

## Outside Counsel

## Expert Analysis

# Effects of New Standards For Company Plan Fiduciaries

In its 2014 decision in *Fifth Third Bancorp v. Dudenhoeffer*,<sup>1</sup> the U.S. Supreme Court held that fiduciaries of plans that hold publicly traded company stock are subject to the same duty of prudence that applies to fiduciaries in general under the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. §1000. In doing so, the Supreme Court effectively rejected decades of law applied by nearly all the circuit courts of appeals affording fiduciaries of company stock plans a special “presumption of prudence” not available to the fiduciaries of other varieties of ERISA plans.

In place of the presumption of prudence, the *Dudenhoeffer* decision announced new standards that apply when deciding whether a fiduciary of a company-stock plan acted prudently within the meaning of ERISA §1104(a)(1)(B). The overruling of the presumption of prudence is likely to have significant implications for future claims against these fiduciaries.

### The Moench Presumption

Congress enacted ERISA to protect the interests of participants in employee benefit plans and their beneficiaries by creating substantive regulatory requirements for employee benefit plans.<sup>2</sup> The Supreme Court has previously noted that “[t]he purpose of ERISA is to provide a uniform regulatory regime over employee benefit plans.”<sup>3</sup> Under Section 1104(a)(1), ERISA plan fiduciaries are required to administer their plans “with skill, prudence, and diligence” such that a “prudent man acting in a like capacity and familiar with such matters would use” as well as “by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so.”

Congress, however, provided an exception to the diversification requirement in the case of employer stock option plans (ESOPs).<sup>4</sup> This exception allows fiduciaries of ESOPs to invest



By  
**Barry  
Temkin**



And  
**Kate  
DiGeronimo**

their funds primarily in the company’s stock without violating ERISA’s prudent person standard of care. The 1995 U.S. Court of Appeals for the Third Circuit case *Moench v. Robertson* adopted a presumption that ESOP fiduciaries are acting prudently in holding or offering employer stock as plan investments.<sup>5</sup> Other circuits followed the *Moench* presumption with the added exception

The Supreme Court effectively rejected decades of law affording fiduciaries of company stock plans a special “presumption of prudence” not available to fiduciaries of other varieties of ERISA plans.

that the presumption is rebutted when there is reason to believe the company’s survival is at risk or in doubt.<sup>6</sup> In one form or another, virtually all circuit courts had adopted the *Moench* presumption of prudence prior to *Dudenhoeffer*.

### Background of ‘Dudenhoeffer’

Fifth Third Bancorp maintained a retirement savings plan by which its employees could contribute a portion of their income as retirement savings. The company would make a 4 percent matching contribution. The plan’s assets were invested in 20 separate funds, one of which was an employer stock option plan. While employees were allowed to allocate their contributions among the funds as

they saw fit, Fifth Third initially invested its contributions through the ESOP. Once the company contribution was made, the employee would be able to reinvest the contribution in another fund.

John Dudenhoeffer was a former Fifth Third ESOP participant who filed a putative class action claiming that the plan’s fiduciaries violated their duties of loyalty and prudence under ERISA. Specifically, the complaint alleged that by July 2007, the plan fiduciaries knew or should have known that company stock was overvalued and excessively risky from both publicly available information and nonpublic information to which they were privy as company insiders. The plan participants argued that the fiduciaries should have known that subprime lending, a large part of Fifth Third’s business, would lead to a housing market crash, and that nonpublic information available to the fiduciaries indicated that Fifth Third officers were deceiving the markets by making material misstatements about the company’s financial prospects, resulting in an overvaluing of its stock.

The plaintiffs alleged that the plan defendants breached their fiduciary duties by continuing to purchase overvalued stock in the plan, and that a prudent fiduciary should have: (1) sold the ESOP holdings of company stock before the value declined, (2) refrained from purchasing any more stock, (3) canceled the plan’s ESOP option, and (4) disclosed the information to allow the market to correct the share price of the company stock.

The district court held that the fiduciaries were entitled to the *Moench* presumption that their decision to remain invested in employer stock was prudent, and dismissed the complaint after finding that the plaintiffs’ allegations were insufficient to overcome the presumption of prudence. The Sixth Circuit reversed, holding that the presumption was evidentiary in nature and therefore irrelevant in deciding a pre-answer motion to dismiss.

### ‘Moench’ Overruled

The Supreme Court, in *Dudenhoeffer*, overruled *Moench*, ruling that the law does not cre-

ate a special presumption favoring ESOP fiduciaries.<sup>7</sup> According to the court, a “presumption of prudence” for an ESOP cannot be found in the statute. After reviewing the statutory language relating to fiduciaries’ duties under ERISA, the court concluded that “the same standard of prudence applies to all fiduciaries, including ESOP fiduciaries, except that an ESOP fiduciary is under no duty to diversify the ESOP’s holdings.”<sup>8</sup>

The court reasoned that ERISA’s requirement that fiduciaries act “in accordance with the documents and instruments governing the plan *insofar as such documents and instruments are consistent with the provisions of this subchapter*” trumps the terms of any particular plan. Thus, the statutory duty of prudence takes precedence over any particular plan document. (Emphasis in court opinion.)

In overruling the Moench presumption of prudence, the court provided some guidance for district courts to apply when evaluating motions to dismiss. First, the court presumptively ruled out an ERISA claim against an ESOP fiduciary based solely on public information. As the court explained:

In our view, 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....ERISA fiduciaries, who... could reasonably see little hope of outperforming the market...based solely on their analysis of publicly available information may, as a general matter...prudently rely on the market price.<sup>9</sup>

With regard to claims alleging a violation based on nonpublic information, the analysis is more complex, as company insiders may not run afoul of insider trading laws in the performance of their fiduciary duties. In this regard, the court instructed that “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 to help it.”<sup>10</sup> The court provided three considerations that should be used to scrutinize the allegations of such claims.

First, the duty of prudence cannot require a fiduciary to perform an action that would violate the federal securities laws, which prohibit insider trading based on material, nonpublic information. Second, the district courts should consider whether claims alleging the failure to act with regard to making additional purchases or disclosing information to the public conflict with “the complex insider trading and corporate disclosure requirements imposed by the federal securities laws or the objectives of those laws.”<sup>11</sup> Third, lower courts should consider:

whether the complaint has plausibly alleged 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 and a concomitant drop in the value of the stock already held by the fund.<sup>12</sup>

‘Dudenhoeffer’ overruled the Moench presumption of prudence for fiduciaries of ESOPs. In addition, the court’s reasoning calls into question claims based on conduct involving public information, conduct that would implicate federal insider-trading laws, and situations likely to precipitate a further stock drop.

#### After ‘Dudenhoeffer’

*Dudenhoeffer* overruled the Moench presumption of prudence for fiduciaries of ESOPs. In addition, the court’s reasoning calls into question claims based on conduct involving public information, conduct that would implicate federal insider-trading laws, and situations likely to precipitate a further stock drop. The court upheld the exemption from the diversification requirement that allows ESOPs to invest exclusively in employer stock.

The court’s narrowing of claims based on public information may tend to permit ESOP fiduciaries to argue that ending the acquisition of stock, or divesting altogether, would do more harm than good by sending a negative signal to the markets. Further, ERISA claims based on material non-public information must be re-examined in light of *Dudenhoeffer*, as the court stated that plaintiffs now must “plausibly allege an alternative action that would have been consistent with the securities laws” and also plead that such an action “would not have [been] viewed [by a prudent fiduciary] as more likely to harm the fund than to help it.”<sup>13</sup>

Already, post-*Dudenhoeffer*, plaintiffs have been successful in opposing motions to dismiss that might have been previously granted. For example, in *Harris v. Amgen*<sup>14</sup> the U.S. Court of Appeals for the Ninth Circuit held that the plaintiffs had met their pleading burden and that their claims, which had been dismissed when the district court applied the “presumption of prudence” standard, were viable against plan fiduciaries and non-fiduciaries alike.

In *Harris*, there was significant evidence that the employer’s stock price was artificially inflated

and likely to decline as a result of material public and non-public evidence of tests showing that the company’s pharmaceutical product was not effective, posed significant health risks, and was subject to non-approval by the Food and Drug Administration. The court found that the plan fiduciaries could have removed the company stock fund as an investment option, which would have protected plan participants from purchasing more of the company stock while the price remained artificially high.<sup>15</sup> Further, the court reasoned that such action would have complied with the fiduciaries’ obligations under both ERISA and the securities laws because revealing material information to the public in a timely fashion would have allowed informed plan participants and other investors to decide whether to invest in company stock, and thereby allowed the market to accurately evaluate the value of the stock.<sup>16</sup>

In another action, in the U.S. District Court for the Southern District of Texas, plaintiffs were permitted to amend a complaint against four BP Group employee benefits plans alleging breaches of fiduciary duty before and after the 2010 Deepwater Horizon explosion on the basis of alleged alternatives to inaction that would have been consistent with the securities laws.<sup>17</sup>

Relying in part on the Ninth Circuit’s *Harris* decision, the court held that it could not determine at the pleading stage whether the proposed alternative actions would have done more good than harm to the plan members and allowed the case to proceed with an amended complaint. However, it remains to be seen just how much the landscape has been changed by *Dudenhoeffer*.

In the meantime, some lawyers recommend that ESOP fiduciaries “develop and follow processes for monitoring employer stock” to safeguard themselves now that they can no longer rely on a presumption of prudence.<sup>18</sup>

1. 134 S.Ct. 2459 (2014).
2. See 29 U.S.C. §1001(b).
3. *Aetna Health Inc. v. Davila*, 542 U.S. 200, 208 (2004).
4. 29 U.S.C. §1104(a)(2).
5. 62 F.3d 553, 571 (1995).
6. See 134 S. Ct. at 2466.
7. 134 S. Ct. at 2467.
8. 134 S. Ct. at 2467.
9. 134 S. Ct. at 2471 (citations omitted) (emphasis added).
10. 134 S. Ct. at 2472.
11. 134 S. Ct. at 2473.
12. 134 S. Ct. at 2473.
13. 134 S. Ct. at 2472.
14. 770 F.3d 865, 879 (9th Cir. 2014).
15. 770 F.3d at 877-78.
16. 770 F.3d at 878.
17. Memorandum and Order, *In Re: BP p.l.c. Securities Litigation*, 4:10-cv-4214 (MDL No. 10-md-2185) (S.D. Tex. Jan. 15, 2015).
18. Robertson, Adrienne L., “*Fifth Third Bancorp v. Dudenhoeffer: Supreme Court Rejects Special ‘Presumption of Prudence’*” for Employer Stock, BLOOMBERG BNA, July 11, 2014, [www.bna.com/fifth-third-bancorp-n17179892147/](http://www.bna.com/fifth-third-bancorp-n17179892147/).