Client Alert

June 26, 2014

U.S. Supreme Court Abolishes the Presumption of Prudence in ERISA Stock Drop Cases

By Paul Flum and Nicholas S. Napolitan

A recurring scenario in ERISA litigation involves claims against fiduciaries of 401(k) retirement plans who are alleged to have breached their fiduciary duty by failing to discontinue investment in employer stock following a material drop in the stock price. The question is: Under what circumstances will a failure to stop investment in employer stock support a claim for breach of fiduciary duty? To date, every circuit—except the Sixth—that has considered the issue has applied a "presumption of prudence" that required a complaint to allege non-conclusory facts showing that the fiduciaries knew or should have known that the corporate employer faced dire circumstances that threatened its financial viability.

On June 25, 2014, the U.S. Supreme Court issued its opinion in *Dudenhoeffer v. Fifth Third Bancorp, et al.*, No. 12-751, categorically rejecting the "presumption of prudence." The Court instead held that complaints in ERISA stock drop cases should be reviewed under Rule 12 "plausibility" standards, applying a "careful, context-sensitive scrutiny of a complaint's allegations."

DEVELOPMENT OF THE PRESUMPTION OF PRUDENCE

ERISA imposes a "prudent person" standard of care on plan fiduciaries. To comply with that standard, a fiduciary must act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."

Before the Supreme Court's ruling in *Fifth Third Bancorp*, courts had developed a deferential "presumption of prudence" to resolve cases that involved investment in employer stock. Courts set forth various bright line tests for how this standard could be met. In the Ninth Circuit, for example, a plaintiff had to show that the company's viability was in jeopardy or was subject to serious mismanagement to rebut the presumption. In the Third Circuit, a plaintiff had to show that the company faced a dire situation. The presumption of prudence was intended to strike a balance between ensuring responsible management of company retirement plans, on the one hand, and encouraging the adoption of plans that link employee compensation to the company's success, on the other.

THE *FIFTH THIRD BANCORP* CASE

The plaintiffs in *Fifth Third Bancorp* were participants in a defined contribution retirement plan offered by Fifth Third Bancorp, a financial services company. The plan offered 20 investment options, including a fund invested in company stock. The plaintiffs alleged that, beginning in July 2007, Fifth Third Bancorp faced growing risks due to its participation in the subprime loan market and that, because of these risks, company stock was not a prudent investment. They further alleged that the defendants—most of whom were members of the company's Pension, Profit Sharing, and Medical Plan Committee—knew of the risks to the company's operations. The plaintiffs contended that these defendants breached their fiduciary duties under ERISA by continuing to allow plan participants to invest in company stock.

The district court granted the defendants' motion to dismiss the case, finding that the plaintiffs had failed to allege facts that could overcome the presumption of prudence adopted in other circuits. The Sixth Circuit reversed, holding that the presumption of prudence does not apply at the motion to dismiss stage. According to the Sixth Circuit, a fiduciary's decision to remain invested in employer stock is subject to an abuse of discretion standard, which "only requires a plaintiff to prove that 'a prudent fiduciary acting under similar circumstances would have made a different investment decision.'"

The Supreme Court granted the Bank's petition for certiorari.

THE SUPREME COURT'S REJECTION OF THE PRESUMPTION OF PRUDENCE

The Supreme Court unanimously rejected the presumption of prudence as contrary to ERISA's text. As the Court explained, nothing in ERISA "makes reference to a special 'presumption' in favor of ERISA fiduciaries," or requires plaintiffs to allege that an employer was on the "brink of collapse" to state a claim for permitting investment in employer stock. Instead, the Court held that the same standard of prudence applies to all ERISA fiduciaries and that complaints in ERISA stock drop cases should be evaluated under Rule 12 to "divide the plausible sheep from the meritless goats." Because ERISA provides that the duty of prudence "'turns on the circumstances… prevailing' at the time the fiduciary acts," the "appropriate inquiry will necessarily be context specific."

The balance of the opinion lays out a series of "considerations" that govern the application of that pleading standard in a duty of prudence case. Notably, the Court did not take up the question of whether the defendants in *Fifth Third Bancorp* violated their disclosure-related duties under ERISA, or whether they breached their duty of loyalty, both of which are commonly alleged alternative theories of liability in ERISA stock drop cases.

First, the Court addressed the Sixth Circuit's determination that the complaint adequately alleged that plan fiduciaries knew or should have known that investment in the employer was imprudent in light of publically available information. The Court rejected that finding, explaining that "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…." Instead, ERISA fiduciaries are entitled to rely on the accuracy of market prices, except in "special circumstances affecting the reliability of the market price . . . that would make reliance on the market's valuation imprudent." The Court did not explain what facts might qualify as "special circumstances."

Second, the Court turned to the standards for pleading a breach of fiduciary duty claim based on inside information. The Court held that to state such a claim, "a plaintiff must plausibly allege an alternative action" that the fiduciaries could have taken. The Court emphasized three points that "inform the requisite analysis" of any alleged alternative:

- The action cannot involve divestment of the plan's existing holdings in employer stock, as this would require the fiduciaries to breach the federal securities laws. In most circumstances, this holding should prevent plaintiffs from alleging that fiduciaries breached their duty of prudence by failing to sell plan investments based on inside information.

- If the alleged alternative involves causing the plan to stop new purchases of company stock or to disclose nonpublic information "so that the stock would no longer be overvalued," the Court noted that "additional considerations arise," including whether the alternative "could conflict with the complex insider trading and corporate disclosure requirements imposed by federals securities laws or with the objectives of those laws." The Court did not elaborate on the answer to this legal question, except to note that the views of the U.S. Securities and Exchange Commission "may well be relevant."

- Finally, if the alleged alternative does not conflict with federal securities laws, then the plaintiff must plausibly allege "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 cause 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." This statement, on its face, presents a formidable pleading burden in cases where the plan already holds a significant amount of employer stock.

THE BOTTOM LINE FOR PLAN FIDUCIARIES

By rejecting a bright line test that had been adopted by most circuits, the *Fifth Third Bancorp* opinion adds uncertainty to ERISA stock drop cases and can be expected to engender increased litigation against plan fiduciaries. The opinion also provides fertile ground for motions to dismiss claims that continued investment in employer stock was imprudent. It will be important to watch how district and appellate courts deal with these issues over the next several years.

Contact:

Paul Flum	**Nicholas S. Napolitan**
(415) 268-7335	(415) 268-6789
paulflum@mofo.com	nnapolitan@mofo.com

About Morrison & Foerster:

