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What Fifth Third Bancorp v. Dudenhoeffer May Mean for ERISA Stock-Drop Litigation

August 28, 2014

Did the future course of "stock-drop" litigation under the Employee Retirement Income Security Act (ERISA) against fiduciaries of public company employee stock ownership plans (ESOPs) take a sharp turn on June 25, 2014, when the United States Supreme Court issued its unanimous opinion in *Fifth Third Bancorp v. Dudenhoeffer*? Maybe—but then again, maybe not. Ultimately, the Supreme Court's decision may not alter the probability of obtaining a dismissal at the pleading stage in stock-drop cases. But even if the concentration of defense-friendly litigation results remains largely the same, the *Dudenhoeffer* decision will alter the analytical framework for evaluating pleading allegations and dispositive motions in these cases in important ways. Why? Because, in *Dudenhoeffer*, the Supreme Court proclaimed the death of the so-called presumption of prudence—or what became known as the "*Moench* presumption"—which has effectively insulated ESOP fiduciaries from liability in all but the most dramatic stock-drop cases for nearly two decades. But before we discuss the Supreme Court's ruling and what practitioners should be thinking about in light of that ruling, we briefly review the origin and prevailing lower court acceptance of the presumption prior to the Supreme Court's decision. **The Origin and Broad Acceptance of the "Presumption Of Prudence"** In *Moench v. Robertson*, 62 F.3d 553 (3d Cir. 1995), the U.S. Court of Appeals for the Third Circuit addressed the appropriate standard of review for the discharge of an ERISA plan fiduciary's responsibilities in administering a company's ESOP plan in light of a significant drop in the share price of the company's stock. Charles Moench was a former employee of Statewide Bancorp and a participant in its ESOP. *Moench*, 62 F.3d at 559. Between July 1989 and May 1991, Statewide's share price fell from $18.25 to less than 25 cents per share. *Id.* at 557. During that time, bank regulators repeatedly expressed concern to Statewide's board of directors (who were also members of Statewide's ESOP Committee) about the company's financial condition. Statewide filed a voluntary bankruptcy petition under Chapter 11 in May 1991. Mr. Moench filed a class action lawsuit alleging, among other claims, that Statewide's ESOP Committee breached ERISA fiduciary duties by continuing to invest in Statewide stock in the face of regulatory and financial problems and declining stock values. *Id.* at 559. The district court granted the committee's motion for summary judgment, holding that the

committee had no discretion under the terms of the ESOP plan to invest in anything other than Statewide stock. *Id.* at 560. The Third Circuit vacated the district court's decision and remanded for further proceedings. After finding that the terms of the Statewide ESOP "did not absolutely require the Committee to invest exclusively in Statewide stock" (*id.* at 568), the Third Circuit observed that the Committee, in limited circumstances, could be liable under ERISA for continuing to invest in employer stock despite the plan's primary purpose. The court nevertheless held that, "in the first instance, an ESOP fiduciary who invests [plan] assets in employer stock is entitled to a presumption that it acted consistently with ERISA by virtue of that decision," but the presumption may be overcome "by establishing that the fiduciary abused its discretion by investing in employer securities." *Id.* at 571. To rebut the presumption, the court further explained, "the plaintiff may introduce evidence that owing to circumstances not known to the settlor and not anticipated by him the making of such investment would defeat or substantially impair the accomplishment of the purposes of the trust." *Id.* (quoting *Restatement (Second) of Trusts* § 227 cmt. g (1959) (internal quotations and alterations omitted)). In arriving at an appropriate standard of review in the summary judgment context, the *Moench* court attempted to reconcile the duties of loyalty and prudence that ERISA fiduciaries generally owe to plan participants and beneficiaries, Congress's express goal of encouraging employee investment in company stock, and basic principles of trust law, which were codified in and made applicable to ERISA. In 2007, the Third Circuit explicitly extended the *Moench* presumption beyond ESOPs to all ERISA-governed "Eligible Individual Account Plans" (EIAPs). *See Edgar v. Avaya, Inc.*, 503 F.3d 340 (3d Cir. 2007). By their terms, EIAPs invest primarily in qualifying employer securities (*see id.* at 347) but are often part of a larger company retirement plan platform offering participants other investment options, as was the case in *Dudenhoeffer*. In *Edgar*, the Third Circuit also affirmed that the *Moench* presumption was properly applied at the pleading stage, on a Rule 12 motion to dismiss. *See id.* at 349. In the years since *Moench*, every other United States Court of Appeals to confront the issue likewise adopted some strain of the fiduciary-friendly presumption—either at the pleading stage or as an "evidentiary presumption" applicable later in the proceedings. *See, e.g.*, *White v. Marshall & Ilsley Corp.*, 714 F.3d 980, 989 (7th Cir. 2013); *In re Citigroup ERISA Litig.*, 662 F.3d 128, 139–40 (2d Cir. 2011); *Quan v. Computer Sciences Corp.*, 623 F.3d 870, 882 (9th Cir. 2010); *Kirschbaum v. Reliant Energy, Inc.*, 526 F.3d 243, 256 (5th Cir. 2008); *Kuper v. Iovenko*, 66 F.3d 1447, 1459 (6th Cir. 1995). While some district courts denied motions to dismiss in particular cases because they concluded that the plaintiff's allegations overcame the presumption or that the presumption did not apply at the pleading stage, no court outright rejected the presumption's validity in some form under ERISA. That changed with*Dudenhoeffer*. **The Supreme Court's Rejection of the Presumption** The lower *Dudenhoeffer* courts set the stage for the Supreme Court's pronouncement regarding the demise of the presumption. While neither lower court rejected the bona fides of the presumption under ERISA, each went in a different direction regarding the applicability of the presumption to the posture of the case. Relying, in part, on the pleading-stage form of the presumption, the United States District Court for the Southern District of Ohio dismissed the *Dudenhoeffer* complaint for failure to state a claim. *See Dudenhoeffer v. Fifth Third Bancorp*, 757 F. Supp. 2d 753, 758–59, 760–

62 (S.D. Ohio 2010). The Sixth Circuit reversed, holding that although ESOP fiduciaries are entitled to a presumption of prudence, the presumption is evidentiary only and thus should not apply at the pleading stage. *Dudenhoeffer v. Fifth Third Bancorp*, 692 F.3d 410, 418–19 (6th Cir. 2012). The appellate court then concluded that the plaintiff ESOP participants' allegations—that, by July 2007, Fifth Third's ESOP fiduciaries knew or should have known that Fifth Third's stock was overvalued and excessively risky based on both publicly available and nonpublic information regarding the subprime lending business—were sufficient to state a claim for breach of fiduciary duty. *Id.* at 419–20. Effectively wiping the slate clean, the Supreme Court ruled that the "presumption of prudence" in favor of ESOP fiduciaries' buy and hold decisions has no place in ERISA jurisprudence. *Fifth Third Bancorp v. Dudenhoeffer*, 134 S. Ct. 2459 (2014). According to the Court, no such presumption should be applied at the pleading stage or otherwise in ERISA stock-drop cases. *See id.* at 2467 ("In our view, the law does not create a special presumption favoring ESOP fiduciaries."). "Instead, ESOP fiduciaries are subject to the same duty of prudence that applies to ERISA fiduciaries in general, except that they need not diversify the fund's assets." *Id.* at 2463 (citing 29 U.S.C. § 1104(a)(2)). Moreover, the Court stated, ERISA "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." *Id.* at 2468 (citing 29 U.S.C. §§ 1104(a)(1)(D), 1110(a)). Thus, according to the Supreme Court's rationale, the string of lower courts that for years had required stock-drop plaintiffs to plead or prove around the presumption—by essentially having to show that the employer company was "on the brink of collapse" while the ESOP fiduciary continued to buy and hold stock for the plan—had been uniformly misinterpreting ERISA. *See id.* at 2462. If the Court had stopped there and affirmed the Sixth Circuit's ruling that the *Dudenhoeffer* complaint sufficiently alleged a claim for breach of fiduciary duty, the ERISA class action plaintiffs' bar would surely be heralding the *Dudenhoeffer* decision as a huge victory. But the Court did not do that. The Court had more to say, and lawyers on both sides should be listening. **The Supreme Court's Emphasis on Rule 12(B)(6) to Weed Out Meritless Suits** Before dispensing with the presumption of prudence, the Court called out a concern it shared with Fifth Third that turned out to be a precursor for a significant portion of the Court's opinion. That concern involved the potential for conflict between ERISA's duty of prudence and the federal securities laws' prohibition on insider trading. *See id.* at 2469 ("This [petitioner] concern is a legitimate one."). As the Court observed:

> "The potential for conflict arises because ESOP fiduciaries often are company insiders and because suits against insider fiduciaries frequently allege, as the complaint in this cases alleges, that the fiduciaries were imprudent in failing to act on inside information they had about the value of the employer's stock."

Id. Although the Court concluded that this legitimate concern did not warrant preserving the presumption of prudence, the Court did find that there were "alternative means of dealing with the potential for conflict" (*id.* at 2470), while also paying heed to ERISA's "'careful balancing' between ensuring fair and prompt enforcement of rights under a plan and the encouragement of the creation of such plans" (*id.*) *and* addressing the petitioner's plea for an effective mechanism "to weed out

meritless lawsuits” (*id.*). As the Court observed, “one important mechanism for weeding out meritless claims [is] the motion to dismiss for failure to state a claim.” *Id.* at 2471. Citing *Ashcroft v. Iqbal*, 556 U.S. 662, 677–80 (2009), and *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 554–63 (2007), the Court emphasized that the pleading-stage motion to dismiss “requires careful judicial consideration of whether the complaint states a claim that the defendant has acted imprudently,” and in light of the nature of the ERISA duty of prudence under 29 U.S.C. § 1104(a)(1)(B), “the appropriate inquiry will necessarily be context specific.” *Dudenhoeffer*, 134 S. Ct. at 2471. But the Court did not stop there. In vacating the Sixth Circuit’s ruling that the *Dudenhoeffer* plaintiffs stated a plausible duty-of-prudence claim, the Court laid out several important “considerations” for the lower court to take into account when reapplying the *Twombly*/*Iqbal* pleading standard to the stock-drop allegations at issue. First, the Court stated 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.” *Id.* at 2471. In other words, ERISA fiduciaries, akin to retail investors, “may, as a general matter, likewise prudently rely on the market price” of the employing company’s stock. *Id.* The Court expressly declined to consider what types of “special circumstances” might overcome this general rule of implausibility for an imprudence claim based on publicly available information. *See id.* at 2472. Interestingly, this aspect of the Supreme Court’s decision is consistent with the early observations in *Moench* and its progeny that a plan fiduciary should not be compelled to predict the company stock’s future performance—essentially being subjected to potential liability no matter what decision the fiduciary makes with respect to investment in the stock. *See, e.g.*, *Kirschbaum*, 526 F.3d at 256 (“A fiduciary cannot be placed in the untenable position of having to predict the future of the company’s stock performance.”); *Edgar*, 503 F.3d at 348–49 (“had defendants divested . . . during the Class Period, they would have risked liability for having failed to follow the terms of the Plans”). The Court then moved to the *Dudenhoeffer* plaintiffs’ claim that Fifth Third’s ESOP fiduciaries failed to act prudently based on nonpublic information that was allegedly available to them because they were Fifth Third insiders. The Court began:

> "To 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."

Dudenhoeffer, 134 S. Ct. at 2472. In articulating this standard, the Court first emphasized that the ERISA duty of prudence “does not require a fiduciary to break the law”; thus, an ESOP fiduciary cannot be required “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.” *Id.* Moreover, with respect to claims that the ESOP fiduciary should have refrained from additional stock purchases or disclosed inside information to the public so that the stock would no longer be overvalued, the Court instructed the lower courts to “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." *Id.* at 2473. In this regard, the Court observed that "[t]he U.S. Securities and Exchange Commission has not advised us of its views on these matters, and we believe those views may well be relevant." *Id.* Finally, the Court advised that lower courts should evaluate whether the complaint has plausibly alleged that a prudent fiduciary 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."

Id. While some questions remain unanswered, the Court's guidance undoubtedly establishes a significant pleading burden for stock-drop plaintiffs. So what should ERISA stock-drop practitioners expect to see in the wake of the Supreme Court's *Dudenhoeffer* opinion? We turn to that question next. **Practical Implications For Litigators** Notwithstanding the demise of the *Moench* presumption, ESOP fiduciary defendants remain armed with substantial weapons to combat, at the pleading stage, what will likely be an uptick in litigation at least until the lower courts resolve the questions left open by the Supreme Court. *Dudenhoeffer* has created three notable battlegrounds for future stock-drop motions practice. The first is what, if any, allegations will be sufficient to constitute "special circumstances" that would render imprudent a fiduciary's reliance on the market-derived share price for claims based solely on publicly available information. The Supreme Court expressly declined to offer any examples, and none may prove to exist. While plaintiffs in particular cases may allege that revelations of serious corporate malfeasance or economic anomalies would have caused a prudent fiduciary to divest immediately, defendants should still be well positioned to argue that the market is the best determiner of stock value based on the mix of information available to the market at any given time. *See Dudenhoeffer*, 134 S. Ct. at 2472 ("A fiduciary's failure to outsmart a presumptively efficient market is not a sound basis for imposing liability.") (citation omitted). The second issue that will likely be a focus of future dispositive motions is the sufficiency of allegations regarding how a fiduciary could have acted differently under the circumstances, based on inside information, without violating the securities laws. Defendants in ESOP stock-drop cases have long asserted that it would be impossible to walk this line. Clearly, fiduciaries cannot sell off the plan's holdings based on inside information. Nevertheless, future ESOP plaintiffs will surely attempt to allege just enough facts to obtain discovery on the company insiders' knowledge and deliberations. Defendants, however, remained fortified by the Supreme Court's unambiguous holding that the plaintiff must "plausibly allege an alternative action that the defendant could have taken" that would not violate securities laws—a clear call for concrete allegations in a complaint, not conclusory assertions or innuendo in the hope that the trial court will allow the discovery doors to be opened. *Dudenhoeffer*, 134 S. Ct. at 2472. The Supreme Court invited guidance from the Securities and Exchange Commission (SEC) on this issue; it will be interesting to see what, if any, views the SEC provides in the future, either sua

sponte or at the request of a lower court or stakeholder. A third issue that could be heavily litigated at the pleading stage is the plaintiff's ability to demonstrate that "a prudent fiduciary in the same circumstances would not have viewed" the suggested action or inaction in light of inside information "as more likely to harm the [ESOP] fund than to help it." *Dudenhoeffer*, 134 S. Ct. at 2472. This is a muddy standard, but it is the plaintiffs' burden to satisfy it. Defendants can argue that ESOP plaintiffs must plausibly allege *both* that "an alternative action . . . would have been consistent with securities laws" *and* that the action would not have been more likely to hurt than help the stock fund. *Id.* This is a tall order. As the Supreme Court pointed out, if ESOP fiduciaries stop investing in company stock, the market may perceive such action negatively, thereby driving the share price down and harming existing ESOP participants. *Id.* at 2473. How stock-drop plaintiffs tackle this and the other significant pleading quandaries posed by *Dudenhoeffer* will dictate the future success or failure of their efforts to impose ERISA liability on ESOP fiduciaries. **Republished with permission by the American Bar Association**

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