ERISA Litigation & Company Stock: Supreme Court’s Decision in Fifth Third v. Dudenhoeffer

August 11, 2014

Presentation for American Benefits Council by:
Ms. Theresa S. Gee, Counsel
O’Melveny & Myers LLP
Unexpected Result: The *Moench* Presumption Falls

- The Supreme Court’s June 25, 2014 decision in *Fifth Third Bancorp v. Dudenhoeffer* eliminated the long-standing *Moench* presumption
  - The *Moench* presumption, named after the first case where it was applied, presumes that the offering of employer stock in an Employee Stock Ownership Plan (ESOP) is prudent and the burden to prove it is not prudent shifts to the plaintiffs. Most stock funds in 401(k) plans are set up as ESOPs.

- ERISA “does not create a special presumption favoring ESOP fiduciaries. 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.”
Supreme Court’s Reasoning

- ERISA § 404(a)(2) generally exempts ESOP fiduciaries from the duty of diversification.

- “But aside from that distinction, because ESOP fiduciaries are ERISA fiduciaries and because [ERISA’s] duty of prudence applies to all ERISA fiduciaries, ESOP fiduciaries are subject to the duty of prudence just as other ERISA fiduciaries are.”
“Baking” It Into The Plan Doesn’t Work

- The *Dudenhoeffer* decision puts to rest any argument that plan documents requiring investments in employer stock insulate ESOP fiduciaries from liability for investments in employer stock.
Supreme Court’s Reasoning

ERISA § 404(a)(1)(D) demands that fiduciaries follow plan documents and instruments governing the plan “insofar as such documents and instruments are consistent with the provisions of” ERISA’s fiduciary provisions.

Thus, even where the plan document requires that plan assets be invested in employer stock, the “duty of prudence trumps the instructions of a plan document, such as an instruction to invest exclusively in employer stock”.

But could such a requirement lead to a deferential standard of review?
The Court recognized that Congress has acknowledged the special nature of ESOPs and encouraged the adoption of ESOPs, but this favored policy is not a "benefit" bestowed by ERISA: the "benefits" protected by ERISA "do[] not cover nonpecuniary benefits" such as those that "arise from employee ownership of employer stock."

The duty of prudence does not "var[y] depending upon the specific nonpecuniary goal set out in an ERISA plan."

ESOP fiduciaries are bound to consider the "financial benefits (such as retirement income)" available through investment in company stock just as they do for any other plan investments.
A Rock and A Hard Place

The Supreme Court acknowledged that ESOP fiduciaries may find themselves “between a rock and a hard place”.

- ESOP fiduciaries who continue to invest and the stock goes down could be sued for acting imprudently.
- ESOP fiduciaries who stop investing and the stock goes up may be sued for disobeying plan documents.
A Rock and A Hard Place

 Nonetheless, said the Supreme Court, “we do not believe that the presumption ... is an appropriate way to weed out meritless lawsuits.”

 Addressing the need to weed out claims with no merit – a way to “readily divide the plausible sheep from the meritless goats” – the Supreme Court instructed that one such mechanism is to carefully scrutinize the complaint’s allegations and set out new pleading standards.
A slight digression on publicly traded stock:

- Three days before Dudenhoefeer was decided, the Supreme Court re-validated the efficient market theory in Halliburton v. Erica P. John Fund (decided June 23, 2014).
- Under the efficient market theory, the company’s stock price is presumed to reflect all publicly available information about the company.
- In Halliburton, the Court ruled that, at the class certification stage, defendants may present evidence that allegedly misleading statements did not affect the price of a company’s securities.
“Special Circumstances”

Complementing its decision in *Halliburton*, the Supreme Court’s *Dudenhoefeffer* decision announced that, with respect to public company stock, fiduciaries may rely on the stock’s market price unless there are “special circumstances”:

“[W]here 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*.”
What Constitutes “Special Circumstances”?  

- To allege that public stock is over or undervalued, “special circumstances” must now be plead to present a plausible claim.

- The Supreme Court did not address this question except to conclude that the riskiness of business activity, such as that alleged in *Dudenhoeffer*, *is not* an example of “special circumstances.”
Claims Based on Inside Information

- *Dudenhoeffer* also announced an additional set of pleading requirements for claims based on inside information.

- The complaint in *Dudenhoeffer* presented typical allegations:
  - plaintiffs claimed the fiduciaries withheld material nonpublic information, resulting in the stock price being artificially inflated.
  - plaintiffs asserted that the fiduciaries should have sold off or frozen the plan’s employer stock investments or made a public disclosure of the inside information.
Need Helpful, Legal Alternative Action

- To survive on remand, the *Dudenhoeffer* plaintiffs and plaintiffs in future employer stock cases involving inside information must now plausibly identify “an alternative action” that the fiduciary could have taken.

- The “alternative action” must be –
  - consistent with the securities laws and
  - an action that a prudent fiduciary in the same circumstances would not have viewed as more likely to harm the fund than to help it.
To plausibly allege a fiduciary’s “alternative action”, the Supreme Court offered three considerations:

First, a fiduciary is never required to break the law, including securities laws, and allegations that a fiduciary should have acted on nonpublic information by selling or divesting the plan of employer stock is not plausible and cannot survive.

Second, a fiduciary should not be liable for failing to refrain from trading in company stock based on inside information (or for failing to disclose the inside information publicly) if doing so would conflict with the securities laws or their objectives.
Third, to be plausible, an imprudence claim must allege “that a prudent fiduciary in the defendant’s position could not have concluded that stopping purchases . . . 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.”
Plan Sponsor Considerations

- **Fiduciaries**: Consider appointing fiduciaries who are knowledgeable and capable, but not in a position to have access to inside financial or sensitive information.

- **Plan Document**: Assuming employer stock is to be offered through the plan, consider making the investment in employer stock mandatory in the plan document and investment policy statement. Such a provision may provide the basis for a deferential standard of review for the fiduciary’s decisions in the event of litigation, at least in some courts. The Supreme Court is considering whether to address this issue.

- **Independent Fiduciaries**: Appointing an independent fiduciary has become more routine in managing fiduciary risk, particularly with respect to access to nonpublic information.
Plan Sponsor Considerations

- **Follow the Securities Laws:** Dudenhoeffer confirms that ESOP fiduciaries who gain inside information must comply with the securities laws and trade only on public information.

- In deciding whether to buy, sell, or refrain from trading employer stock or disclose nonpublic information, ESOP fiduciaries with inside information should consider obtaining legal counsel concerning their obligations under the securities laws. In such a circumstance, fiduciaries may also consider whether to appoint an independent fiduciary.
Plan Sponsor Considerations

Follow a Prudent Process: ERISA’s prudence rule governs fiduciary conduct and how fiduciaries make their decisions. Fiduciaries should engage in a prudent process to evaluate and document their decisions with respect to employer stock:

- **Fiduciary Meetings**: Hold regular meetings and maintain meeting minutes.
- **Review Company Stock Performance**: Consider monitoring performance and returns and other factors such as statistically significant downturns in stock price, publicly known facts about the company’s performance, unusual trading of company stock by corporate insiders, recommendations by investment analysts, and holdings of the company stock by institutional investors or other pension plans.
- **Investment Professionals**: Consider the need for an investment consultant, investment manager, or other professionals.