on Publicly Available Information

As a threshold issue, "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." Thus, an ERISA fiduciary may, as a general matter, "prudently rely on the market price" of a security. The Court noted:

> 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 under a general rule, at least in the absence of special circumstances. Many investors take the view that "they have little hope of outperforming the market in the long run based solely on their analysis of publicly available information," and accordingly, they "rely on the security's market price as an unbiased assessment of the security's value in light of all public information."

Because the Sixth Circuit "did not point to any special circumstances rendering reliance on the market price imprudent," the Court concluded that the Sixth Circuit's "decision to deny dismissal therefore appears to have been based on an erroneous understanding of the prudence of relying on market prices."

Allegations of Fiduciary Breaches Based on Nonpublic Information

Next, the Court instructed that to state a claim for breach of the duty of prudence on the basis of *nonpublic* 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 would not have viewed as more likely to harm the fund than to help it." The Court articulated three principles that should guide this analysis:

1. "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." Applying this principle, the Court concluded: "To the extent that the Sixth Circuit denied dismissal based on the theory that the duty of prudence required petitioners to sell the ESOP's holdings of Fifth Third stock, its denial of dismissal was erroneous."

2. "[C]ourts should consider the extent to which an ERISA-based obligation either to refrain on the basis of inside information from making a planned trade or to disclose inside information to the public could conflict with the complex insider trading and corporate disclosure requirements imposed by the federal securities laws or with the objectives of those laws." This point was raised by Justice Breyer several times

at oral argument, and the Court's opinion reiterates his concern: "The U.S. Securities and Exchange Commission has not advised us its views on these matters, and we believe those views may well be relevant."

3. Courts "should also 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." The Court vacated the judgment of the Sixth Circuit and remanded for further proceedings.

Impact of Decision on Future Cases and Plan Administration

While the *Dudenhoeffer* decision is seen by some as a blow to fiduciaries of plans that offer employer stock funds, the decision is more of a mixed bag and likely even a positive outcome for fiduciaries of plans sponsored by public companies. Although the Court rejected the presumption of prudence that had been applied in one form or another by the majority of circuits for more than a decade, the Court went on to maintain a high pleading bar for plaintiffs to avoid a motion to dismiss and focused in particular on the reliability of stock market prices and the practical problems of fiduciaries with negative inside information.

Because these cases can be expensive to litigate and the potential damages exposure so high, many of these cases previously focused on motions to dismiss, in which the presumption of prudence offered defendants a significant avenue to obtain dismissal of meritless claims at an early stage. Although that avenue is now closed, the Court's instruction to lower courts to emphasize efficient market theory and that fiduciaries cannot be required to violate securities laws in the exercise of their duties provides significant alternative grounds to dismiss these cases. It also puts a high burden on plaintiffs to plead specific facts, such as the specific *legal* "alternative action" the fiduciaries allegedly were supposed to perform that would not itself have damaged the stock or participants further.

For public companies, this new focus on the stock market price may well be a simpler defense than the presumption of prudence for motions to dismiss divestment claims. Of course, the lower courts will now have to grapple with what sort of "special circumstances" preclude a fiduciary without insider information from relying on the publicly traded stock price. But if the lower courts stay faithful to the Court's view of efficient market theory, it will be difficult for plaintiffs to allege special circumstances to plead around the general rule that it is "not imprudent" for a fiduciary to assume that a major stock market "provides the best estimate of the value" of the company stock.

The opinion did not address all the issues that commonly arise in stock-drop class actions. In particular, the Court did not address (likely because of the case posture of a motion to dismiss) the prudent process defense available to fiduciaries who carefully analyze the available information to make decisions. Although there may no longer be any presumption of prudence, the Court did not foreclose fiduciaries from showing (on summary judgment or at trial) that they acted prudently through reasoned and good faith decisions—even if another fiduciary might have reached a different decision. Notably, in one of the first appellate decisions citing *Dudenhoeffer*, the US Court of Appeals for the Fourth Circuit in *Tatum v. RJR Pension Inv. Comm.*,[6] considered an appeal involving a "reverse stock-drop" case in which the plan fiduciaries were sued for selling the employer stock when they deemed the stock fund imprudent but then the stock price rose, allegedly causing the plaintiffs to lose out on the gain. The *Tatum* case emphasizes the problem the Supreme Court noted of putting fiduciaries "between a rock and a hard place" by eliminating the presumption of prudence. In *Tatum*, the fiduciary got into trouble because of the apparent lack of a prudent process. As noted, that process may now be even more critically important in light of *Dudenhoeffer*.

Plan sponsors will have to carefully analyze whether there is any continuing advantage to "hard wire" company stock into a plan when the company wants to encourage investment in company stock. Previously, some cases held that the presumption of prudence applied when the plan terms required that a company stock fund "shall" be invested in company stock, limiting the discretion of the plan fiduciaries to divest the stock. In light of *Dudenhoeffer*, plan sponsors should consider any advantages of allowing more discretion to fiduciaries such that the plan "may" invest in company stock as oppose to "shall."

In light of *Dudenhoeffer*, plan sponsors may also want to carefully consider whether to hire an independent, third-party fiduciary to make decisions concerning the prudence of continuing to invest in or maintain a company stock fund as an investment option. An independent, third-party fiduciary, with no insider information, may be a way to limit potential liability by avoiding the insider-trading issues addressed by the Court as well. The use of an independent, third-party fiduciary also helps to avoid allegations of a conflict of interest by the fiduciary. Such a third-party fiduciary may be particularly useful in avoiding creative pleading by plaintiffs as to what "alternative action" an insider should have taken in compliance with securities laws.

The biggest negative effects from the Court's ruling may be for fiduciaries of plans sponsored by nonpublic companies. For them, the Court's dictates regarding reliance on the price of publicly traded stock or actions based on nonpublic information may be an insufficient substitute for the presumption of prudence that was previously an effective early defense in many company stock class actions.

Notes

1. *Fifth Third Bancorp v. Dudenhoeffer*, __ U.S. __, 134 S.Ct. 2459 (June 25, 2014)
2. *Moench v. Robertson*, 62 F.3d 553, 571 (3d Cir. 1995).
3. *Dudenhoeffer v. Fifth Third Bancorp*, 692 F.3d 410, 418 (6th Cir. 2012).
4. 556. U.S. 662, 129 S.Ct. 1937 (2009).
5. 550. U.S. 544, 127 S.Ct. 1955 (2007).
6. No. 13-1360, __ F.3d __, 2014 WL 3805677, (4th Cir. Aug. 4, 2014).

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