Fifth Third Bancorp v. *Dudenhoeffer*: Where Does It Leave Fiduciaries of Public Company Employee Stock Ownership Plans?

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The Supreme Court recently concluded that the ERISA fiduciaries of an employee stock ownership plan (an "ESOP") are not entitled to a presumption that they acted prudently in connection with the ESOP's investment in employer stock.[1] While the Court recognized several alternative defenses to ERISA "stock drop" cases, the Court's rejection of the presumption of prudence – which had previously been adopted by a number of U.S. courts of appeals and was routinely relied upon by ESOP fiduciaries – could encourage the filing of lawsuits against public companies and their ESOP fiduciaries in the event of a decline in the company's stock price. Accordingly, public companies should carefully consider this potential litigation risk along with other risks and benefits when determining whether to offer an ERISA employee benefit pension plan that invests in company stock.

WHAT IS AN ESOP?

An ESOP is an individual account pension plan that by its terms invests primarily in employer stock and provides that distributions can be made in company stock. An ESOP can be either a standalone plan or included as a feature in a 401(k) plan in which participants otherwise direct the investment of their accounts into a menu of investment choices selected by the plan fiduciary.

RESPONSIBILITIES OF FIDUCIARIES

Before the Supreme Court's decision in *Fifth Third Bancorp* v. *Dudenhoeffer*, many U.S. courts of appeals had recognized a presumption of prudence for ESOP fiduciaries at the litigation's pleading stage. While there were variations among courts in the presumption, the presumption generally required plaintiffs in "stock drop" cases involving ESOPs to plead facts demonstrating that the employer was in grave danger, akin to being "on the brink of collapse," as the Court phrased it. The *Fifth Third* decision eliminated the presumption of prudence at the pleading stage.

In light of the *Fifth Third* opinion, ESOP fiduciaries should give further consideration to what is required of them to comply with ERISA's duty of prudence with respect to ESOPs and other company stock funds in retirement plans, including 401(k) plans that are not structured as ESOPs but offer company stock as one investment choice. Although the Court in *Fifth Third* did

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[1] *See* *Fifth Third Bancorp v. Dudenhoeffer*, 573 U.S. ___, 189 L. Ed. 2d 457 (2014). For a summary of the Court's opinion, *see* Simpson Thacher & Bartlett LLP, *The Supreme Court Clarifies Pleading Standards for ERISA Breach of Duty of Prudence Claims Against ESOP Fiduciaries* (June 25, 2014).

not elaborate on the requirements of ERISA's duty of prudence, the decision leads to several observations:

- **Exercising the Duty of Prudence.** Without a presumption that ESOP investments in company stock are prudent, it could be argued that plan fiduciaries need to develop or maintain procedures for investigating, monitoring, and evaluating investments in company stock, just as they would with regard to other ERISA plan investments. Given ERISA's duty of prudence, plan fiduciaries often have a procedure for assessing and monitoring investment choices and for adding and removing investment fund choices from a plan's fund lineup, as appropriate. ERISA fiduciaries typically evaluate the prudence of an investment in part by considering, among other factors, the availability, riskiness, and potential return of alternative investments for the plan. The *Fifth Third* Court made clear that ESOP fiduciaries are excused from the ERISA duty to diversify. Absent an underlying duty to diversify the investments of the plan, it is not yet clear to what degree (if at all) ESOP fiduciaries need to consider alternative investments in exercising their duty of prudence with respect to the ESOP.
- **Reliance on Public Information.** As a general matter, when evaluating the prudence of investing a plan in company stock, fiduciaries may rely on the market price of the company's stock as an estimate of the stock's value. The *Fifth Third* Court held that fiduciaries are not generally expected to determine, based on publicly available information, that the stock is over- or undervalued. However, fiduciaries may need to take action where there are "special circumstances" affecting the reliability of the market price as "an unbiased assessment of the security's value in light of all public information" that could make relying on the market's valuation imprudent.[2] This is one reason, among others, why it may make sense for an ESOP not to use insiders in possession of material nonpublic information as fiduciaries making investment choice decisions for the plan.
- **Reliance on Nonpublic Information to Sell the Fund's Holdings.** Fiduciaries are not necessarily required to sell an ESOP's holdings in reaction to nonpublic information that could imply that the market had been overvaluing the company's stock. The duty of prudence does not (and cannot) "require an ESOP fiduciary to perform an action – such as divesting the fund's holdings of the employer's stock on the basis of insider information – that would violate the securities laws."[3] Appointing as an ESOP fiduciary either an employee who is not privy to material nonpublic information or an independent fiduciary may be a good way to eliminate the risk that the fiduciary might make an investment decision on the basis of material nonpublic information.

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[2] Although the *Fifth Third* decision did not elaborate on what constitute "special circumstances," it did find that the fact that the plaintiffs alleged "that Fifth Third engaged in lending practices that were equivalent to participation in the subprime lending market, that Defendants were aware of the risks of such investments by the start of the class period, and that such risks made Fifth Third stock an imprudent investment" did not amount to "any special circumstance rendering reliance on the market price imprudent."

[3] *Fifth Third Bancorp*, 189 L. Ed. 2d at 474.

- **Reliance on Nonpublic Information to Stop Making Additional Stock Purchases or Public Disclosure of Inside Information.** With regard to whether fiduciaries should either stop making additional purchases based on inside information or disclose inside information to the public:
  - Fiduciaries should carefully assess whether such a decision "could conflict with the complex insider trading and corporate disclosure requirements imposed by the federal securities laws or with the objectives of those laws."[4] Fiduciaries should keep in mind that ERISA's duty of prudence does not supersede federal securities laws and rules. The *Fifth Third* Court seems to have invited the Securities and Exchange Commission to provide its views on the relationship between insider trading and corporate disclosure requirements, on the one hand, and fiduciaries' obligations under ERISA; the SEC has not yet issued guidance on this issue.
  - Fiduciaries should also determine whether a prudent fiduciary could reasonably conclude that stopping stock purchases (which could be viewed by the market as a sign that the stock is a bad investment) 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."

ESOP fiduciaries (and the fiduciaries of plans with other company stock funds) may consider whether they should review company stock as an investment choice for the ESOP in the same way they would any other investment choice for an ERISA plan in order to satisfy ERISA's prudence requirements. Fiduciaries could use procedures commonly used for other employee benefit pension plans (which typically involve regular meetings with outside investment advisors who help analyze the investment choices and make recommendations, followed by a reasoned decision by the fiduciaries as to what investment choices remain the right ones for the plan). As with ERISA actions brought in other contexts, enhanced processes may prove critical to defending against a future claim of ERISA violations by ESOP fiduciaries.

While the *Fifth Third* decision emphasizes that ESOP fiduciaries are subject to the duty of prudence, it is still unclear how the decision's imposition of a duty of prudence without a duty to diversify will impact the behavior of ESOP fiduciaries in practice. ESOP fiduciaries should carefully track market developments in this area over the coming months in order to inform their decisions. In the meantime, companies might consider either leaving the prudence questions to corporate personnel who are walled off from material nonpublic information or hiring independent fiduciaries for their ESOPs (and other account balance pension plans offering company stock as an investment choice) for the limited purpose of conducting the prudence analysis. Among other things, such an approach may mitigate the risk that investment decisions will be made on the basis of nonpublic information.

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[4] *Id.*

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