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COMMENTARY

Fifth Third Bancorp v. Dudenhoeffer: Supreme Court Rejects "Presumption of Prudence" for Stock Drop Cases

On June 25, the United States Supreme Court issued its decision in *Fifth Third Bancorp v. Dudenhoeffer*, a decision that had been highly anticipated by the ERISA bar. The question before the Court was whether the so-called *Moench* presumption of prudence applied to a motion to dismiss. Rather than deciding whether the presumption was an evidentiary presumption to be applied at summary judgment or trial or a presumption to be applied at the motion to dismiss stage, the Court turned to the more fundamental question of the validity of the *Moench* presumption of prudence and rejected the presumption of prudence in its entirety. Although the Court rejected the presumption of prudence (on which many employers had relied in defeating breach of fiduciary duty claims in "stock drop" cases at the motion to dismiss stage), the Court also included a discussion of how to determine whether a complaint meets the *Twombly* "plausibility" standard. The Court's decision created a new battleground for litigants and new uncertainties for plan sponsors who provide the opportunity for employees and other plan participants to invest in employer stock through their 401(k) plans or employee stock ownership plans ("ESOPs").

Background

Congress chose to encourage employee ownership of employer stock in the structure of ERISA. ERISA contains special provisions for individual account plans (including ESOPs and 401(k) plans) that invest in employer stock. Among other things, ERISA's general requirement that investments be diversified to avoid the risk of large loss does not apply to the acquisition or holding of employer stock by an eligible individual account plan such as a 401(k) plan or ESOP. In addition, employer stock is exempt from ERISA's prudence requirement but "*only to the extent that it requires diversification*."

Attempting to find an appropriate balance between the Congressional policy in favor of employee ownership and ERISA's duty of prudence, every court of appeals to consider the issue over nearly two decades held that a fiduciary is entitled to a presumption that holding employer stock is prudent. The presumption of prudence was first set forth by the Third Circuit in *Moench v. Robertson*, 62 F.3d 553 (3d Cir. 1995). The *Moench* presumption provides that an investment in employer stock is entitled to a presumption that the investment is consistent with ERISA unless it is established that the fiduciary abused its discretion by investing in employer stock (or allowing participants the option of investing in employer stock).

The *Moench* presumption has served as a powerful defense in a multitude of so-called "stock drop" cases. Plaintiffs began filing stock drop cases in earnest after the Enron scandal, and dozens of companies that allowed investment in employer stock through their 401(k) plans were sued over the past decade. The suits generally alleged that the fiduciaries of the 401(k) plan violated ERISA's fiduciary obligations by allowing participants to continue investing in employer stock when they knew that doing so was imprudent. Defendants frequently responded to such suits with a motion to dismiss alleging that unless the company was on the brink of collapse, the *Moench* presumption permitted the fiduciary to continue to allow investment in employer stock. Although every court of appeals to consider the issue adopted the *Moench* presumption, there was less uniformity in describing the circumstances under which the presumption could be overcome (e.g., "brink of collapse," "dire circumstances," or something less drastic), and in considering the degree to which the question could be affected by plan drafting. The Sixth Circuit, which often appeared to be the shakiest of the adopters of the *Moench* presumption, broke from other courts of appeals that allowed application of the *Moench* presumption on a motion to dismiss, and it held in *Dudenhoeffer* that while the *Moench* presumption was valid, it was an evidentiary presumption that could apply only at summary judgment, not on a motion to dismiss.

Supreme Court Decision

Not only did the Supreme Court reject application of the *Moench* presumption on a motion to dismiss, it rejected it altogether. The Court, looking to the plain language of ERISA, held that ESOPs were not subject to any special standard of prudence, and that the statute says nothing about "brink of collapse" or similar concepts. Instead the Court held that "the same standard of prudence applies to all ERISA fiduciaries, including ESOP fiduciaries…." The Court also held that the duty of prudence trumps the terms of plan documents, such as a requirement that a plan invest in employer stock.

The Court, however, did not stop with its holding that eviscerated the presumption of prudence. In an effort to provide a mechanism to weed out meritless claims, and to provide a proper balancing of employer and employee interests reflected in the structure of ERISA, the Court looked to the pleading standard espoused in *Ashcroft v. Iqbal*, 556 U.S. 662 (2009) and *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007). As a preliminary point, the Court noted that evaluating a complaint for failure to act prudently would be context specific, as the duty of prudence is dependent on the circumstances prevailing at the time of the fiduciary act.

Despite this broad statement, the Court offered some guidance regarding what types of allegations a plaintiff would need to include in a complaint asserting a breach of fiduciary duty in order to survive a motion to dismiss. Perhaps the most clear pronouncement the Court made was 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." In other words, a claim based only on publicly available information would be subject to dismissal. In addition, because the Court held that a fiduciary can reasonably conclude that it has little hope of outperforming the market based solely on the fiduciary's analysis of publicly available information, any claim that a fiduciary should have anticipated that the employer stock fund would underperform the market, or underperform other investment options or performance benchmarks, should also fail to state a plausible claim in the absence of special circumstances. The Court, however, did not provide any explanation or examples of what might constitute the "special circumstances" sufficient to get around this rule, other than to state that the special circumstances would have to render reliance on efficient markets unreasonable.

The Court also held that when stating a claim for breach of fiduciary duty based on 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 help it." The Court elaborated somewhat, offering three things that lower courts should consider in applying this standard. First, a fiduciary cannot be required to break the law, particularly the securities laws, in order to fulfill fiduciary duties. Second, the courts should consider the interplay between ERISA's fiduciary obligations and the complex securities laws and their objectives when assessing a complaint involving an ESOP or employer stock fund. Third, the complaint must 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." The Court, however, did not provide any further details on how to apply these three "considerations."

Significance of Opinion

The Court's opinion offers some certainty to plan sponsors with respect to potential litigation, while leaving many other questions unanswered. Clearly, the presumption of prudence is dead, but any claim that is based solely on public information is similarly buried. The Court has seemingly replaced the presumption of prudence with a new pleading standard that remains to be unpacked and explored, particularly with respect to claims based on fiduciary knowledge of nonpublic information. The three "considerations" the Court mandated are all subject to interpretation and will almost certainly be litigated extensively. What specifically a plaintiff must allege with respect to the prudence of offering employer stock as an investment option (or offering an ESOP) in order to survive a motion to dismiss remains to be hashed out.

In the Court's phrase, the new pleading standard should be used to "divide the plausible sheep from the meritless goats." While the Court (thankfully) identified several meritless claims, it never really stated what a meritorious claim against an employer stock fiduciary would look like. So at this point, we cannot determine what a "plausible sheep" looks like, or how many of them may be in the flock.

What to Do Now?

Even if the *Fifth Third v. Dudenhoeffer* decision eventually proves neutral or even positive for fiduciaries and plan sponsors—which may be the case—it undoubtedly increases the near-term risk of maintaining an ESOP or employer stock fund in a 401(k) plan. By changing the legal framework that had developed over more than 15 years, and by rejecting an approach that had been adopted by every court of appeals that had considered the issue, the Supreme Court created a level of uncertainty that is likely to generate a new wave of litigation.

Plan sponsors and fiduciaries should begin the process of reviewing plan design, plan documents, fiduciary procedures, and participant communications in light of the Supreme Court's holding and reasoning. Among other things:

- Plan documents or fiduciary procedures that require an employer stock investment to be maintained unless the company is on the brink of collapse or facing some other dire circumstance will likely need to be revised. In the meantime, a fiduciary cannot rely on such plan terms if prudence would require otherwise.
- Fiduciaries must implement procedures for carefully evaluating employer stock investments in the absence of a presumption of prudence. Procedures that focus solely or primarily on whether the company faces serious financial difficulties will no longer be sufficient.
- As part of the context-specific inquiry demanded by the Court, a plan design that allows participants to freely choose whether or not to invest in employer stock may be more defensible as a prudent alternative despite the inevitable fluctuations in the stock's performance over time.
- Participant communications will likely be even more important. An evaluation of a fiduciary's prudence in maintaining an employer stock investment may be influenced by whether the fiduciary has made significant efforts to educate plan participants about the risks of a single stock investment and the benefits of diversification.
- Plans that have not engaged the services of an independent fiduciary should take this opportunity to consider the question again in light of the Supreme Court's new landscape. On the one hand, the Court's decision

provides additional defenses to fiduciaries that may possess inside information. On the other hand, there are many questions about how lower courts will respond to the Court's direction to consider potential conflicts between ERISA and securities laws in the context of inside fiduciaries. For independent fiduciaries, the Court's endorsement of efficient market principles may provide an effective line of defense less cluttered by those issues.

- Finally, some plan sponsors will want to consider whether to continue to maintain an ESOP or other employer stock investment option in the current environment. For example, some plan sponsors may want to consider whether the goal of encouraging employee ownership can be served through a Section 423 stock purchase plan or other alternative not subject to ERISA. Others may choose to make employer stock available in their 401(k) plan, if at all, only through individual choice in a brokerage window rather than through a company-designated investment alternative.

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