Dudenhoeffer: An Effective Tool to 'Weed Out Meritless' Employer Stock-Drop Claims?

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In *Fifth Third Bancorp v. Dudenhoeffer*, 573 U.S. __, 134 S. Ct. 2459 (2014), a unanimous U.S. Supreme Court held that fiduciaries of an employee stock ownership plan (ESOP) are not entitled to a special presumption that their decisions to hold or buy employer stock satisfy the duty of prudence imposed on fiduciaries under the Employee Retirement Income Security Act of 1974 (ERISA). Previously, several courts of appeals had recognized that such decisions were entitled to a presumption of prudence and applied this presumption at the pleading stage. This frequently resulted in the dismissal of claims by plan participants — commonly referred to as stock-drop claims — alleging that ESOP fiduciaries had acted imprudently by retaining investments in employer stock despite a precipitous decline in the stock's value. While rejecting the presumption of prudence, the Court articulated pleading standards that, according to many commentators, could be an equally effective barrier to stock-drop claims. However, a recent decision by the Court of Appeals for the Ninth Circuit applying these standards suggests that this assessment may have been premature.

The plaintiffs in *Dudenhoeffer* were former employees of Fifth Third Bancorp who participated in a profit-sharing plan sponsored by Fifth Third. Under the plan, participants were allowed to invest their contributions in different funds, including an ESOP that invested exclusively in Fifth Third common stock. Although matching contributions made by Fifth Third were automatically invested in the ESOP, participants also had the right to move these contributions to the other funds. The price of Fifth Third common stock declined 74 percent between July 2007 and September 2009, when the plaintiffs filed suit against Fifth Third, its CEO, and members of Fifth Third's Pension, Profit Sharing and Medical Plan Committee. The plaintiffs alleged that by July 2007, the defendants knew or should have known, based on inside information as well as public reporting on the subprime mortgage industry, that Fifth Third common stock was overvalued. They also alleged that the defendants breached their fiduciary duty of prudence by failing to sell the stock held by the ESOP and failing to prevent further investments in the stock.

The District Court for the Southern District of Ohio granted the defendants' motion to dismiss the prudence claim. The district court determined that, because the stock fund was an ESOP, the plan fiduciaries were entitled to a presumption that their decision to allow the ESOP to remain invested in the Fifth Third common stock was prudent. The district court further determined that this presumption applied at the pleading stage, and that the facts alleged in the plaintiffs' complaint — which indicated that, despite incurring substantial losses with respect to its portfolio of subprime mortgage loans, Fifth Third remained a viable business — were insufficient to overcome the presumption. The Court of Appeals for the Sixth Circuit reversed, holding that the presumption of prudence did not apply at the pleading stage, the plaintiffs had met their burden by alleging facts sufficient to establish that a fiduciary breach had occurred, and there was a causal connection between the breach and the losses suffered by the plan.

On appeal, the Supreme Court held that ERISA did not create a special presumption of prudence for ESOP fiduciaries but rather, "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." Although some circuit courts had justified the

presumption as a way of balancing an ESOP fiduciary's duty to act prudently with its duty to act in accordance with the terms of a plan's governing documents, the Court observed that, under the statute, the latter duty applied only insofar as the plan documents were consistent with ERISA. Accordingly, the Court noted, "the duty of prudence trumps the instructions of a plan document, such as an instruction to invest exclusively in employer stock … ."

While the Court held that ESOP fiduciaries are not entitled to a presumption of prudence with respect to investments in employer stock, it did recognize the need for meaningful protections "to weed out meritless lawsuits." To address that need, the Court established the following standards to be applied by courts when considering motions to dismiss stock-drop claims:

First, where the employer stock is publicly traded, allegations that an ESOP fiduciary should have recognized from publicly available information alone that stock was overvalued "are implausible as a general rule, at least in the absence of special circumstances." In the Court's view, ESOP fiduciaries could not reasonably be expected to outperform the market based solely on their analysis of publicly available information, and thus it would be prudent for such fiduciaries to rely on the market price of publicly traded employer stock.

Second, to state a claim based on an ESOP fiduciary's failure to act on nonpublic information, plaintiffs must plausibly allege both that the ESOP fiduciary should have taken an alternative action that would not violate securities laws and that such alternative action would not do more harm than good to the ESOP.

Third, when evaluating claims predicated on nonpublic information, courts should apply the following additional principles:

- Allegations that an ESOP fiduciary acted imprudently by failing to sell employer stock based on nonpublic information do not state a claim, because such selling would violate insider trading laws; and
- In evaluating claims that an ESOP fiduciary possessing nonpublic information acted imprudently by failing to refrain from making additional investments in employer stock or failing to publicly disclose that information, courts should consider the extent to which imposing an ERISA-based duty to take such actions would conflict with insider trading and corporate disclosure requirements under federal securities laws (or the objectives of those laws) and whether the plaintiffs have plausibly alleged that a prudent fiduciary in the defendant's position could not have concluded that such actions would do more harm than good by driving down the value of the stock already held by the ESOP.

As noted by many Court observers, these standards, if applied strictly, would establish a formidable barrier to stock-drop claims. Nevertheless, variations in how rigorously such standards are applied by the lower courts are inevitable. For example, in *Harris v. Amgen, Inc.*, 770 F.3d 865 (9th Cir. 2014), a case that was remanded to the Court of Appeals for the Ninth Circuit for reconsideration in light of the *Dudenhoeffer* decision, the circuit court reaffirmed an earlier ruling that the plaintiffs had sufficiently alleged that the defendants acted imprudently. The plaintiffs argued that [the] defendants should not have continued to

allow participants in plans sponsored by Amgen, Inc. to invest in Amgen stock knowing that the company had engaged in illegal marketing and sales of off-label drugs.

While disagreeing with the defendants' claim on remand that *Dudenhoeffer*. had established higher pleading standards for stock-drop claims, the circuit court concluded that even if this were the case, its prior ruling was consistent with those standards. But the circuit court's analysis in *Amgen* bears little resemblance to the close scrutiny of prudence claims envisioned by the Supreme Court in *Dudenhoeffer*. For example, the circuit court readily concluded that the plaintiffs had alleged plausible alternative actions the defendants could have taken that would not violate federal securities laws but did not separately consider whether imposing a duty under ERISA to take such actions would further the objectives of such laws. The circuit court also determined that it was at least plausible that the defendants could have taken these actions without causing undue harm to plan participants. But the pleading standards described in *Dudenhoeffer* clearly require that a court go further and determine whether the plaintiffs have plausibly alleged that a prudent fiduciary in the defendants' position could not have concluded that the alternative actions would do more harm than good.

Although *Dudenhoeffer's* rejection of a presumption of prudence might be viewed as a setback to ESOP fiduciaries, the Court established a potentially effective tool for ESOP fiduciaries to challenge stock-drop allegations with respect to publicly traded stock. As demonstrated in *Amgen*, however, how rigorously that framework is applied and the extent to which courts conduct the "careful, context-sensitive scrutiny of a complaint's allegations" contemplated by *Dudenhoeffer* remain to be seen and will be closely watched issues in 2015. In the meantime, plan sponsors should re-evaluate the practice of appointing investment committee members who are in possession of nonpublic information, and consider whether they should engage an independent fiduciary to manage employer stock funds.