U. S. Supreme Court Clarifies Fiduciaries' Duty of Prudence Under ERISA In Connection with Employee Stock Ownership Plans

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On June 24, 2014, a unanimous Supreme Court held in *Fifth Third Bancorp v. Dudenhoeffer* that fiduciaries to an employee stock ownership plan ("ESOP") were not entitled to a presumption under the Employee Retirement Income Security Act ("ERISA") that their decision to buy or hold employer stock was prudent. In that case, the employer Fifth Third Bancorp maintained for its employees a defined contribution retirement plan. Employees could choose to contribute a portion of their wages to the plan, and Fifth Third agreed to make matching contributions of up to 4% of an employee's compensation. The plan allowed participants to choose among twenty different investment options, including an ESOP. However, employer matching contributions were always invested initially in the ESOP, although participants could move them to another option. The ESOP invested primarily in shares of common stock of Fifth Third.

In September 2009, a group of participants filed a putative class action against Fifth Third and some of its officers, alleging that the defendants violated their fiduciary duty of prudence to the plan. Specifically, they alleged that the fiduciaries should have known that by July 2007, Fifth Third's stock was overvalued and risky for two separate reasons. First, publicly available information provided early warning signs about subprime lending, which was a large part of the company's business. Second, nonpublic information (which was known to the defendants because they were insiders) indicated that Fifth Third had made material misstatements about the company's financial prospects. The plaintiffs alleged that a prudent fiduciary would have (1) sold the ESOP's holdings in Fifth Third stock; (2) refrained from purchasing any more of the company's stock; (3) canceled the ESOP option, and (4) disclosed the inside information so that the market would adjust the valuation of Fifth Third's stock. Rather than follow any of these courses of action, the plaintiffs alleged that the fiduciaries continued to hold and buy Fifth Third stock. Between July 2007 and the filing of the complaint, Fifth Third's stock price fell by 74%, resulting in large losses to participants' allocations in the ESOP.

The defendants moved to dismiss the complaint for failing to state a claim. In analyzing that motion, the district court applied a presumption that the fiduciaries' decision to remain invested in employer stock was reasonable. A number of other court decisions had adopted this presumption in order to balance two competing directives within ERISA -- (1) that a plan fiduciary owes a duty of prudence to the plan, including the duty to diversify assets to minimize the risk of large losses, and (2) that the use of ESOPs is encouraged, although assets are invested primarily in employer stock and thus are not diversified. Applying the presumption to this case, the trial court then assessed whether plaintiffs had alleged sufficient facts to overcome the presumption that the fiduciaries had acted reasonably. It concluded that the complaint failed to overcome the presumption and dismissed the case. On appeal, the Court of Appeals for the Sixth Circuit agreed that the fiduciaries were entitled to the benefit of a presumption of prudence, but held that the presumption was an evidentiary one and thus that the complaint should not have been dismissed at the initial stage of the case.

Fifth Third petitioned the Supreme Court to review the case. A unanimous Court held that fiduciaries to an ESOP are not entitled to a special presumption of prudence regarding their decisions to buy or hold employer stock. The Court explained that while ESOP fiduciaries are not required to diversify assets, ERISA's general duty of prudence otherwise applies to them in that they have an obligation to maximize retirement savings for participants while avoiding excessive risk. Fifth Third argued that a presumption of prudence is necessary to protect ESOP fiduciaries from frivolous lawsuits, but the Court reasoned that careful scrutiny of the complaint allegations was the better way to separate out the plausible claims from the meritless ones.

In this respect, although the Court refused to adopt the presumption, it questioned whether the plaintiffs' allegations were sufficient to set forth a claim that the defendants acted imprudently. First, the Court characterized as implausible the plaintiffs' theory that the fiduciaries should have recognized from publicly available information that Fifth Third's stock was overvalued. The Court explained that it is not imprudent for a fiduciary to assume that the market price is an unbiased assessment of the security's value. However, the Court left open the possibility that the plaintiffs could allege that special circumstances affected the reliability of the market price. Second, as to plaintiffs’ theory that defendants as insiders had non-public information, the Court explained that because the securities laws prevent insiders from trading on the basis of inside information, ERISA’s duty of prudence cannot require ESOP fiduciaries to perform an action, such as divesting the fund’s holdings, that would violate the securities laws. It thus stated that the lower courts should take into account whether an ERISA-based obligation either to refrain from making a planned trade based on inside information or to disclose that information to the public could conflict with the complex securities laws on these issues. Similarly, the Court instructed the lower courts to consider whether a decision to stop buying employer stock or to disclose negative inside information would do more harm than good to the fund by causing a drop in the stock price. The Court thus remanded the case to the Sixth Circuit to re-assess defendants’ motion to dismiss based on this guidance.

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