EMPLOYEE STOCK OWNERSHIP PLANS

THE SUPREME COURT OF THE UNITED STATES HOLDS THAT ESOP FIDUCIARIES ARE NOT ENTITLED TO A PRESUMPTION OF PRUDENCE, CLARIFIES STANDARDS FOR STOCK DROP CLAIMS

by Christopher T. Horner II & Eric W. Gregory

On June 25, 2014, the Supreme Court of the United States unanimously held that there is no special presumption of prudence for fiduciaries of employee stock ownership plans ("ESOPs"). *Fifth Third Bancorp v. Dudenhoeffer*, No. 12-751, 573 U.S. ___ (June 25, 2014) (slip op.).

Background

The Employee Retirement Income Security Act of 1974, as amended ("ERISA") imposes legal duties on fiduciaries of employee benefit plans, including ESOPs.[1] Specifically, ERISA requires the fiduciary of an employee benefit plan to act prudently in managing the plan's assets. [2] In addition, ERISA requires the fiduciary to diversify plan assets.[3]

ESOPs are designed to be invested primarily in employer securities.[4] ERISA exempts ESOP fiduciaries from the duty to diversify plan assets and from the duty to prudently manage plan assets, but only to the extent that prudence requires diversification of plan assets.[5]

The recent financial crisis generated a wave of ERISA "stock drop" cases, which were filed after a precipitous drop in the value of employer securities held in an ESOP. Generally, the plaintiff alleged that the ESOP fiduciary breached its duty of prudence by investing in employer securities or continuing to offer employer securities as an investment alternative. Defendant fiduciaries defended on the ground that the plaintiff failed to rebut the legal presumption that the fiduciary acted prudently by investing in employer securities or continuing to offer employer securities as an investment alterative.

The Federal Circuit Courts of Appeals that had considered the issue adopted the rebuttable presumption of prudence but split on the issues of (1) whether the legal presumption applied at the pleadings stage of litigation or whether the legal presumption was evidentiary in nature and did not apply at the pleadings stage of litigation and (2) the rebuttal standard that the plaintiff of a stock drop action must satisfy. [6]

Dudenhoeffer held that ESOP fiduciaries are not entitled to a legal presumption that they acted prudently by investing in employer securities or continuing to offer employer securities as an investment alternative.[7]

The Dudenhoeffer Case

Fifth Third Bancorp maintained a defined contribution plan, which offered participants a number of investment alternatives, including the company's ESOP. The terms of the ESOP required that its assets be "invested primarily in shares of common stock of Fifth Third [Bancorp]."[8] The company offered a matching contribution that was initially invested in the ESOP. In addition, participants could make elective deferrals to the ESOP.

ESOP participants alleged that the ESOP fiduciaries knew or should have known on the basis of public information that the employer securities were overvalued and an excessively risky investment. In addition, the ESOP fiduciaries knew or should have known on the basis of non-public information that the employer securities were overvalued. Plaintiffs contended that a prudent ESOP fiduciary would have responded to this public and non-public information by (1) divesting the ESOP of employer securities, (2) refraining from investing in employer securities, (3) cancelling the ESOP investment alternative, and (4) disclosing non-public information to adjust the market price of the employer securities.

Procedural Posture

The United States District Court for the Southern District of Ohio dismissed the complaint for failure to state a claim, holding that ESOP fiduciaries were entitled to a presumption of prudence with respect to their collective decisions to invest in employer securities and continue to offer employer securities as an investment alternative.[9] The District Court concluded that presumption of prudence applied at the pleadings stage of litigation and that the plaintiffs failed to rebut the presumption.[10]

The United States Court of Appeals for the Sixth Circuit reversed the District Court judgment, holding that the presumption of prudence is evidentiary in nature and does not apply at the pleadings stage of litigation.[11] The Sixth Circuit concluded that the complaint stated a claim for a breach of the fiduciary duty of prudence.[12]

ESOP Fiduciaries Not Entitled to Presumption of Prudence

In a unanimous decision, the Supreme Court of the United States held that ESOP fiduciaries are not entitled to a presumption of prudence with regard to their decisions to invest in employer securities and continue to offer employer securities as an investment alternative; rather, ESOP fiduciaries are subject to the same duty of prudence that applies to other ERISA fiduciaries, except that ESOP fiduciaries need not diversify plan assets.[13]

The Court began its analysis by acknowledging a tension within the statutory framework of ERISA. On the one hand, ERISA imposes a duty on all fiduciaries to discharge their duties prudently, which includes an obligation to diversify plan assets. On the other hand, ERISA recognizes that ESOPs are designed to invest primarily in employer securities and

are not intended to hold diversified assets. The Court concluded that an ESOP fiduciary is not subject to the duty of prudence to the extent that the legal obligation requires the ESOP fiduciary to diversify plan assets. The Court found no special legal presumption favoring ESOP fiduciaries.

New Standards for Stock Drop Claims

Although the Court rejected the presumption of prudence, it vacated the judgment of the Sixth Circuit Court of Appeals (which held that the complaint properly stated a claim) and announced new standards for lower courts to observe in evaluating whether a complaint properly pleads a claim that an ESOP fiduciary breached its fiduciary duty of prudence by investing in employer securities or continuing to offer employer securities as an investment alternative.

Public Information

First, the Court concluded that "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."[14] In other words, a plaintiff generally cannot state a plausible claim of imprudence based solely on publicly available information. An ESOP fiduciary does not necessarily act imprudently by observing the efficient market theory, which holds that a major stock market provides the best estimate of the value of employer securities. To be clear, the Court did not rule out the possibility that a plaintiff could properly plead imprudence based on publicly available information indicating special circumstances affecting the reliability of the market price.

Non-Public Information

Second, the Court concluded that "[t]o 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 [fiduciary] could have taken that would have been consistent with [applicable Federal and state securities laws] and that a prudent fiduciary in the same circumstances would not have viewed as more likely to harm the [ESOP] than to help it."[15]

The Court reasoned that where a complaint alleges imprudence based on an ESOP fiduciary's failure to act on non-public information, a lower court's analysis should be guided by three considerations. First, ERISA does not require a fiduciary to violate applicable Federal and state securities laws. In other words, an ESOP fiduciary does not act imprudently by declining to divest the ESOP of employer securities or by prohibiting investments in employer securities on the basis of non-public information. Second, where a complaint faults fiduciaries for failing to decide, on the basis of non-public information, to refrain from making additional investments in employer securities or for failing to disclose non-public information to correct the valuation of the employer securities, lower courts should consider the extent to which the duty of prudence conflicts with complex insider trading and corporate disclosure requirements imposed by Federal securities laws or the objectives of such laws. Third, lower courts should consider whether the complaint has plausibly alleged that a prudent fiduciary could not have concluded that discontinuing investments in employer securities or disclosing adverse, non-public information to the public, or taking any other action suggested by the plaintiff would result in more harm than good to the ESOP by causing a drop in the value of the employer securities.

Quantifying the Unknowns

Fifth Third Bancorp v. Dudenhoeffer will undoubtedly reshape the landscape of ERISA litigation and, specifically, stock drop litigation. To fully understand the decision's impact, a number of questions must still be answered, including the correct application of the standards espoused by the Court. In addition, *Dudenhoeffer* involved a publicly-traded company; it is unclear what application, if any, the decision will have in the context of employer securities of a privately held company.

Dickinson Wright's ESOP team will continue to follow developments in this area. Please contact the authors of this Alert, any member of the ESOP team or your regular Dickinson Wright attorney for guidance.

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[1] See generally, ERISA § 404(a).

[2] ERISA § 404(a)(1)(B).

[3] ERISA § 404(a)(1)(C).

[4] Code § 4975(e)(7)(A).

[5] ERISA § 404(a)(2).

[6] *See e.g. Moench v. Robertson*, 62 F.3d 553, 571 (3d Cir. 1995); *In re Citigroup ERISA Litig.*, 662 F.3d 128, 138 (2d Cir . 2011); *Kirschbaum v. Reliant Energy, Inc.*, 526 F.3d 243, 254 (5th Cir. 2008); *Kuper v. Iovenko*, 66 F.3d 1447 (6th Cir. 1995); *White v. Marshall & Ilsley Corp.*, Case No. 11-2660, 2013 WL 1688918 (7th Cir. Apr. 19, 2013); *Quan v. Computer Sciences Corp.*, 623 F.3d 870, 881 (9th Cir. 2010) *Lanfear v. Home Depot*, Inc., 679 F.3d 1267 (11th Cir. 2012).

[7] No. 12-751, 573 U.S. ___ at 1-2.

[8] Id.

[9] *Dudenhoeffer v. Fifth Third Bancorp, Inc.*, 757 F. Supp. 2d 753, 759 (S.D. Ohio 2010).

[10] Id. at 762.

[11] *Dudenhoeffer v. Fifth Third Bancorp*, 692 F. 3d 410, 418-19 (2012).

[12] Id. at 423.

[13] *Fifth Third Bancorp v. Dudenhoeffer*, No. 12-751, 573 U.S. ___ at 1-2.

[14] Id. at 16.

[15] Id. at 18.

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FOR MORE INFORMATION CONTACT:

Christopher T. Horner II practices in the area of ESOP law and is an Associate in Dickinson Wright's Washington, D.C. office. He can be reached at 202.659.6961 or chorner@dickinsonwright.com.

Eric W. Gregory practices in the area of employee benefits and is an Associate in Dickinson Wright's Ann Arbor office. He can be reached at 734.623.1946 or fgregory@dickinsonwright.com.

Cynthia A. Moore practices in the area of employee benefits and is a member and practice department manager in Dickinson Wright's Troy office. She can be reached at 248.433.7295 or cmoore@dickinsonwright.com.

Deborah L. Grace practices in the area of employee benefits and is a member in Dickinson Wright's Troy office. She can be reached at 248.433.7217 or dgrace@dickinsonwright.com.

Michael R. Holzman practices in the area of ESOP law and is Member in Dickinson Wright's Washington, D.C. office. He can be reached at 202.659.6931 or mholzman@dickinsonwright.com.

Roberta P. Granadier practices in the area of employee benefits and is Of Counsel in Dickinson Wright's Troy office. She can be reached at 248.433.7552 or rgranadier@dickinsonwright.com.