Supreme Court to Address Presumption of Prudence for ERISA "Stock Drop" Cases

The Supreme Court agreed on December 13, 2013 to review an issue critical to ERISA "stock drop" cases and important more generally for ERISA individual-account plans that invest in employer stock.

An exception to ERISA's investment diversification rules permits ESOPs, 401(k) plans and similar plans to buy and hold employer stock without diversifying. The statute does not expressly relieve plan fiduciaries of any *non*-diversification-related duty to invest prudently. Lacking Supreme Court guidance, many lower courts have tried to define this limited or residual duty of prudence by holding that relevant fiduciaries investing in employer stock are entitled to a presumption of prudence but not to absolute exemption.

In its grant of *certiorari* in *Fifth Third Bancorp v. Dudenhoeffer*, the Supreme Court agreed to review whether the presumption of prudence applies at the pleadings stage of a case alleging fiduciary breach or only later and as part of evidentiary proceedings, as the Sixth Circuit held. The U.S. Solicitor General has urged the Court to consider the broader question of whether any presumption of prudence applies to eligible individual account plan investments in employer stock.

Background

The U.S. Court of Appeals for the Third Circuit articulated the presumption of prudence in *Moench v. Robertson*[1] to address ERISA's competing statutory purposes of encouraging plan-based employee ownership of employer stock and the requirement that fiduciaries of ERISA plans prudently invest plan assets. In *Moench*, plaintiffs argued that ERISA's employer-stock exception to the diversification rules should be applied narrowly and that a court reviewing a related claim of fiduciary breach should not defer to the fiduciaries' decision to invest plan assets in the stock. Defendants, on the other hand, urged the court to adopt the "arbitrary and capricious" standard that the Supreme Court had previously applied to discretionary determinations of benefit claims under ERISA plans. The court rejected plaintiffs' argument on the ground that, among other things, "strict judicial scrutiny" would "essentially render meaningless" the exception to the diversification requirement. It held that a fiduciary investing the assets of an eligible defined contribution plan requiring investment primarily in employer stock should be presumed to have acted prudently but that plaintiffs could rebut the presumption by establishing that the fiduciary had abused its discretion.[2]

Subsequent Developments

The bursting of the "dot-com bubble" in the early 2000s and the financial crisis of the late 2000s each led to a surge of stock drop cases, resulting in multi-million dollar settlements. Over time, however, defendants have successfully persuaded the U.S. Courts of Appeals for the Second, Fifth, Sixth, Seventh, Ninth and Eleventh Circuits to adopt the presumption of prudence, with most of those Circuit Courts having done so within the last several years.

While the *Moench* case involved an ESOP, most courts addressing the issue, including the Third Circuit, have held that the presumption of prudence can also apply to ERISA-governed non-ESOP eligible individual account

[1] 62 F.3d 553 (3d Cir. 1995).

[2] In *Moench*, the court held that the plaintiffs' allegations of a "precipitous decline" in the price of the employer's stock, coupled with allegations of fiduciaries' "knowledge of [the employer's] impending collapse" and the fiduciaries' own "conflicted status," sufficed to overcome the presumption of prudence.

plans that invest most of their assets in securities other than employer securities (such as a 401(k) plan with an employer stock fund).

The Supreme Court's Decision to Grant Certiorari *in* Fifth Third Bancorp

The claims of breach of the ERISA duty of prudence in *Fifth Third Bancorp* stem from the fact that plan fiduciaries maintained the plan's investment in employer stock even though the company's stock value was suffering a 74% decline resulting from the company's exposure to subprime mortgages.

While the facts of the case are similar to many other ERISA stock drop cases, the Sixth Circuit broke with other Circuit Courts in two important (and plaintiff-friendly) respects. First, rather than requiring plaintiffs to overcome the presumption of prudence by alleging that fiduciaries knew or should have known that the company faced a dire financial situation, the Sixth Circuit required only an allegation that a prudent fiduciary acting under similar circumstances would have made a different investment decision. Second, the Sixth Circuit held that the presumption of prudence was an evidentiary standard, meaning that it would not apply at the motion-to-dismiss stage – a distinction that could be very costly to defendants.

It is the latter point that the defendants in *Fifth Third Bancorp* asked the Supreme Court to review; but, as the Solicitor General noted, that question is "closely bound up" with the question of whether the presumption should apply at all. If the Court does review the broader question, its holding is likely to have important implications for all ERISA-governed individual account plans investing in employer stock. Even if the Court were to decide only the more limited question of when the presumption applies, its ruling has the potential to affect stock drop claims litigation significantly.

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