Supreme Court Rules On ERISA "Stock Drop" Suits

Summary and Impact of the June *Dudenhoeffer v. Fifth Third Bancorp* decision.

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One June 25, 2014, the Supreme Court vacated the Sixth Circuit's decision in *Dudenhoeffer v. Fifth Third Bancorp* and directed the court of appeals to reconsider whether the suit stated plausible claims for breach of ERISA fiduciary duty based on allegations that 401(k) plan fiduciaries imprudently remained invested in company stock as the stock dropped in value.

The court did not accept the presumption of prudence for employee stock ownership plan (ESOP) fiduciaries (generally referred to as the "*Moench* presumption"), which several courts of appeal — other than the Sixth Circuit — had used to justify dismissing ERISA "stock drop" claims on motions to dismiss. The Supreme Court held that ESOP fiduciaries have the same duty of prudence applicable to all ERISA fiduciaries, except that ESOP fiduciaries have no duty to diversify plan investments.

Nonetheless, a unanimous Supreme Court directed the Sixth Circuit to reconsider whether the participants' complaint states a claim under the pleading standards in *Ashcroft v. Iqbal*, 556 U. S. 662 (2009) and *Bell Atlantic Corp. v. Twombly*, 550 U. S. 544 (2007), recognizing that such claims are subject to dismissal at the pleading stage in the absence of plausible factual allegations of breach of fiduciary duty.

The Supreme Court said that allegations that a fiduciary should have recognized, on the basis of publicly available information, that the market was overvaluing or undervaluing the stock generally do not meet the plausibility requirement. As a result, in the absence of "special circumstances," such allegations are insufficient to state a claim under *Twombly* and *Iqbal* and are thus subject to dismissal.

To state a claim for breach of the duty of prudence on the basis that fiduciaries failed to act on *nonpublic* (i.e., inside) information, the court said, a complaint must plausibly allege some legal action the fiduciary could have taken, that a prudent fiduciary in the same circumstances would not have viewed as more likely to harm the fund than to help it. The Supreme Court indicated that the following principles should be applied by a court to make this determination:

- ERISA's duty of prudence never requires a fiduciary to break the law; therefore, a fiduciary cannot be imprudent for failing to buy or sell stock in violation of federal securities laws regarding insider trading.
- Where a complaint alleges that the fiduciary breached ERISA duties by making additional stock purchases or failing to publicly disclose negative inside information, courts should consider whether imposing ERISA-based fiduciary duties could conflict with existing insider trading and corporate disclosure requirements under federal securities laws.
- Courts should consider whether the complaint has plausibly alleged that a prudent fiduciary could not have reasonably concluded that stopping purchases or publicly disclosing negative information would do more harm than good to the fund.

Background

Seven other circuit courts of appeal had held that the congressional policy of encouraging employee stock ownership requires that ERISA fiduciaries be given a "presumption of prudence" when offering participants an option to invest in company stock. In stark contrast, the Sixth Circuit held that whether a fiduciary acts prudently by offering an employer stock fund turns on whether a "prudent fiduciary acting under similar circumstances would have made a different investment decision." (See *Dudenhoeffer v. Fifth Third Bancorp*, 692 F.3d 410, 418-19 (6th Cir. 2012), cert. granted, 82 U.S.L.W. 3364 (U.S. Dec. 13, 2013) (No. 12-751).) The Sixth Circuit agreed that a presumption of prudence would be appropriate in these circumstances, but only at the summary judgment and trial stage of the lawsuit, after plaintiffs had the opportunity for extensive and expensive discovery against the fiduciaries.

This procedural question presented in *Dudenhoeffer* is of major significance in determining the viability of a "stock-drop" claim. Expensive and time-con-

suming discovery follows the denial of a motion to dismiss, which can pressure plan fiduciaries to settle regardless of the merits.

Facts Alleged in Dudenhoeffer

The complaint in *Dudenhoeffer* made allegations common to most ERISA stock-drop cases.

Fifth Third maintained a Section 401(k) retirement plan that provided for participant-directed investments. The plan offered several investment options for participants, including the company stock fund and 17 mutual funds. As is frequently the case with such plans, particularly those sponsored by employers whose stock is publicly traded, the company stock fund was structured to qualify as an ESOP for purposes of ERISA and the Internal Revenue Code. The company matched 100 percent of the first 4 percent of an employee's compensation with company contributions to the Fifth Third stock fund, but permitted participants to reinvest the matching contribution in other investment options.

Like many financial institutions, Fifth Third experienced a substantial decline in its stock price from July 2007 to September 2009, causing the stock fund to decline in value by tens of millions of dollars. Plaintiffs argued in their lawsuit that the plan's fiduciaries violated ERISA fiduciary duties by holding and purchasing shares of Fifth Third long after it ceased to be prudent to do so.

The district court dismissed the lawsuit, finding that the company was entitled to a presumption that its continued investment in company stock was reasonable. The Sixth Circuit reversed, reasoning that plaintiffs had sufficiently alleged that the fiduciaries had violated their fiduciary duty and caused the losses to the plan. The Sixth Circuit ruled that the presumption is not to be applied at the pleading stage of the lawsuit.

Oral Argument

The justices focused much of the hour-long oral argument in April on what an ERISA fiduciary must do if it has inside information that employer stock held by an ESOP is overvalued. During the argument, justices questioned whether Fifth Third's counsel was proposing a lower level of responsibility for ESOP fiduciaries. The justices also closely questioned plaintiffs' counsel and the solicitor general (who supported the participants in arguing for affirmance), as to actions a fiduciary with inside information concerning employer stock should take. The justices raised questions as to whether a fiduciary's decision to merely stop purchasing more shares would be sufficient to protect participants' interests, as the market likely would interpret that action as raising concerns over the value of the stock.

Supreme Court Standards for Evaluating Stock Drop Claims

As forecast in the oral argument, the Supreme Court rejected the formulaic "presumption of prudence" analysis as an "ill-fitting means" of analyzing an ESOP fiduciary's ERISA duties. While recognizing a clear Congressional intent to promote ESOPs and employee ownership and acknowledging that potential conflicts of interest for plan fiduciaries who are corporate insiders is a "legitimate" concern, the Supreme Court found no support in ERISA for relaxing ERISA' s fiduciary duties beyond the specific exception in Section 404(a)(2) from the diversification requirement. In addition, the Supreme Court rejected the notion that plan terms requiring investment in employer stock could waive the fiduciary's duty of prudence to the extent that duty came into conflict with those plan terms (so-called "hardwiring" of the plan).

Despite its failure to follow the presumption of prudence, the Supreme Court's unanimous decision nevertheless appears to set high standards for "stock drop" complaints to meet. As in other recent cases, the Supreme Court emphasizes the importance of discouraging "meritless lawsuits" under ERISA:

> *And we have recognized that "ERISA represents a 'careful balancing' between ensuring fair and prompt enforcement of rights under a plan and the encouragement of the creation of such plans.'"* Conkright v. Frommert, *559 U. S. 506, 517 (2010) (quoting* Aetna Health Inc. v. Davila, *542 U. S. 200, 215 (2004)); see also* Varity Corp. v. Howe, *516 U. S. 489, 497 (1996) ("In interpret[ing] ERISA's fiduciary duties," "courts may have to take account of competing congressional purposes, such as Congress' desire to offer employees enhanced protection for their benefits, on the one hand, and, on the other, its desire not to create a system that is so complex that administrative costs, or litigation expenses, unduly discourage employers from offering welfare benefit plans in the first place").*

Rather than use a "presumption of prudence" to weed out meritless lawsuits, the Supreme Court determined that "[t]hat important task can be better accomplished through careful, context-sensitive scrutiny of a complaint's allegations."

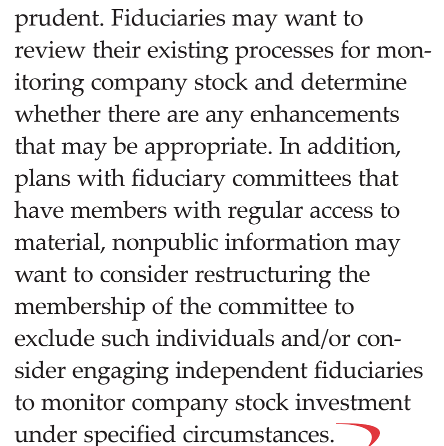
It will now be very difficult for plaintiffs to fashion a "stock drop" complaint based on allegations that fiduciaries were imprudent for failing to act based on publicly available information. The Supreme Court does not expect a fiduciary to outsmart "a presumably efficient market," which the court made clear by citing excerpts from its recent decision in *Halliburton Co. v. Erica P. John Fund, Inc*. 573 U. S. _____, (2014). The court suggested that evidence that market prices were "unreliable" might be sufficient "special circumstances" to support such a complaint. We suspect plaintiffs will allege such "special circumstances" in the future, but it is likely that the lower courts will be highly skeptical of such claims.

Where the complaint alleges that the fiduciary acted imprudently due to its possession of nonpublic, insider information, the complaint faces other hurdles, of the type the justices raised during oral argument. Just what is a fiduciary to do when it has inside information about company stock?

The court clearly provides that such a fiduciary cannot violate insider trading laws and stated that the Sixth Circuit’s denial of dismissal on this ground “was erroneous.” The court cautions against judge-made ERISA obligations that potentially conflict with complex federal securities regulations. The court also emphasizes that fiduciaries could reasonably refrain from stopping purchases of company stock to avoid harm to participants from a drop in the stock price and the value of stock held by participants.

On the whole, a unanimous Supreme Court seems most skeptical of these lawsuits and is instructing the lower courts to critically evaluate these allegations and dismiss claims that fail to allege plausible facts in the light of stock market realty. Although the presumption of prudence is gone, we expect to see future boilerplate “stock drop” complaints not based on sufficient supporting allegations to be dismissed on the pleadings.

While all of the implications of the decision likely will take some time to become fully apparent, it is clear that plan fiduciaries and their advisers will need to begin reorienting their perspectives on this topic. For example, plan provisions requiring investment in employer stock no longer can be read to treat fiduciary decisions with respect to company stock as presumptively prudent. Fiduciaries may want to review their existing processes for monitoring company stock and determine whether there are any enhancements that may be appropriate. In addition, plans with fiduciary committees that have members with regular access to material, nonpublic information may want to consider restructuring the membership of the committee to exclude such individuals and/or consider engaging independent fiduciaries to monitor company stock investment under specified circumstances.



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