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ESOP Fiduciaries Are Not Entitled to a Presumption of Prudence

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Fiduciaries of employee stock ownership plans (ESOPs) are not entitled to a "presumption of prudence," the U.S. Supreme Court unanimously ruled in *Fifth Third Bancorp v. Dudenhoeffer*, released June 25, 2014.

The Court effectively abrogated several Court of Appeals decisions that permitted ESOP fiduciaries to rely on the presumption to escape "stock drop" class actions either at the pleading stage, or on summary judgment.

Former employees and ESOP participants filed suit alleging that the fiduciaries knew or should have known that Fifth Third's stock was overvalued and excessively risky. Fifth Third's stock had dropped 75 percent between July 2007 and September 2009. The complaint alleged that the fiduciaries failed to take various actions, including selling the stock before its price fell, refraining from purchasing more stock, cancelling the Plan's ESOP option and disclosing inside information – which the fiduciaries knew about because they were Fifth Third officers – to correct the market price. The district court had dismissed the complaint based on a presumption that it was prudent to remain invested in employer securities. The Sixth Circuit reversed, finding that the presumption of prudence was evidentiary and did not apply at pleading stage.

The Supreme Court held that Employee Retirement Income Security Act (ERISA) does not create a special presumption favoring ESOP fiduciaries. Instead, the same standards of prudence apply to all ERISA fiduciaries, except that ESOP fiduciaries are under no duty to diversify the ESOP's holdings. In reaching this result, the Court noted that the ERISA provision which sets forth the prudent man standard of care only modified the duties of an ESOP fiduciary "to the extent that it requires diversification," and that it made no reference to a special presumption favoring fiduciaries.

The Court remanded the case to the Sixth Circuit to determine if the complaint satisfied the *Ashcroft v. Iqbal* and *Bell Atlantic v. Twombly* pleading standards. It also provided several considerations which are likely to be dissected by litigants and the lower courts in future stock drop cases:

- When a stock is publicly traded, allegations that the fiduciary should have recognized from publicly available information alone that the market was over- or under-valuing a stock are implausible, absent special circumstances.
- 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 securities laws and that a prudent fiduciary would not have viewed as causing more harm than help to the fund. In this regard, the Court commented that fiduciaries are not obligated to break insider trading laws by sharing non-public information. The Court further explained that when a complaint alleges that fiduciaries failed to take (or refrain) from action on the basis of inside information, courts should consider the extent to which ERISA-based obligations could conflict with insider trading and disclosure requirements imposed by federal securities laws. Finally, courts should consider whether a complaint plausibly alleges that a prudent fiduciary could not have concluded that stopping purchases of stock or publicly disclosing negative information would do more harm than good.

What does this mean for fiduciaries?

By rejecting the presumption of prudence, *Fifth Third* will make it more difficult for ESOP fiduciaries to dismissal claims before engaging in costly discovery. However, fiduciaries may be able to nix stock drop complaints by arguing that the allegations are implausible and conclusory and therefore do not satisfy the pleading standards of *Iqbal* and *Twombly*.

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