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United States Supreme Court Rejects Presumption of Prudence for Stock-Drop Cases

In a highly anticipated decision, the United States Supreme Court held that fiduciaries of employee stock ownership plans ("ESOPs") are not entitled to any special presumption of prudence when investing in employer stock. In *Fifth Third Bancorp v. Dudenhoffer*, the Supreme Court rejected the so-called "*Moench* presumption," which had been adopted by numerous circuit courts of appeal, and often resulted in the dismissal of employer stock-drop class actions at the pleading stage. The Supreme Court ruled that "no such presumption applies"; instead, ESOP fiduciaries are subject to the same standard of prudence as other ERISA fiduciaries, other than the duty to diversify plan assets.

Background

In *Moench v. Robertson*, the Third Circuit Court of Appeals attempted to balance the congressional objective of encouraging employee ownership of employer stock with the requirement that ERISA fiduciaries prudently invest plan assets. In formulating what came to be known as the *Moench* presumption, the Third Circuit held that fiduciaries of plans that required investment in employee stock were entitled to a presumption that they acted prudently under ERISA. The *Moench* presumption had been adopted by several courts of appeal and generally required allegations that the employer faced "the brink of collapse" or "dire circumstances," as opposed to merely a drop in the price of the employer's stock, in order for plaintiffs to rebut the presumption. Many courts applied the presumption at the motion to dismiss stage, which made it increasingly difficult for stock-drop cases to proceed into discovery.

The Sixth Circuit's Decision

The facts of *Fifth Third* are common to most ERISA stock-drop cases. Fifth Third maintained a 401(k) retirement plan that included several different funds, including mutual funds and an employer stock fund. Plan participants could allocate their contributions however they desired, although Fifth Third's matching contributions were always initially invested in the company stock fund. Like many other companies during the financial crisis, Fifth Third's stock price fell significantly, causing the fund to lose tens of millions of dollars.

Former Fifth Third employees who participated in the ESOP filed suit and alleged that the plan fiduciaries violated their duties of prudence and loyalty under ERISA by holding and purchasing shares of Fifth Third stock long after it stopped being prudent to do so. In granting Fifth Third's motion to dismiss, the district court held that the company was entitled to a presumption that its continued investment in company stock was reasonable, and that the plaintiffs' allegations were insufficient to overcome the *Moench* presumption. The Sixth Circuit reversed, and while it agreed that ESOP fiduciaries are entitled to a presumption of prudence, it found that the presumption was evidentiary and did not apply at the pleading stage of the lawsuit.

The Supreme Court Rejects The Presumption Of Prudence

In a unanimous decision, the Supreme Court rejected the *Moench* presumption and held that ERISA does not create a special presumption of prudence for ESOP fiduciaries. Instead, the Court explained that "the same standard of prudence applies to all ERISA fiduciaries, except that an ESOP fiduciary is under no duty to diversify the ESOP's holdings."

The Court refused to accept the petitioners' argument that the special purpose of an ESOP – investing participants' contributions in employer stock – calls for a presumption that such investment is prudent. The Court stated that the duty of prudence trumps the terms of a plan document, such as an "instruction to invest exclusively in employer stock even if financial goals demand the contrary."

Interplay between ERISA and Securities Laws

The Court also rejected the participants' argument that Fifth Third knew or should have known in light of publicly available information that continuing to hold and purchase employer stock was imprudent. According to the Court, where a stock is publicly traded, allegations that a fiduciary should have recognized from publicly available information alone that the market was overvaluing or undervaluing the stock "are implausible as a general rule." The Court stated that it is not imprudent to assume that a major stock market provides the best estimate of the value of the stocks traded on it. However, the Court noted that a plaintiff could plausibly allege imprudence on the basis of publicly available information by pointing to "special circumstances affecting the reliability of the market price."

The Supreme Court then addressed the issue of whether an ESOP fiduciary could be found to act imprudently by failing to use non-public information. To state a claim for breach of the duty of prudence based on inside information, the Court explained 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 circumstances would not have viewed as more likely to harm the fund than to help it." Where a complaint alleges that a fiduciary was imprudent in failing to act on the basis of inside information, the Court set out three points for lower courts to consider in its analysis:

- The Court reiterated that ERISA's duty of prudence cannot require an ESOP fiduciary to break the law or to perform an action – such as divesting the fund's holdings of the employer stock on the basis of inside information – if such action would violate the securities laws.
- Lower courts should consider the extent to which an ERISA-based 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 the complex insider trading and corporate disclosure laws.
- Lower courts should consider whether the complaint has plausibly alleged that a prudent fiduciary could not have concluded that stopping trading – which might be a signal to the stock market that insider fiduciaries viewed the employer stock as a bad investment – or publicly disclosing negative information would do more harm than good by causing the stock price to drop and thereby causing further harm to participants.

The Supreme Court vacated the Sixth Circuit's decision and remanded to decide whether the plaintiffs' claim was plausible in light of the new factors set forth by the Court.

The Impact Of The Supreme Court's Ruling On ERISA Stock-Drop Cases

Some predicted that without the Moench presumption, employers would be discouraged from offering employer stock as an investment option for their employees given that, as Justice Breyer noted in his opinion, an ESOP fiduciary can be "between a rock and a hard place." It remains to be seen whether that will be the case, but there is no dispute that the Moench presumption was a valuable defense for employers as it often allowed for the dismissal of stock-drop claims before discovery commenced. While the Supreme Court reiterated that meritless claims would still be subject to dismissal, and outlined a number of factors which suggest that it will remain difficult for employees to get past the pleadings stage, without the viability of the Moench presumption, there is a risk that more of these cases will proceed to the later stages of litigation, which could be very costly for employers.

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