U.S. Supreme Court: No Presumption of Prudence for ESOP Fiduciaries, Court Details Pleading Requirements for Breach of Prudence Claims

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On June 25, 2014, in ***Fifth Third Bancorp et al. v. Dudenhoeffer et al.***, the U.S. Supreme Court unanimously overturned the presumption of prudence that has been applied in "stock drop" cases brought under the Employee Retirement Income Security Act of 1974 ("**ERISA**") for nearly two decades. The Court held that fiduciaries of employee stock ownership plans ("**ESOP**") are subject to the same duty of prudence that applies to ERISA fiduciaries in general, except that ESOP fiduciaries do not need to diversify the fund's assets.[1] The Court also described pleading requirements for plaintiffs bringing breach of prudence claims.

Presumption of Prudence

A number of circuits have adopted a "presumption of prudence", first adopted in *Moench v. Robertson*,[2] which generally provides that, if a plan's terms require or encourage investment in company stock, the fiduciaries are entitled to a presumption that continuing to invest in, or to offer company stock as a plan investment option, is prudent, unless doing so would constitute an abuse of discretion. With the exception of the Sixth Circuit, courts have applied the presumption at the pleading stage and have generally permitted lawsuits to proceed only if the complaints alleged that the fiduciary knew or should have known that the employer, and therefore its stock, was subject to impending collapse or in an otherwise dire situation.[3]

Fifth Third Bancorp v. Dudenhoeffer

Participants in Fifth Third Bancorp's ESOP filed a class action lawsuit in 2008[4] claiming that executives knew through public sources and inside information that Fifth Third Bancorp's stock had become unacceptably risky, because the bank had switched from being a conservative lender to a risky sub-prime lender. The participants argued that the stock should have been divested before it suffered a 74% price drop over a roughly two-year period. Applying the presumption of prudence, the district court dismissed the complaint. The Sixth Circuit reversed the decision and held that, because the presumption of prudence concerns questions of fact, it cannot be applied at the motion-to-dismiss stage.[5]

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[1] 29 U.S.C. § 1104(a)(1)(B) (fiduciaries must act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a 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").

[2] 62 F.3d 553, 571 (3d Cir. 1995).

[3] *See, e.g.*, *Gray v. Citigroup (In re Citigroup ERISA Litig.),* 662 F.3d 128 (2d Cir. Oct. 19, 2011); *Quan v. Computer Sciences Corporation*, 623 F.3d 870 (9th Cir. 2010); *Lanfear v. Home Depot, Inc.*, 679 F.3d 1267 (11th Cir. 2012); *White v. Marshall & Isley Corp*., 714 F. 3d 980, 989 (7th Cir. 2013).

[4] 757 F. Supp. 2d 753 (S.D. Ohio 2010).

[5] 692 F.3d 410 (6th Cir. 2012).

The Supreme Court vacated the Sixth Circuit's decision.[6] Holding that ERISA does not create a special presumption of prudence for ESOP fiduciaries at any stage in a litigation, the Court also ruled that the statutory standard of care for fiduciaries cannot be reduced or waived by hardwiring in plan documents the requirement to invest in a stock fund or offer it as a plan investment option.[7] The Court rejected the presumption as an appropriate means to address the legal prohibition on insider trading and to weed out meritless lawsuits.[8] Instead, the task of dividing "the plausible sheep from the meritless goats" can better be accomplished by courts through "careful, context-sensitive scrutiny of a complaint's allegations."[9]

The Court instructed the Sixth Circuit on remand to apply the *Twombly* and *Iqbal*[10] pleading standard which requires courts to determine whether a plaintiff's claims are plausible. Further, the Court explained that, where a stock is publicly traded, allegations that a fiduciary should have recognized from publicly available information that the market improperly valued the stock are implausible and insufficient to state a claim. The Court's decision also noted the following considerations:

- 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 defendants 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 help it.[11]
- ERISA's duty of prudence never requires a fiduciary to break the law and so a fiduciary cannot be imprudent for failing to buy or sell stock in violation of insider trading laws.[12]
- Where a complaint faults a fiduciary for failing to use negative inside information to refrain from making additional stock purchases or for failing to publicly disclose that information so that the stock would no longer be overvalued, courts should consider (i) whether and the extent to which such actions would conflict with complex insider trading and corporate disclosure requirements under the federal securities laws[13] and (ii) whether the complaint has plausibly alleged that a prudent fiduciary in the defendant's position could not have concluded that stopping purchases 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.[14]

Although the Court eliminated the bright-line presumption of prudence, standards articulated by the Court for assessing claims of imprudence should provide some comfort for plan fiduciaries, particularly of ESOPs of companies whose stock is publicly traded. The decision does raise questions as to when and in what circumstances fiduciaries should deviate from the express language of plan documents, particularly for fiduciaries of ESOPs of companies with closely held or thinly traded stock, and it remains to be seen how the new standard/s will be worked out by the courts. The long-term effects of the Court's rejection of the presumption of prudence remain to be seen.

[6] *Fifth Third Bancorp et al. v. Dudenhoeffer*, 12-751, slip op. at 1-2 (U.S. June 25, 2014).

[7] *Id*. at 11.

[8] *Id*. at 15.

[9] *Id*.

[10] *Ashcroft v. Iqbal*, 556 U.S. 662, 677-680 (2009); *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 554-563 (2007).

[11] *Fifth Third Bancorp et al*. at 18.

[12] *Id*.

[13] *Id*. at 19.

[14] *Id*. at 20.

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