Supreme Court Rejects "Presumption of Prudence" in ESOP Cases

On June 25, 2014, the Supreme Court issued a decision in *Fifth Third Bancorp v. Dudenhoeffer*[1] regarding the availability of relief against fiduciaries of an employee stock ownership plan ("ESOP") for alleged breaches of the fiduciary duty of prudence in investing in employer stock.

The Court held that ESOP fiduciaries are not entitled to a special "presumption of prudence" when their decision to buy or hold employer stock is challenged in court. This is a departure from the previous trend among federal appellate courts -- including in the Second Circuit -- which had applied a fiduciary-friendly presumption of prudence in employee stock-drop cases brought under the Employee Retirement Income Security Act of 1974 ("ERISA"). To overcome the presumption, plaintiffs were required to show that fiduciaries knew or should have known that the employer faced dire circumstances and was on the brink of collapse. Under the Supreme Court's *Fifth Third Bancorp* ruling, ESOP fiduciaries are now held to the same duty of prudence as are general ERISA fiduciaries, except that, in accordance with statute, no diversification requirement exists with respect to an ESOP's accumulation of employer stock.

Background

Defendant Fifth Third Bancorp ("FTB") maintained a defined-contribution retirement savings plan for its employees, which included as one option a company stock fund meeting the requirements to be treated as an ESOP.

Former FTB employees and ESOP participants, plaintiffs claimed that retirement plan fiduciaries breached the duty of prudence imposed by Section 404(a)(1)(B) of ERISA,[2] by maintaining the ESOP's holdings of company stock. Specifically, they alleged that FTB knew or should have known, through publicly available information and inside nonpublic information, that FTB stock was overvalued and therefore risky. Plaintiffs suggested several supposedly prudent courses of action for FTB to have pursued: these included divesting the ESOP of FTB stock, refraining from purchasing any more FTB stock, removing the ESOP option, or publicly disclosing negative information to allow for market correction of the allegedly overpriced stock.

The trial court dismissed the complaint for failure to state a claim upon which relief could be granted, holding that the allegations did not overcome a presumption that the plan fiduciaries' decision to invest in employer stock was prudent. The Sixth Circuit reversed, agreeing that ESOP fiduciaries are entitled to a presumption of prudence, but holding that the presumption is an evidentiary one and that it does not apply at the pleading stage.

The Supreme Court unanimously vacated the Sixth Circuit's decision. Contrary to a bevy of lower courts, the Court held that no presumption of prudence exists for ESOP fiduciaries at any stage of litigation. The Court's conclusion followed from the pertinent provisions of ERISA – *e.g.,* Section 404(a)(1)(B),[3] which imposes a "prudent person" standard upon all ERISA fiduciary decisions, and Section 404(a)(2),[4] which modifies those duties in the ESOP context by providing that an ESOP fiduciary is exempt from the duty of prudence with respect to employer stock "only to the extent that it requires diversification."

The Court emphasized that these provisions make no reference to a special presumption for ESOP fiduciaries, and do not require plan beneficiaries to allege that an employer was on the "brink of collapse" or facing "extraordinary circumstances" to state a claim for breach of the duty of prudence. Nor does the requirement in Section 404(a)(1)(D)[5]

1 No. 12-751, 573 U.S. __.
2 29 U.S.C. § 1104(a)(1)(B).
3 *Id*.
4 29 U.S.C. § 1104(a)(2).
5 29 U.S.C. § 1104(a)(1)(D).

to manage a plan "in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with" ERISA provide any basis to presume that ESOP fiduciaries were prudent in continuing to invest in or failing to divest company stock. Rather, according to the Court, "[t]his provision makes clear that the duty of prudence trumps the instructions of a plan document, such as an instruction to invest exclusively in employer stock."

Cognizant of a need to weed out non-meritorious and burdensome claims of corporate fiduciary malfeasance, the Court urged lower courts to engage in "careful, context-sensitive scrutiny" of allegations at the motion-to-dismiss stage. For example, ESOP fiduciaries are entitled to rely on market prices. The Court reasoned 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." Without more, such claims should fail.

At the same time, aware that plan fiduciaries may face seemingly conflicting demands, the Court offered particular guidance to courts in assessing circumstances potentially implicating fiduciaries' access to inside information. First, ERISA does not require fiduciaries to break the law, such as by selling company stock on the basis of non-public information. Second, courts ought to consider how discharging the ERISA duty of prudence might interact with company insiders' obligations under the law, including the federal securities laws. Third, the mere act of selling or refusing to purchase company stock by insiders, evincing a lack of faith in the company's prospects, might itself send a negative signal and potential shockwave through the market, doing more harm than good to the fund by causing a steeper drop in stock price or value than might otherwise occur.

Likely Effects of the Decision

The Supreme Court has removed a substantial hurdle previously faced by plan beneficiaries seeking to challenge the actions of ESOP fiduciaries in maintaining or increasing holdings in employer stock. Gone are the days of plaintiffs needing to show that a company was on the brink of collapse or suffering a huge stock price decline amidst other dire circumstances to make out a claim of fiduciary imprudence.

On the other hand, the Court's decision is laden with caveats regarding the close scrutiny that should be undertaken by courts in evaluating employer stock-drop complaints and also regarding the seeming lack of alternatives available to plan fiduciaries allegedly in possession of inside information that might negatively affect the price of company stock. The Court goes so far as to suggest guidelines for the lower courts to consider at the motion to dismiss stage. If claims based on publicly available information will routinely fail as a matter of law, and claims based on inside information will not be viable as a matter of practice, then the Court's decision in *Fifth Third Bancorp* may undermine the viability of many of these cases.

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