ALSTON & BIRD LLP

WWW.ALSTON.COM

ERISA Litigation ADVISORY ▪

JUNE 27, 2014

Supreme Court Rejects "Presumption of Prudence" for ESOP Fiduciaries, But Nonetheless Sets a High Bar for the Plausibility of Employer Stock Drop Claims.

By H. Douglas Hinson and Richard S. Siegel

On June 25, 2014, the Supreme Court issued its decision in *Fifth Third Bancorp v. Dudenhoeffer*.[1] In a unanimous decision, the Court overruled the United States Court of Appeals for the Sixth Circuit (the "Sixth Circuit") and every other circuit to address the issue,[2] by holding that fiduciaries of employee stock ownership plans (ESOPs) are not entitled to a presumption of prudence with regard to investments in employer securities. The Court held that "the law does not create a special presumption favoring ESOP fiduciaries," and that "the same standard of prudence applies to all ERISA fiduciaries, including ESOP fiduciaries, except that an ESOP fiduciary is under no duty to diversify the ESOP's holdings."[3]

However, notwithstanding the rejection of the presumption of prudence, the Supreme Court provided clear guidance to the lower courts, instructing them to carefully consider the plausibility of claims alleging breach of the fiduciary duty of prudence under ERISA based upon publicly traded employer stock drop allegations. Indeed, the Court's decision arguably makes it at least as difficult, if not more difficult, for plaintiffs to state a plausible claim than in the pre-*Fifth Third*, "presumption of prudence" world.

Background

The petitioner, Fifth Third Bancorp ("Fifth Third"), like many employers, sponsored a 401(k) plan (the "Plan") for its employees.[4] The Plan offered participants the opportunity to select from 20 different investments, including an ESOP.[5]

---

1 *Fifth Third Bancorp v. Dudenhoeffer*, No. 12-751, 2014 WL 2864481 (U.S. June 25, 2014) (hereafter "*Fifth Third*").

2 The presumption was first announced by the Third Circuit in *Moench v. Robertson*, 62 F.3d 553 (3d Cir. 1995). Subsequently, every other circuit to determine whether there was such a presumption answered in the affirmative. *See White v. Marshall & Ilsley Corp.*, 714 F.3d 980 (7th Cir. 2013); *Lanfear v. Home Depot, Inc.*, 679 F.3d 1267 (11th Cir. 2012); *Gray v. Citigroup, Inc. (In re Citigroup ERISA Litig.)*, 662 F.3d 128 (2d Cir. 2011); *Quan v. Computer Scis. Corp.*, 623 F.3d 870 (9th Cir. 2010); *Kirschbaum v. Reliant Energy, Inc.*, 526 F.3d 243 (5th Cir. 2008); *Kuper v. Iovenko*, 66 F.3d 1447 (6th Cir. 1995).

3 *Fifth Third*, 2014 WL 2864481, at *7.

4 *Id.* at *3.

5 *Id.*

Plan participants were entitled to allocate their investments as they saw fit, although employer matching contributions were initially made in the ESOP.[6] The Plan required the ESOP to be "invested primarily in shares of common stock of Fifth Third."[7]

The plaintiffs—former employees and ESOP participants—filed a class action in the United States District Court for the Southern District of Ohio (the "District Court"), alleging that the Plan's fiduciaries breached their duties when they knew, or should have known, that the company's stock was overvalued, yet continued to allow the Plan's participants to hold and invest in company stock.[8]

The District Court Dismissed Plaintiffs' Claims

Like most of these "stock drop" cases in recent years, the District Court granted the defendants' motion to dismiss.[9] Because the Plan contains an ESOP, the District Court held that "the plan fiduciaries start with a presumption that their 'decision to remain invested in employer securities was reasonable.'"[10] The District Court further held that "there really is no choice but to apply the . . . presumption at the pleading stage," and that "a claim for breach of fiduciary duty only becomes plausible if there are sufficient facts alleged to conclude that a prudent fiduciary acting under similar circumstances would have made a different investment decision."[11] Applying that standard, the District Court held that "Plaintiffs have failed to allege facts which overcome the presumption that Defendants' decision to remain invested in [company] stock was reasonable."[12]

The Sixth Circuit Affirmed the Existence of the Presumption, But Held it Did Not Apply at the Pleadings Stage

On appeal,[13] the Sixth Circuit reaffirmed its prior precedent holding that an ESOP "fiduciary's decision to remain invested in employer securities is presumed to be reasonable."[14] Nevertheless, the Sixth Circuit created a circuit split as to when the presumption applies. Specifically, the Sixth Circuit held that the presumption should only apply "at summary judgment to a fully developed evidentiary record and reasoned that it would be inconsistent to apply the . . . presumption—which concerns questions of fact—at the pleading stage where the court must accept the well pled factual allegations of a complaint as true."[15]

Rather than relying upon the presumption, the Sixth Circuit held that "the proper question at the Rule 12(b)(6) stage in this case is whether the . . . Complaint pleads 'facts to plausibly allege that a fiduciary has breached its duty to the plan' and a causal connection between that breach and the harm suffered by the plan—'that an adequate investigation

---

6 *Id.*

7 *Id.*

8 *Id.*

9 *Dudenhoeffer v. Fifth Third Bancorp.*, 757 F. Supp. 2d 753 (S.D. Ohio 2010).

10 *Id.* at 758 (quoting *Kuper v. Iovenko*, 66 F.3d 1447, 1459 (6th Cir. 1995)).

11 *Id.*

12 *Id.* at 760.

13 *Dudenhoeffer v. Fifth Third Bancorp,* 692 F.3d 410 (6th Cir. 2012).

14 *Id.* at 418 (internal citations omitted).

15 *Id.*

would have revealed to a reasonable fiduciary that the investment . . . was improvident.'"[16] The Sixth Circuit concluded that the complaint satisfied that standard and therefore reversed the dismissal.[17]

The Supreme Court Rejects the Presumption

In reviewing the Sixth Circuit's decision, the Supreme Court first considered whether the presumption of prudence was appropriate under the statute. The Court began this analysis with the statutory provision at issue, specifically ERISA § 404(a)(2),[18] which provides that ESOP fiduciaries do not violate either ERISA's diversification requirement or its prudence requirement—to the extent prudence requires diversification—by holding or purchasing employer stock. The Court ruled that this section "makes no reference to a special 'presumption' in favor of ESOP fiduciaries," and that "[i]t does not require plaintiffs to allege that the employer was on the 'brink of collapse,' under 'extraordinary circumstances,' or the like."[19] Rather, the Court held that Section 404(a)(2) only alters ERISA's fiduciary duties "in a precisely delineated way: It provides that an ESOP fiduciary is exempt from [ERISA]'s diversification requirement and also from [the] duty of prudence, but '*only to the extent that it requires diversification*.'"[20]

Other than the fact that "ESOP fiduciaries . . . are not liable for losses that result from a failure to diversify," the Court concluded that "because ESOP fiduciaries are ERISA fiduciaries and because [ERISA]'s duty of prudence applies to all ERISA fiduciaries, ESOP fiduciaries are subject to the duty of prudence just as other ERISA fiduciaries are."[21]

The Court rejected several arguments proffered by the defendants as to why the presumption should continue to apply. First, the defendants argued that ESOPs were intended to promote employee stock ownership, and that the presumption was thereby consistent with ERISA § 404(a)(1)(B),[22] which "defines the duty of prudence in terms of what a prudent person would do 'in the conduct of an enterprise of a like character and with like aims.'"[23]

The Court rejected this reading of Section 404(a)(1)(B) in light of the preceding subsection, ERISA § 404(a)(1)(A), which requires that fiduciaries act "for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan."[24] The Court thus concluded that a plan's exclusive purpose must be to provide benefits, and that, "[r]ead in the context of ERISA as a whole, the term 'benefits' . . . must be understood to refer to . . . *financial* benefits (such as retirement income)," rather than "nonpecuniary benefits like those supposed to arise from employee ownership of employer stock."[25]

The Court further held that a contrary reading was inconsistent with ERISA § 404(a)(1)(D), which requires fiduciaries to act "in accordance with the documents and instruments governing the plan insofar as such documents and instruments

---

16 *Id.* (quoting *Pfeil v. State Street Bank & Trust Co.*, 671 F.3d 585, 596 (6th Cir. 2012)).

17 *Id.*

18 29 U.S.C. § 1104(a)(2).

19 *Fifth Third*, 2014 WL 2864481, at *6.

20 *Id.* at *7 (quoting ERISA § 404(a)(2)) (emphasis in original).

21 *Id.*

22 29 U.S.C. § 1104(a)(1)(B).

23 *Fifth Third*, 2014 WL 2864481, at *7 (quoting ERISA § 404(a)(1)(B)).

24 29 U.S.C. § 1104(a)(1)(A).

25 *Fifth Third*, 2014 WL 2864481, at *7 (emphasis in original).

are consistent with the provisions of" ERISA.[26] The Court held that "[t]his provision makes clear that the duty of prudence trumps the instructions of a plan document, such as an instruction to invest exclusively in employer stock even if financial goals demand the contrary."[27]

The Court also rejected a second defense argument that, "under the common law of trusts . . . the settlor can reduce or waive the prudent man standard of care by specific language in the trust instrument," and that this common law rule would mean that the Plan's "documents waived the duty of prudence to the extent that it comes into conflict with investment in [company] stock."[28] The Court held that this was inconsistent with its prior precedent that, "by contrast to the rule at common law, 'trust documents cannot excuse trustees from their duties under ERISA.'"[29]

The Court likewise rejected a third defense argument "that subjecting ESOP fiduciaries to a duty of prudence without the protection of a special presumption will lead to conflicts with the legal prohibition on insider trading."[30] While finding this concern to be "legitimate," the Court held that such a rule would be "ill-fitting" because "[w]hile ESOP fiduciaries may be more likely to have insider information about a company that the fund is investing in than are other ERISA fiduciaries, the potential for conflict with the securities laws would be the same for a non-ESOP fiduciary who had relevant inside information about a potential investment."[31]

Finally, the Court addressed the argument "that, without some sort of special presumption, the threat of costly duty-of-prudence lawsuits will deter companies from offering ESOPs to their employees, contrary to the stated intent of Congress."[32] While recognizing "that Congress sought to encourage the creation of ESOPs," the Court held that the presumption was not "an appropriate way to weed out meritless lawsuits or to provide the requisite 'balancing.'"[33] As the Court explained, "[s]uch a rule does not readily divide the plausible sheep from the meritless goats. That important task can be better accomplished through careful, context-sensitive scrutiny of a complaint's allegations."[34]

What the Supreme Court Giveth the Plaintiffs, the Supreme Court Taketh Away, a/k/a How to "Divide the Plausible Sheep from the Meritless Goats"

Having rejected the presumption, the Court proceeded to guide the lower courts on how to evaluate the plausibility of stock drop complaints without the presumption. The Court began this section of the opinion with a direct reference to its prior decisions in *Ashcroft v. Iqbal*[35] and *Bell Atlantic Corp. v. Twombly*,[36] making it absolutely clear that the standards from those cases must be followed in the context of a Rule 12(b)(6) motion to dismiss for stock drop cases.

---

26 29 U.S.C. § 1104(a)(1)(D).

27 *Fifth Third,* 2014 WL 2864481, at *8.

28 *Id.*

29 *Id.* (quoting *Central States, Southeast & Southwest Areas Pension Fund v. Central Transport, Inc.*, 472 U. S. 559, 568 (1985)).

30 *Id.* at *9.

31 *Id.* at *9.

32 *Id.*

33 *Id.* at *10.

34 *Id.*

35 556 U.S. 662, 677-80 (2009).

36 550 U.S. 544, 554-63 (2007).

First, the Court addressed the common allegations raised in stock drop cases that ESOP fiduciaries "knew or should have known in light of publicly available information, such as newspaper articles, that continuing to hold and purchase [company] stock was imprudent."[37] The Court held 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."[38] As the Court explained, a contrary holding would require ERISA fiduciaries to outperform the market.[39] Thus, the Court explained, "a fiduciary usually is not imprudent to assume that a major stock market . . . provides the best estimate of the value of the stocks traded on it that is available to him."[40]

The Court did leave open the possibility that "a plaintiff could nonetheless plausibly allege imprudence on the basis of publicly available information by pointing to a special circumstance affecting the reliability of the market price as 'an unbiased assessment of the security's value in light of all public information.'"[41] In this regard, the Court cited its recent opinion in *Halliburton Co. v. Erica P. John Fund, Inc.*,[42] which affirmed the continuing viability of *Basic Inc. v. Levinson*,[43] and the "fraud-on-the-market" presumption in most cases, but left open the possibility for securities class action defendants to rebut this presumption under appropriate circumstances.

In ERISA cases, however, it will be the plaintiffs who seek to rebut "fraud-on-the-market" if they try to build their ERISA stock drop case on public information. In any event, absent allegations designed to rebut fraud-on-the-market, the general rule announced by the Court is that a complaint that seeks to hold fiduciaries liable for failing to act upon publicly available information fails to state a plausible claim. Applying that standard to the case at bar, the Court held that the Sixth Circuit "did not point to any special circumstance rendering reliance on the market price imprudent," and that its "decision to deny dismissal therefore appears to have been based on an erroneous understanding of the prudence of relying on market prices."[44]

The Court then turned to whether and how fiduciaries are required to use nonpublic, or insider, information in satisfying their ERISA fiduciary duties. The Court held that "[t]o state a claim for breach of the duty of prudence on the basis of inside 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 to help it."[45]

The Court provided three points of emphasis to guide this analysis. First, the Court held that "in deciding whether the complaint states a claim upon which relief can be granted, courts must bear in mind that the duty of prudence, under ERISA as under the common law of trusts, does not require a fiduciary to break the law."[46] Noting that "[f]ederal securities

---

37 *Fifth Third*, 2014 WL 2864481, at *11.

38 *Id.*

39 *Id.*

40 *Id.*

41 *Id.* (quoting *Halliburton Co. v. Erica P. John Fund, Inc.*, No. 13-317, 2014 WL 2807181, at *10 (U.S. June 23, 2014)).

42 No. 13-317, 2014 WL 2807181, at *10 (U.S. June 23, 2014).

43 485 U.S. 224 (1988).

44 *Fifth Third*, 2014 WL 2864481, at *11.

45 *Id.* at *12.

46 *Id.*

laws 'are violated when a corporate insider trades in the securities of his corporation on the basis of material, nonpublic information,'" the Court held that "ERISA's duty of prudence cannot require an ESOP fiduciary to perform an action—such as divesting the fund's holdings of the employer's stock on the basis of inside information—that would violate the securities laws."[47] The Court held that "[t]o the extent that the Sixth Circuit denied dismissal based on the theory that the duty of prudence required petitioners to sell the ESOP's holdings of Fifth Third stock, its denial of dismissal was erroneous."[48]

The Supreme Court also instructed lower courts that "where a complaint faults fiduciaries for failing to decide, on the basis of the inside information, to refrain from making additional stock purchases or for failing to disclose that information to the public so that the stock would no longer be overvalued . . . [t]he 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 requirements imposed by the federal securities laws *or with the objectives of those laws*."[49] Thus, the Court directed the lower courts to consider whether imposing an ERISA fiduciary duty would not only conflict with the letter of the securities laws, but that they should also consider whether such a duty would conflict with the *spirit* of the securities laws.

Finally, the Court counseled that "lower courts faced with such claims should also 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."[50] In other words, the Court explained that a plaintiff must plausibly allege that no prudent fiduciary would have (1) continued purchasing, or (2) failed to disclose negative insider information, despite the substantial risk (expressly acknowledged by the Court) that taking such an action would cause the company stock price to drop, thereby harming the plan's participants.

So What Does All of This Mean For the Future of These Cases?

The most immediate impact with respect to this decision on stock drop cases is that there will be more of them. The demise of the presumption of prudence, and its replacement with what the plaintiffs' bar will refer to as "dicta" with regard to the plausibility of these claims, will likely cause renewed interest in the ERISA class action plaintiffs' bar. Many of them had lost hope of surviving a motion to dismiss, and this brand new approach announced by the Court in place of the presumption will open the door for a whole new round of litigation over what the Court's "plausibility" guidance means under the circumstances at issue in new or recently filed cases.

Hopefully, the lower courts will take the Supreme Court's analysis to heart. The Court has left a very narrow window for plaintiffs to plausibly allege a breach of fiduciary duty claim based upon a drop in publicly traded company stock.

For one thing, the decision all but eliminates plaintiffs' ability to rely upon publicly available information as a basis to allege a breach of fiduciary duty. In the absence of "special circumstances" that would rebut the fraud-on-the-market presumption, public information is simply not sufficient to state a plausible claim. Undoubtedly, some plaintiffs will try

---

47 *Id.* (quoting *United States v. O'Hagan*, 521 U.S. 642, 651-52 (1997)).

48 *Id.*

49 *Id.*

50 *Id.* (emphasis added).

to allege such "special circumstances." But this will be difficult for them to do, and indeed it may require expert analysis and testimony at the pleading stage of such a case. As such, we believe most plaintiffs will avoid this approach and instead focus their claims on nonpublic, insider information.[51]

But plaintiffs should find an equally hard road ahead of them with respect to the use of nonpublic information because there are several important and severely limiting aspects of the guidance provided by the Court.

First, the Court held, unremarkably, that ESOP fiduciaries have no obligation to violate insider trading or other federal securities laws. This should eliminate most, if not all, claims of "holders"—those who already owned the stock at the beginning of the alleged class period. If the fiduciaries cannot sell stock based on nonpublic information, that leaves only their ability to disclose such information or cut off future purchases. Under the efficient market theory reaffirmed by the Supreme Court in Halliburton, the market will promptly adjust to reflect disclosure of negative information in the price of the stock, and holders will be left without a way to avoid the alleged harm at issue. Since the "holders" often represent a significant amount of the potential exposure in many of these cases, this affirmation by the Court should result in significantly smaller cases.

Second, the Court has made it clear that the securities laws are in control here, not ERISA. The Court notes that such laws are complex and control both trading and disclosure obligations. Manifestly, such laws do not require disclosure by ERISA fiduciaries, but instead specify duties of disclosure that apply to others. In our view, an alleged obligation for ERISA fiduciaries to make separate or competing public disclosures with regard to public companies would clearly and significantly conflict with the "complex" and comprehensive disclosure rules enunciated by the securities laws and the SEC regulations established thereunder, as well as the "objectives of those laws." Moreover, even though avoiding a purchase based on nonpublic information might not be a technical violation of insider trading laws, it also arguably violates the objectives of such laws, which include establishing a fair playing field for all investors in public companies and not giving any investors—not even retirement plans or their participants—special treatment.

Finally, any complaint which alleges that a fiduciary should have taken some type of corrective action should be viewed against the Court's warning that plaintiffs must plausibly allege that a prudent fiduciary could not determine that such an action would do more harm than good. And the Court specifically acknowledges that either of the potentially, or arguably, "legal" options available—disclosure and/or preventing purchases—will likely cause the price of the company stock to drop, thereby harming the plan and its participants. Thus, it is unclear to what extent, if any, claims based upon nonpublic information will truly be viable in the wake of *Fifth Third*.

In sum, because *Fifth Third* puts an end to the presumption of prudence, there will undoubtedly be another round of cases focused on interpreting the Court's guidance regarding the plausibility of these claims. Defendants in these cases will have much to argue in their favor on future motions to dismiss. When the dust settles, plaintiffs will likely find it very difficult—perhaps even more difficult than under the presumption—to state plausible prudence claims against defendant fiduciaries with regard to employer stock in retirement plans.

The *Fifth Third* decision seems to significantly change the landscape for employers and ESOP fiduciaries. Employers and fiduciaries should consider their options as they contemplate how to react to this decision. We are happy to share our thoughts further with you as you consider your next steps.

---

51 The difficulty with building such a case on public information may lead more employers to consider using an independent fiduciary to be responsible for employer stock in these plans, and to avoid providing the independent fiduciary nonpublic information.

If you would like to receive future *ERISA Litigation Advisories* electronically, please forward your contact information to **erisa.advisory@alston.com**. Be sure to put "**subscribe**" in the subject line.

If you have any questions or would like additional information, please contact your Alston & Bird attorney or any of the following:

Emily Seymour Costin
202.239.3695
emily.costin@alston.com

Patrick C. DiCarlo
404.881.4512
pat.dicarlo@alston.com

Ashley Gillihan
404.881.7390
ashley.gillihan@alston.com

David R. Godofsky, F.S.A.
202.239.3392
david.godofsky@alston.com

John R. Hickman
404.881.7885
john.hickman@alston.com

H. Douglas Hinson
404.881.7590
doug.hinson@alston.com

Emily C. Hootkins
404.881.4601
emily.hootkins@alston.com

Jonathan G. Rose
202.239.3693
jonathan.rose@alston.com

Thomas G. Schendt
202.239.3330
thomas.schendt@alston.com

Richard S. Siegel
202.239.3696
richard.siegel@alston.com

Elizabeth Vaughan
404.881.4965
beth.vaughan@alston.com

ALSTON & BIRD LLP

WWW.ALSTON.COM

ATLANTA: One Atlantic Center ▪ 1201 West Peachtree Street ▪ Atlanta, Georgia, USA, 30309-3424 ▪ 404.881.7000 ▪ Fax: 404.881.7777
BRUSSELS: Level 20 Bastion Tower ▪ Place du Champ de Mars ▪ B-1050 Brussels, BE ▪ +32 2 550 3700 ▪ Fax: +32 2 550 3719
CHARLOTTE: Bank of America Plaza ▪ 101 South Tryon Street ▪ Suite 4000 ▪ Charlotte, North Carolina, USA, 28280-4000 ▪ 704.444.1000 ▪ Fax: 704.444.1111
DALLAS: 2828 North Harwood Street ▪ 18th Floor ▪ Dallas, Texas, USA, 75201 ▪ 214.922.3400 ▪ Fax: 214.922.3899
LOS ANGELES: 333 South Hope Street ▪ 16th Floor ▪ Los Angeles, California, USA, 90071-3004 ▪ 213.576.1000 ▪ Fax: 213.576.1100
NEW YORK: 90 Park Avenue ▪ 12th Floor ▪ New York, New York, USA, 10016-1387 ▪ 212.210.9400 ▪ Fax: 212.210.9444
RESEARCH TRIANGLE: 4721 Emperor Blvd. ▪ Suite 400 ▪ Durham, North Carolina, USA, 27703-85802 ▪ 919.862.2200 ▪ Fax: 919.862.2260
SILICON VALLEY: 1950 University Avenue ▪ 5th Floor ▪ East Palo Alto, CA 94303-2282 ▪ 650.838.2000 ▪ Fax: 650.838.2001
WASHINGTON, DC: The Atlantic Building ▪ 950 F Street, NW ▪ Washington, DC, USA, 20004-1404 ▪ 202.756.3300 ▪ Fax: 202.756.3333