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# Presumption of ESOP Fiduciary Prudence: A Fading Memory

BY GLOBAL COMPENSATION, BENEFITS, AND ERISA

In what some herald as a game-changer, the US Supreme Court unanimously held ESOP fiduciaries should not be presumed to have acted prudently when judging whether their investment in employer stock was prudent.[1] There is no question that this heightens the risk ESOP fiduciaries face, but the Supreme Court decision is helpful to ERISA fiduciaries in other ways.

## THE LITIGATION

Fifth Third Bancorp sponsored a defined-contribution retirement savings plan with various investment options, including an "employee stock ownership plan" (ESOP) that invested primarily in Fifth Third stock. In the wake of the sub-prime mortgage melt down, Fifth Third Bancorp's stock took a nose-dive, losing almost 75% of its value. Plaintiff participants sued the ESOP fiduciaries in *Fifth Third Bancorp v. Dudenhoeffer*, alleging that the fiduciaries breached ERISA's fiduciary duty of prudence because they did nothing when they should have known, based on both publicly available and insider information, that Fifth Third stock was overpriced and excessively risky. Plaintiffs claimed that the fiduciaries should have (i) sold off the ESOP's employer stock holdings, (ii) not purchased more Fifth Third stock, (iii) cancelled the ESOP option, or (iv) disclosed the negative inside information, allowing the market to mark down the employer's stock, which would result in the ESOP not paying too much for future purchases.

The District Court dismissed the complaint for failure to state a claim, applying the "presumption of prudence" at the pleading stage. The Sixth Circuit reversed, finding that ESOP fiduciaries are entitled to an evidentiary "presumption of prudence" that does not apply to other ERISA fiduciaries.

After surveying the Circuit Court decisions and parsing ERISA's language, the Supreme Court found that ESOP fiduciaries are subject to the same duty of prudence as every other ERISA fiduciary, except diversification. In other words, ESOP fiduciaries still must ensure that employer stock is a prudent plan investment.

Nevertheless, the Supreme Court's decision suggests that district courts should dismiss many typical "stock drop" claims.

## PUBLIC INFORMATION — ERISA FIDUCIARIES ARE NOT REQUIRED TO OUTSMART THE MARKET

When "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."[2] In other words, a fiduciary usually "'is not imprudent to assume that a major stock market . . . provides the best estimate of the value of the stocks traded on it that is available to him.'"[3]

Some commentators have observed that the Supreme Court required that plaintiffs plead "special circumstances" showing why the fiduciaries should have been able to outsmart the market based on public information. But, this is not actually what the Supreme Court held. Rather, it saved that question for another day:

> We do not here consider whether a plaintiff could nonetheless plausibly allege imprudence on the basis of publicly available information by pointing to a special circumstance affecting the reliability of the market price as an unbiased assessment of the security's value in light of all public information, that would make reliance on the market's valuation imprudent.[4]

Obviously, this nod to Economist Eugene Fama's efficient market hypothesis is of great help to fiduciaries of ESOPs that hold publicly-traded employer stock. But taken to its logical conclusion, it should provide a powerful defense tool to all ERISA fiduciaries by holding that the market normally prices in risk, etc., making virtually all publicly-traded assets equivalent in risk-adjusted investment potential. Thus, US large cap growth ETF X may be equivalent to US large cap growth ETF Y because the market has priced-in their expected investment performance differentials.

## NON-PUBLIC INFORMATION[5]

The Supreme Court held that in order for a plaintiff 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.[6]

### *Dumping Company Stock Not Required*

First, ERISA's prudence requirement never will force an ERISA fiduciary to break the law by selling stock based on non-public information. As the Supreme Court pointed out, "Federal securities laws 'are violated when a corporate insider trades in the securities of his corporation on the basis of material, nonpublic information.'"[7]

### *Disclosing Inside Information to the Market*

Second, the Supreme Court found that the question is whether a prudent fiduciary in the same circumstances would have viewed disclosure as more likely to harm the plan's investment than helping it. In other words, would the disclosure drive prices so low as to cause more harm to the plan than benefit. Interestingly, the question identified by the Court is not whether the particular ERISA fiduciaries at issue actually held this belief, but rather whether a prudent ERISA fiduciary would have held that belief.

Thus, the relevant question is not whether the ERISA fiduciary should have dumped employer stock based on inside information, but rather whether the ERISA fiduciary could legally have disclosed the information to the market and whether a prudent fiduciary would think that disclosure would cause the plan more benefit than harm.

The Supreme Court recognized that whether an ERISA fiduciary could even legally disclose non-public information in the first instance is a complicated question and that it requires courts to:

> 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.[8]

The Supreme Court invited the Securities and Exchange Commission to issue relevant guidance.

### *Not Buying More Company Stock*

The Supreme Court did not address whether ERISA fiduciaries might violate insider trading laws if they did not purchase more employer stock on the basis of non-public information. Although that likely would not violate insider trading laws, if it would violate those laws, the Court held that ERISA fiduciaries would not be required to break the law. More likely, fiduciaries who refrain from buying additional employer stock would be telegraphing to the investment world that they have concerns about the employer – constructively disclosing their inside information. The Supreme Court directed lower courts to consider whether complaints plausibly allege 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.[9]

*Id*. Again, the Supreme Court indicates that whether the fiduciaries at issue actually held this belief is irrelevant – rather, courts should look to whether a prudent fiduciary would believe that not making future purchases would do more harm than good.

## CONCLUSION

As the Supreme Court noted, ESOP fiduciaries may often find themselves between a rock and a hard place: If they continue to hold and buy employer stock and the stock price goes down, they may be sued. On the other hand, if they sell or do not buy employer stock and the stock price goes up, they may be sued. By rejecting the presumption of prudence, the Supreme Court may have exposed ESOP fiduciaries to additional risk because it remains to be seen whether district courts will follow the Court's suggestion that they courageously grant 12(b)(6) motions to dismiss questionable stock drop suits. In this regard, the Supreme Court directed the Sixth Circuit on remand to apply the pleading standard as outlined in *Ashcroft v. Iqbal*[10] and *Bell Atlantic Corp. v. Twombly*[11] in determining whether the complaint states a claim that the fiduciary has acted imprudently in light of the considerations described above.[12]

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1 *Fifth Third Bancorp v. Dudenhoeffer*, --- S. Ct. ---, 2014 WL 2864481 (June 25, 2014). The Supreme Court also held that ERISA's duty of prudence trumps plan provisions requiring investment in employer stock. Some lower courts previously held that fiduciaries cannot breach their duty of prudence by investing in employer stock when the plan mandates an employer stock investment. *See, e.g., Smith v. Delta Air Lines,* 422 F. Supp. 2d 1310, 1330 (N.D. Ga. 2006) (granting defendant investment committee's motion to dismiss because plan terms prohibited divestment of employer stock); *In re Dynergy, Inc. ERISA Litig.*, 309 F. Supp. 2d 861, 895-896 (S.D. Tex. 2004) (holding that plan's requirement that matching contributions be made in employer stock made it impossible for defendants to have breached their fiduciary duties by not diversifying the stock into other investments). These decisions were based on the Court's prior holdings that a plan sponsor is not acting as a fiduciary when it adopts or amends an ERISA plan. *See, e.g., Hughes Aircraft Co. v. Jacobson,* 525 U.S. 432, 443 (1999); *Lockheed Corp. v. Sping,* 517 U.S. 882, 891 (1996). The Court's *Dudenhoeffer* holding rejects the extension of its settlor line of cases to shield ERISA fiduciaries from imprudence claims simply because the plan mandates an employer stock investment.

2 *Id*. at *11.

3 *Id*. (citations omitted; alteration in original).

4 *Id*. (citation and internal quotation marks omitted).

5 Except with respect to not purchasing additional employer stock, these concerns largely should be inapplicable to ESOPs that invest in non-publicly traded employer stock.

6 *Id*. at *12.

7 *Id.*

8 *Id*.

9 *Id*.

10 550 U.S. 544, 554-563 (2007).

11 556 U.S. 662, 677-680 (2009).

12 Under *Twombly*, to survive a motion to dismiss under Rule 12(b)(6), the plaintiff must allege facts which, if true would entitle it to relief; the plaintiff must plead enough facts to state a claim to relief that is plausible on its face. This requires more than a mere formulaic recitation of the elements of a cause of action, and conclusory statements alone will be insufficient. Explaining this somewhat opaque standard, in *Iqbal*, the Court subsequently noted that this plausibility standard requires plaintiffs to allege "more than a sheer possibility that a defendant has acted unlawfully." 556 U.S. at 678.