Brenda Berg

Partner
303.295.8029
Denver
brberg@hollandhart.com

U.S. Supreme Court Eliminates Fiduciary Protection for Employer Stock Investment

U.S. Supreme Court Eliminates Fiduciary Protection for Employer Stock Investment

Insight — June 25, 2014

Today, the U.S. Supreme Court issued its unanimous opinion that retirement plan fiduciaries are not entitled to a presumption of prudence with respect to the plan's investment in employer stock. *Fifth Third Bancorp v. Dudenhoeffer*, U.S., No. 12-751, 6/25/14. Instead, the fiduciaries are subject to the same duty of prudence that applies to all investment decisions made by ERISA fiduciaries. The rejection of the presumption of prudence might result in an increase in litigation involving employer stock. However, the Court also ruled that the ERISA duty of prudence does not require violating securities laws by disclosing insider information or otherwise taking action that could be in violation of securities laws, and the Court articulated a high pleadings standard for overcoming a motion to dismiss on that point.

Presumption of Prudence

Retirement plan fiduciaries have a duty to act prudently: with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity would act. Many federal circuit courts had adopted a rule that if the governing plan document requires an employer stock investment option, especially where such portion of the plan is designated as an ESOP, then there is a presumption that the fiduciary duty of prudence is met. This presumption is often referred to as the *Moench* presumption, after the case that first articulated it.

Fiduciaries also have a duty to follow the terms of the plan documents, unless doing so would be contrary to ERISA. The *Moench* presumption of prudence was an attempt to balance the duty or prudence with the duty to follow plan documents, considering Congress's intent to encourage employee ownership through ESOPs. Under the presumption, fiduciaries have a duty to follow plan documents that require an employer stock investment option, unless the employer is in such "dire" circumstances, such as an employer's bankruptcy, that would likely make the employer go out of business.

In the *Dudenhoeffer* case, the plaintiffs, who were participants in the plan, alleged that the fiduciaries had violated the duty of prudence by permitting participants to invest in employer stock, and that in July 2007, the fiduciaries knew or should have known that the stock was overvalued. From July 2007 to September 2009, when the complaint was filed, the Fifth Third stock price fell 74%. Although the District Court had dismissed the

case based on the presumption of prudence, the Sixth Circuit Court of Appeals reversed and held that the presumption of prudence did not apply at the pleading stage, but only at the evidentiary stage. The U.S. Supreme Court rejected that as well, since the Court held the presumption of prudence does not apply at all. The Court found the presumption was not supported by the statutory language, which provides an ESOP exception from ERISA's duty to diversify but not from the duty of prudence – and Congress's intent to encourage ESOP investments does not override that. In addition, even where the plan document requires an employer stock investment, the regular duty of prudence applies rather than a requirement that only "dire" circumstances can override the plan language.

Conflict with Insider Trading Laws

The Court acknowledged that potential for conflict with the insider trading laws is a legitimate concern. In publicly traded companies, plan fiduciaries are often corporate insiders as well. However, the Court held that a presumption of prudence "is an ill-fitting means" of addressing the concern. The Court also recognized that lack of a presumption may put the fiduciary between a rock and a hard place, in that the fiduciary could be sued for failing to divest the stock, or could be sued for failing to allow the stock as an investment option where the plan documents require it. Again, though, the Court held that the presumption of prudence is not the proper way to address this concern; rather, a motion to dismiss for failure to state a claim is the proper mechanism.

Ultimately, the Court vacated the judgment of the Court of Appeals and remanded the case to consider whether the pleadings were sufficient to overcome a motion to dismiss. The Court referred to its previous guidance of considerations on the insider trading issue. As a general rule, where a stock is publicly traded, it would not be sufficient to claim that the fiduciary should have recognized the stock was overvalued based on publicly available information unless the plaintiffs could point to special circumstances affecting the reliability of the market price. With respect to nonpublic information available to the fiduciaries as company insiders, the Court said the plaintiffs must allege an alternative action that the fiduciaries 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 (for example, by driving the price down in a sell-off) than to help it.

Note that the case involved publicly traded employer stock, and does not provide much guidance for fiduciaries of ESOPs with non-publicly traded stock.

Next Steps for Plan Fiduciaries

In light of today's *Dudenhoeffer* decision, fiduciaries of retirement plans that allow investments in employer stock should reevaluate whether employer stock is a prudent plan investment. Fiduciaries can no longer rely on the *Moench* presumption that the investment would be prudent as long as the documents required the employer stock and the employer was not experiencing "dire" or other extreme circumstances. Instead, fiduciaries

must evaluate all of the circumstances of the employer, within the confines of securities laws, and determine on that basis whether employer stock is a prudent investment under the plan. In other words, fiduciaries must treat an employer stock investment just like every other investment offered under the plan. If the fiduciaries determine that employer stock should no longer be offered under the plan, the removal of the stock should be undertaken carefully in order to best protect fiduciaries from participant claims for the removal of the stock.

For questions regarding employee benefits, please contact a member of Holland & Hart's Benefits Law Group.
