ERISA Litigation

Supreme Court Adopts New Prudence Pleading Requirements for ERISA Stock-Drop Cases in *Fifth Third Bancorp v. Dudenhoeffer*

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In *Fifth Third Bancorp v. Dudenhoeffer*,[1] the U.S. Supreme Court unanimously declined to adopt a presumption that fiduciaries of employee stock ownership plans (ESOPs) act prudently for purposes of ERISA when they invest in company stock. The Court's decision upends the law of every circuit court to have previously addressed the issue, each of which had adopted a presumption of prudence in some form.

This article summarizes *Fifth Third* and identifies important ramifications of the Court's decision, which affects any company that features its own stock as part of its employee benefits offerings. Although the Court eliminated the presumption of prudence, the Court also articulated pleading requirements that may, practically speaking, make it difficult to state claims against ESOP and other fiduciaries for breach of the duty of prudence. In particular, the Court concluded that, with respect to claims based on a fiduciary's failure to react adequately to publicly available information, a plaintiff must point to "special circumstances" to plead a claim for breach of the duty of prudence. With respect to claims that a fiduciary failed to take appropriate action based on inside information, the Court held that a plaintiff must allege the specific "alternative action" that the fiduciary should have taken and that would not have violated other applicable law.

BACKGROUND

Fifth Third Bancorp (Fifth Third) offered its employees a defined contribution profit sharing plan (Plan), which allowed participants to direct their contributions into a variety of investment funds. One such fund, designated an ESOP, invested almost entirely in Fifth Third stock. Although Plan participants were permitted to invest their contributions either in the Fifth Third stock fund or in any of the other funds offered by the Plan, all company matching contributions were invested initially in the Fifth Third stock fund. Participants could, however, transfer those matching contributions to other investment funds in the Plan.

In 2008, two Plan participants filed a putative class action lawsuit against Fifth Third and various Plan fiduciaries in the U.S. District Court for the Southern District of Ohio. The plaintiffs alleged that the defendants breached their fiduciary duties under ERISA by, among other things, imprudently maintaining the Fifth Third stock fund as an investment option for the Plan after Fifth Third began shifting away from its conservative loan portfolio in favor of subprime loans. The plaintiffs alleged that Fifth Third's shift in its lending strategy caused the Fifth Third stock fund to become an unacceptably risky investment, as demonstrated by the stock's substantial loss of value during the class period.

The district court dismissed the complaint under Federal Rule of Civil Procedure 12(b)(6).[2] The district court held that the plaintiffs had failed to overcome, at the pleading stage, the presumption, adopted by the Sixth Circuit's decision in *Kuper v. Iovenko*,[3] that an ESOP fiduciary's decision to invest plan assets in company stock is reasonable. The district court explained that to overcome the presumption, the plaintiffs would have to plead that the fiduciaries knew of an imminent risk to the viability of Fifth Third. The district court concluded, however, that the bank's continued stability and financial health, despite its problematic subprime loan portfolio, established that Fifth Third stock remained a prudent investment.[4]

The Sixth Circuit reversed.[5] Although the court followed its prior decision in *Kuper* by reaffirming the presumption of prudence, the Sixth Circuit held that the presumption did not apply at the pleading stage, but was instead an evidentiary presumption. The Sixth Circuit based its holding on the text of the ERISA statute, observing that the statutory language imposing the duties of prudence and loyalty on ERISA fiduciaries did not distinguish between ESOP fiduciaries and fiduciaries of other types of ERISA plans. Therefore, the Sixth Circuit held that a plaintiff need not allege that the company was in dire straits to state a claim against an ESOP fiduciary, but rather, only that a reasonably prudent fiduciary in similar circumstances would have diversified the plan's investments. Applying that general pleading standard, the Sixth Circuit held that the plaintiffs stated a claim by alleging that various warning signs based on publicly available information should have put the Plan's fiduciaries on notice of the increased riskiness in Fifth Third stock, which allegedly caused the Plan's continued investment in Fifth Third stock to become imprudent.

Fifth Third petitioned for review of the Sixth Circuit's decision.

THE SUPREME COURT REJECTS A PRESUMPTION OF PRUDENCE

On June 25, 2014, in an opinion by Justice Breyer, a unanimous Supreme Court held that ESOP fiduciaries are not entitled to any special presumption of prudence at any stage for a claim of breach of fiduciary duty under ERISA. In reaching this conclusion, the Court relied heavily on the text of the ERISA statute, which, as the Court explained, "makes no reference to a special 'presumption' in favor of ESOP fiduciaries." Instead, the statutory text relating to ESOPs modifies the duties of ESOP fiduciaries in a "precisely delineated way"; specifically, it exempts ESOP fiduciaries from ERISA's diversification requirement and from the duty of prudence "only to the extent that it requires diversification." Thus, the Court held, ESOP fiduciaries otherwise must comply with ERISA's duty of prudence.

In reaching this conclusion, the Court recognized Congress's intent to encourage companies to establish ESOPs, but it disagreed with Fifth Third – and with many circuit courts to have addressed this issue – that this congressional purpose required courts to create a special presumption of prudence. Instead, the Court observed that ERISA encouraged companies to create ESOPs by exempting ESOP fiduciaries from the duty to diversify, as well as by providing tax incentives. The Court rejected the idea that promoting this purpose was a reason to enshrine a special presumption of prudence for ESOP fiduciaries. The Court also rejected the idea that plan language requiring the exclusive investment in company stock could alter the duty of prudence that ERISA imposes: "This rule would make little sense if, as petitioners argue, the duty of prudence is defined by the aims of the particular plan as set out in the plan documents, since in that case the duty of prudence could never conflict with a plan document."

The Court also acknowledged the conflicting demands imposed on ESOP fiduciaries who have inside information. But the Court concluded that the presumption was not an appropriate response to that conflict because, in the Court's view, both ESOP and non-ESOP fiduciaries alike receive inside information about company investments. Finally, the Court rejected the argument that a presumption of prudence was a suitable way to avoid meritless lawsuits against ESOP fiduciaries because the presumption "does not readily divide the plausible sheep from the meritless goats." Instead, the "important task" of weeding meritless claims from meritorious ones would be "better accomplished through careful, context-sensitive scrutiny of a complaint's allegations."

THE COURT OFFERS GUIDANCE ON HOW ***TWOMBLY*** AND ***IQBAL*** APPLY TO ERISA STOCK-DROP CLAIMS

The Court turned next to the "important mechanism for weeding out meritless claims," *i.e.*, the pleading standard previously articulated by the Court in *Ashcroft v. Iqbal*[6] and *Bell Atlantic Corp. v. Twombly*.[7] Applying *Iqbal* and *Twombly*, the Court distinguished between two categories of allegations in claims against ESOP fiduciaries: those that rely upon publicly available information and those that rely upon material non-public (i.e., inside) information. The Court provided distinct guidance for each.

With respect to claims based on public information, the Court held that, absent “special circumstances,” a plaintiff cannot plausibly allege that a fiduciary breached ERISA’s duty of prudence by failing to recognize from publicly-available information that a stock was incorrectly valued by the market. Drawing directly from the Court’s decision in *Halliburton Co. v. Erica P. John Fund, Inc.*, -- U. S. -- (2014), announced just two days before, the Court reasoned that “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.”

With respect to claims based on nonpublic information, the Court held that a plaintiff must allege that a prudent fiduciary in the same circumstances would have taken a specific “alternative action” that did not violate the securities laws. To flesh out this standard, the Court articulated three specific considerations for courts to consider in evaluating whether a claim based on an alleged failure to act on inside information meets the plausibility standards of *Twombly* and *Iqbal*:

> <u>First</u>, the Court held that fiduciaries are not required to violate the securities laws to satisfy their duty of prudence under ERISA.
>
> <u>Second</u>, the Court noted that imposing an obligation under ERISA either to refrain from purchasing more employer stock based on inside information or to publicly disclose the inside information could run afoul of the securities laws. Thus, the Court directed lower courts to evaluate the alleged prudence of such alternative actions with that potential conflict in mind.
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> <u>Third</u>, the Court also directed lower courts to consider whether a duty under ERISA to end employer stock purchases or disclose negative information about the company “would do more harm than good” by causing the remaining employer stock in the plan to lose value, to the detriment of the plan and its participants.

Ultimately, concluding that the Sixth Circuit did not address the aforementioned standards when permitting the plaintiffs’ complaint to proceed, the Court vacated the judgment of the Sixth Circuit, and remanded for further proceedings consistent with the guidance set forth in its opinion.

POTENTIAL RAMIFICATIONS OF THE DECISION

The *Fifth Third* opinion is noteworthy for all fiduciaries whose plans offer company stock. Such fiduciaries may no longer rely on the protections of the presumption of prudence in continuing to incorporate company stock investment options into the plans they manage. Nevertheless, the Court’s opinion is far from a decisive victory for plaintiffs. Although the lower courts have yet to flesh out the contours of the Court’s standards for claims based on public and non-public information, the Court was clear that trial courts must apply the *Twombly* and *Iqbal* pleading standards to ensure that a plaintiff states a plausible claim before the case can proceed into discovery. Although the *Fifth Third* Court did not alter *Twombly* and *Iqbal*, the *Fifth Third* decision is the Court’s lengthiest and most detailed explanation on how courts should apply the *Twombly* and *Iqbal* standard to ERISA claims.

As a practical matter, the Court’s decision means that plan fiduciaries moving to dismiss stock-drop claims will focus not on the presumption of prudence but instead on whether plaintiffs have satisfied *Twombly* and *Iqbal*. Under *Fifth Third*, a plaintiff may not survive a motion to dismiss by alleging merely that a company had problems and the stock price was declining, or that a fiduciary improperly failed to act on either public or inside information. Rather, the plaintiff must allege “special circumstances” that plausibly suggest a fiduciary acted imprudently or an “alternate action” the fiduciary could have taken (within the bounds of the law), because in most situations, ESOP fiduciaries are entitled to rely on the stock market to determine whether continued investment in company stock was prudent. However, it is unclear after *Fifth Third* just what those “special circumstances” or “alternate action[s]” might be, and that is something that will be up to lower courts to evaluate.

In addition, the Court’s decision may prompt plaintiffs who previously shied away from filing lawsuits given the then-existing presumption of prudence to file claims now, with the goal of testing the limits of the Court’s ruling. Given ERISA’s six-year statute of limitations, a wave of new lawsuits may occur relating to the market turmoil of 2008, as that limitations period is quickly approaching expiration.

ESOP fiduciaries also may be able to take comfort in the Court's definitive holding that ERISA does not require plan fiduciaries to break any other laws (including but not limited to the securities laws), which was an issue previously unresolved among the lower courts. The Court's holding may also benefit non-ESOP fiduciaries. In rejecting the presumption of prudence, the Court emphasized the lack of a statutory distinction between ESOP and non-ESOP fiduciaries beyond the exemption for ESOP fiduciaries from the duty to diversify. Thus, non-ESOP fiduciaries may benefit from the Court's pronouncement that ESOP fiduciaries have no duty to violate other laws in order to comply with ERISA.

Finally, although the Court articulated specific standards to guide lower courts' analyses of claims against ESOP fiduciaries, the specific contours of those standards will be implemented in practice by the lower courts over the coming years. It will be important for ESOP and other ERISA fiduciaries to pay close attention to developments in this area.

NOTES

[1] No. 12-751, 2014 WL 2864481 (U.S. June 25, 2014).

[2] 757 F. Supp. 2d 753 (S.D. Ohio 2010).

[3] 66 F.3d 1447 (6th Cir. 1995).

[4] The district court and the Sixth Circuit also addressed the plaintiffs' claims that the fiduciaries breached additional duties under ERISA by incorporating allegedly misleading SEC statements by reference in plan documents. The Supreme Court denied certiorari on that issue and did not address it in its opinion.

[5] 692 F.3d 410 (6th Cir. 2012).

[6] 556 U.S. 662, 677-80 (2009).

[7] 550 U.S. 544, 554-63 (2007).

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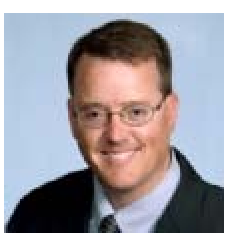

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