



To read the oral argument in *Fifth Third Bancorp. v. Dudenhoeffer*, please [click here](#).

The Supreme Court Considers the Scope of the Fiduciary Duty of Prudence Under ERISA With Respect to the Offering of Investments in Employer Stock

April 9, 2014

Last week, the Supreme Court heard oral argument in *Fifth Third Bancorp. v. Dudenhoeffer*, an ERISA “stock-drop” case where 401(k) plan participants have alleged that the plan’s fiduciaries breached their fiduciary duties by continuing to offer employer stock as an investment option even after the stock had purportedly become an imprudent investment. Several circuits have held that fiduciaries of plans that offer employer stock as an investment option are entitled to a presumption that their decision to offer the stock was prudent under ERISA, rebuttable only on a showing that the company was on the verge of collapse. The circuits are split on whether the presumption of prudence applies at the pleading stage.

THE FIFTH THIRD CASE

Defendant Fifth Third, a financial services company, sponsored a defined contribution plan with a 401(k) feature. Eligible Fifth Third employees were permitted to make voluntary contributions to the plan and direct them to any of the plan’s investment options. The plan required that one investment option offered to plan participants be the Fifth Third Stock Fund, which was an Employee Stock Ownership Plan or ESOP, an investment vehicle that is required to invest primarily in employer stock.

Plaintiffs alleged that Fifth Third and plan fiduciaries violated their fiduciary duties under ERISA by continuing to offer the Fifth Third Stock Fund after it had purportedly become an imprudent investment. The Southern District of Ohio dismissed the complaint, holding that the fiduciaries were entitled to a presumption of prudence with respect to their decision to include the employer stock fund as an investment option. The district court held that plaintiffs had failed to overcome the presumption because they had not plead facts showing that the company was in a dire financial predicament.

The Sixth Circuit reversed, holding that the presumption of prudence did not apply at the pleading stage. The court held that the presumption was an evidentiary standard and not a standard of review, and would apply at summary judgment. The Sixth Circuit’s holding differed from the standards in the Second, Third, Fifth, Seventh, and Eleventh Circuits, all of which have held that the presumption of prudence applies at the pleading stage.

HIGHLIGHTS FROM SUPREME COURT ORAL ARGUMENT

At oral argument, defendants' counsel contended that the presumption of prudence was supported by "statutory language, trust law, congressional policy, and practical considerations." In response, Justice Ginsburg stated that "there is no presumption written into this statute," and "so I don't know where this presumption comes from." Justice Kennedy commented that "you want us to say that we have sort of a coach class trustee. We're all traveling in coach class when we have an ESOP."

Defendants' counsel argued that "[the presumption] comes from the duty of prudence itself which looks to the character and aims of the plan," noting that an ESOP is "designed to invest primarily in the employer's own stock." In response, Justice Scalia observed that "Section 1104 of ERISA . . . says that the fiduciaries must manage a plan" for the "exclusive purpose of providing benefits to the participants," which is different from "running a plan to . . . own stock in the company."

Justice Kagan then asked if it would be prudent for a fiduciary who knew a stock was overvalued because of inside information to retain that stock as an investment. She noted that "it just sort of defies language to say that some -- a prudent person would retain the investment in that kind of wildly overvalued stock, doesn't it?" Defendants' counsel responded, "if you have a stock that is traded on an active market, you really can't tell the fiduciary, absent possible inside information, well, you need to outsmart the market" and you cannot expect a fiduciary to "trade on that inside information" and "violate securities laws." Defendants' counsel also contended that simply to stop allowing future purchases of the stock, while it would not violate the securities laws, would result in a collapse of the stock "that would be terrible for the participants."

Justice Scalia noted that because you cannot expect a fiduciary to outsmart the market, the only information at issue was inside information. Justice Scalia observed that this issue was not unique to ESOPs: even with respect to non-ESOPs, "you have the same problem of not being able to use that inside knowledge," so "why do we need a special rule for ESOPs." Justice Kagan added that even if the duty of prudence only required action when the company was on the "verge of collapse," "even there, you would face the exact same securities law problems."

Plaintiffs' counsel began argument by addressing the issue of inside information, which places the fiduciary, as Justice Kagan observed, between a "rock and a hard place"—having to choose between fiduciary obligations and not trading on inside information, thereby violating the securities laws. Plaintiffs' counsel contended that because the fiduciary had placed him or herself in this position of conflict, the fiduciary could not now "just do nothing." Justice Breyer then asked, "can you give me an example of [a case] where a court said a trustee has breached its fiduciary obligation because he failed to use inside information?" When plaintiffs' counsel did not offer an example, Justice Breyer responded, "what's the problem. Because what's the rock and hard place? . . . The person has an obligation to act prudently," but "he cannot, irrespective of that, have an obligation to use inside information. . . . There is no rule of trust or ERISA law that you can breach a duty to a beneficiary by failing to use inside information." Plaintiffs' counsel also repeatedly stated that a fiduciary must act prudently. Chief Justice Roberts stated that plaintiffs' counsel's "mantra" that a "fiduciary at all times is to behave prudently in managing investment prudently" does not "help me."

At the Court's request, the Solicitor General's Office participated in the argument. The government's counsel contended that fiduciaries must act prudently and

"You want us to say that we have sort of a coach class trustee. We're all traveling in coach class when we have an ESOP."

-Justice Kennedy

"There is no rule of trust or ERISA law that you can breach a duty to a beneficiary by failing to use inside information."

- Justice Breyer

that no presumption of prudence should apply. Chief Justice Roberts asked the government's counsel what trustees should do with inside information: "Do you sell?" The government's counsel responded by stating that a fiduciary should sell but after Justice Alito asked, "you say they should sell based on inside information?," government's counsel changed his answer and suggested that the fiduciary "could stop purchasing." Justice Kennedy asked government's counsel: "Is this a case in which we must decide what the fiduciary standard is [] without regard to inside information? Is inside information just an added issue in the case or is it the key issue in the case?" The government's counsel responded that the use of inside information "is the key issue," and that "a fiduciary of an ESOP, just like the fiduciary of any other plan . . . has a duty of prudence not to remain invested in or to purchase materially overvalued stock" that he knows is overvalued due to inside information.

During defendants' counsel's rebuttal, Justice Sotomayor asked why an ESOP fiduciary should not be obligated to "obey the law" and disclose material nonpublic information, as required by the securities laws. Defendants' counsel responded that this will create "two different centers of communication now out of each corporation with an ESOP: the corporation's own statements and the ESOP," and emphasized that the Court "should be very cautious about interpreting these duties in ways that will make ESOPS unworkable."

IMPLICATIONS

The Court's decision will address whether a presumption of prudence applies to a fiduciary's decision to offer investments in employer stock. If the Court rejects the presumption of prudence, it is possible that more suits will be filed in this area or that some companies might change the construction of their retirement plans.

For further information about this decision, please feel free to contact members of the Firm's Securities Litigation Department, including:

New York City:

[Bruce D. Angiolillo](#)
212-455-3735
bangiolillo@stblaw.com

[Mark G. Cunha](#)
212-455-3475
mcunha@stblaw.com

[Paul C. Curnin](#)
212-455-2519
pcurnin@stblaw.com

[Michael J. Garvey](#)
212-455-7358
mgarvey@stblaw.com

[Paul C. Gluckow](#)
212-455-2653
pgluckow@stblaw.com

[Nicholas Goldin](#)
212-455-3685
ngoldin@stblaw.com

[David W. Ichel](#)
212-455-2563
dichel@stblaw.com

[Peter E. Kazanoff](#)
212-455-3525
pkazanoff@stblaw.com

[Joshua A. Levine](#)
212-455-7694
jlevine@stblaw.com

[Linda H. Martin](#)
212-455-7722
lmartin@stblaw.com

[Joseph M. McLaughlin](#)
212-455-3242
jmclaughlin@stblaw.com

[Lynn K. Neuner](#)
212-455-2696
lneuner@stblaw.com

[Barry R. Ostrager](#)
212-455-2655
bostrager@stblaw.com

[Thomas C. Rice](#)
212-455-3040
trice@stblaw.com

[Mark J. Stein](#)
212-455-2310
mstein@stblaw.com

[Alan C. Turner](#)
212-455-2472
aturner@stblaw.com

[Mary Kay Vyskocil](#)
212-455-3093
mvyskocil@stblaw.com

[George S. Wang](#)
212-455-2228
gwang@stblaw.com

[David J. Woll](#)
212-455-3136
dwooll@stblaw.com

[Jonathan K. Youngwood](#)
212-455-3539
jyoungwood@stblaw.com

Los Angeles:

[Michael D. Kibler](#)
310-407-7515
mkibler@stblaw.com

[Chet A. Kronenberg](#)
310-407-7557
ckronenberg@stblaw.com

Palo Alto:

[Alexis S. Coll-Very](#)
650-251-5201
acoll-very@stblaw.com

[James G. Kreissman](#)
650-251-5080
jkreissman@stblaw.com

Washington, DC:

[Peter H. Bresnan](#)
202-636-5569
pbresnan@stblaw.com

[Cheryl J. Scarboro](#)
202-636-5529
cscarboro@stblaw.com

[Peter C. Thomas](#)
202-636-5535
pthomas@stblaw.com

UNITED STATES

New York

425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Houston

2 Houston Center
909 Fannin Street
Houston, TX 77010
+1-713-821-5650

Los Angeles

1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto

2475 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.

1155 F Street, N.W.
Washington, D.C. 20004
+1-202-636-5500

EUROPE

London

CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing

3919 China World Tower
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong

ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Seoul

West Tower, Mirae Asset Center 1
26 Eulji-ro 5-gil, Jung-gu
Seoul 100-210
Korea
+82-2-6030-3800

Tokyo

Ark Hills Sengokuyama Mori Tower
9-10, Roppongi 1-Chome
Minato-Ku, Tokyo 106-0032
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo

Av. Presidente Juscelino Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000