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High Court rejects presumption of prudence, but imposes new standards for participant stock drop claims

Earlier today in a closely watched ERISA case, a unanimous Supreme Court struck down the "presumption of prudence" that several lower courts had held protects the fiduciaries of 401(k) plans that offer stock as a plan investment option. This ruling will make it easier for participants to plead their case, as they no longer have to demonstrate that the employer faced "dire" economic circumstances or was on the "brink of collapse." On the other hand, however, the Court also imposed new pleading standards on participants suing fiduciaries for failing to act in the face of a drop in the publicly traded company stock price. These new standards may help fiduciaries dispose of many so-called stock drop lawsuits at the early stage of litigation.

Background

Over the past decade, participants in defined contribution plans that offer company stock as an investment option have brought a slew of lawsuits claiming that plan fiduciaries should have eliminated the employer securities (which can take the form of an employer stock fund or an Employee Stock Ownership Plan, or ESOP) from the plan's investment lineup during a time period when the stock's price declined. As explained in our January 17, 2014 *For Your Information*, dozens of these lawsuits — dubbed "stock drop" cases — were filed in the wake of the global financial crisis.

> Buck comment. In most of these cases, participants voluntarily invested their 401(k) plan assets in the company stock fund. Following the drop in stock price, they argued that the plan's fiduciaries should have removed the company stock fund from the plan's investment lineup given the company's alleged declining prospects during the time period at issue.

In these situations, federal courts have struggled to balance the fiduciary duty to protect plan participants against imprudent investments with the special treatment that Congress has given to employee stock ownership. Several circuit courts of appeal adopted a "presumption of prudence" (also known as the *Moench* presumption, after the Third Circuit case where it initiated) as a way to handle this tension, whereby a plan fiduciary is presumed to have acted prudently in offering employer stock unless the participant can

show that the company faced "dire" economic circumstances that threatened the company's viability as a going concern, or was otherwise on the "brink of collapse." This presumption of prudence has been applied at the initial stage of litigation (i.e., the "motion to dismiss" stage). The Sixth Circuit in *Pfeil v. State Street Bank & Trust Co.*, however, took a more lenient approach, applying the presumption at the evidentiary stage of litigation and finding that a participant bringing a stock drop claim need only show that "a prudent fiduciary acting under similar circumstances would have made a different investment decision."

The Supreme Court agreed to resolve this circuit split in *Dudenhoeffer et al. v. Fifth Third Bancorp et al.* on appeal from the Sixth Circuit. There, participants in Fifth Third's 401(k) plan claimed that the plan's fiduciaries should have discontinued Fifth Third stock as an investment option when its price dropped by 74% due to the company's involvement in subprime lending. The Sixth Circuit reversed the district court's dismissal of the participants' claims, and sent the case back to the district court for further action.

Court strikes down presumption, sets forth new pleading standards

Vacating and remanding the Sixth Circuit's decision, the Court held today that no special presumption favors ESOP fiduciaries' purchase or holding of employer stock or protects them from liability when the stock's price drops. Rather, the same duty of prudence that applies generally to ERISA fiduciaries is equally applicable to ESOP fiduciaries. Acknowledging that Congress sought to encourage the creation of ESOPs and exempted them from ERISA's diversification duty (since they are, by definition, undiversified funds), the Court nevertheless found the presumption inappropriate because it prevents a participant from bringing a successful prudence claim unless the employer is in dire economic circumstances.

While the Court struck down the presumption, it also set new standards for a participant to proceed with a stock drop complaint, designed to weed out meritless claims. First, concerning publicly available information about the stock price, the Court held that a participant must allege more than that a fiduciary should have recognized that the market was over- or under-valuing the company stock. According to the Court, a fiduciary can properly assume that a major stock market provides the best estimate of the stocks traded on that market.

> Buck comment. While this finding is helpful to fiduciaries, the Court further noted that it was not deciding whether a participant could bring a successful prudence claim on the basis of publicly available information by pointing to a "special circumstance" that affected the reliability of the market price; such allegations were not before the court in this case. This leaves an opportunity for participants to bring future stock drop claims alleging special circumstances that rendered the stock's price unreliable.

Regarding nonpublic information about the stock's value, the Court acknowledged the concern that subjecting ESOP fiduciaries, many of whom are corporate "insiders" under federal securities laws, to the duty of prudence will lead to conflicts with federal insider trading laws — which prohibit insiders from trading in the securities of their companies on the basis of material, nonpublic information. In light of this conflict, the Court held that a participant must "plausibly allege an alternative action that the [plan fiduciary] 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." In other words, a participant must explain what an insider fiduciary could and should have done that would neither have violated insider trading rules nor caused more harm than good to the employer stock fund.

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The Court offered three points to inform the insider information analysis. First, it clarified that ERISA's duty of prudence never requires a fiduciary to violate federal securities laws by conducting trades in company stock on the basis of material, nonpublic information. Second, it advised lower courts to consider the extent to which an ERISA obligation either to refrain on the basis of inside information from making a planned trade or to disclose inside information to the public could conflict with insider trading and corporate disclosure rules.

> Buck comment. In making this point, the Court noted — as it did during oral argument in this case — that the SEC has not made its views on this issue known, and that those views may be relevant.

Finally, it directed lower courts to consider whether a prudent fiduciary could find that halting plan purchases of employer stock (which the market might perceive as a sign that insider fiduciaries viewed the employer's stock as a bad investment), or publicly disclosing negative information about the company, would do more harm than good to the fund by causing a drop in the stock's price and a corresponding drop in the value of the employer stock fund.

> Buck comment. While the Court's decision technically applies only to ESOPs, it is likely to be read as applicable to all employer stock funds offered within defined contribution plans.

In closing

Employers will rightfully mourn the demise of the presumption of prudence, which has been a helpful and cost-saving litigation tool for plan fiduciaries defending stock drop claims. In the absence of the presumption, participants no longer need to show that the company faced dire economic circumstances, or was on the brink of collapse, to go forward with a stock drop claim. Nevertheless, in today's decision, the Court has set a new standard for participants to pursue stock drop lawsuits that may prove very useful to plan fiduciaries seeking to dispose of these claims early in the litigation process.

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