Fifth Third Bancorp v. Dudenhoeffer: The Supreme Court Establishes New Standards for 401(k) Plan Fiduciaries

Yesterday, in *Fifth Third Bank v. Dudenhoeffer*¹, the United States Supreme Court established new standards for courts to use in evaluating whether the fiduciary of an employer stock ownership plan (“ESOP”) acted prudently with respect to company stock holdings. In doing so, the Court held that such fiduciaries are not entitled to a presumption of prudence – effectively overruling decades of law that had been employed by just about every Circuit Court of Appeals. In its place, the Court established new ground rules that determine whether the basis for the claim of imprudence is publicly available information or non-public insider information. The Court made clear that, in most circumstances, a plausible claim cannot be stated by relying solely on publicly available information. Instead, a plausible claim can only be stated by alleging the existence of insider information that fiduciaries could have used to cease purchasing company stock and whose disclosure would not have caused undue harm to the plan.

**Background**

Plaintiffs were two former employees of Fifth Third Bancorp (“Fifth Third”) who participated in Fifth Third’s 401(k) plan. The plan requires one of the investment options to be the Fifth Third Stock Fund, which invests primarily in shares of Fifth Third common stock.²

Plaintiffs alleged that plan fiduciaries knew or should have known, based on public information such as news articles, that Fifth Third “switched from being a conservative bank lender to a subprime lender,” which made Fifth Third stock overpriced and risky.³ The Complaint also alleged that plan fiduciaries had inside information that indicated that the stock was not a prudent investment, yet the fiduciaries continued to permit plan participants to invest in Fifth Third stock. Plaintiffs contended that a prudent fiduciary would have responded to this information by, among other things, (1) selling Fifth Third stock, (2) refraining from purchasing more Fifth Third stock, or (3) disclosing the adverse non-public information to the market.

The district court dismissed the Complaint for failure to state a claim, holding that ESOP fiduciaries are entitled to a presumption of prudence with respect to their decision to permit the plan to invest in employer stock.⁴ The district court held that the presumption applies at the pleading stage and concluded that plaintiffs had not pleaded sufficient facts to overcome this presumption.⁵

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¹ No. 12-751, 573 U.S. ___ (June 25, 2014) (slip op.).
² No. 12-751, 573 U.S. ___ at 2.
³ *Dudenhoefer v. Fifth Third Bancorp*, 692 F.3d 410, 415 (6th Cir. 2012).
⁵ Id. at 758-759, 760-762.
The Sixth Circuit reversed, holding that while ESOP fiduciaries are entitled to a presumption of prudence, the presumption does not apply at the motion to dismiss stage, and concluded that the Complaint stated a claim for breach of fiduciary duty. (See prior client alert discussing the Sixth Circuit’s decision.)

The Court Rejects the Presumption of Prudence

The unanimous Court held that ESOP fiduciaries are not entitled to a presumption of prudence with regard to a plan’s investment in employer stock. Rather, they are subject to the same duty of prudence that applies to other ERISA fiduciaries, except that ESOP fiduciaries need not diversify the fund’s assets.

The Court first recognized a tension between certain statutory provisions in ERISA. On the one hand, ERISA requires that all fiduciaries comply with a standard of prudence and care, which includes an obligation to diversify plan assets. On the other hand, ERISA recognizes that ESOPs are primarily designed to invest in employer stock, which means that, by definition, those plans are not diversified. The latter provision, however, does not include a special presumption in favor of ESOP fiduciaries. Interpreting the text of the statute, the Court “was not convinced that Congress [...] sought to promote ESOPs by further relaxing the duty of prudence as applied to ESOPs with the sort of presumption proposed by petitioners.”

The Court Announces New Standards

After rejecting the use of a presumption of prudence, the Court announced new standards for evaluating claims of fiduciary imprudence with respect to company stock. The Court’s guidance considered the two primary ways that plaintiffs seek to state claims in ERISA stock drop cases: use of publicly available information and the existence of insider information.

With respect to publicly available information, the Court held that a plaintiff generally could not state a plausible claim of imprudence by pointing only to publicly available information. The Court reasoned that, where a stock is publicly traded, allegations that a fiduciary should have concluded from publicly available information alone that stock was overvalued are implausible absent special circumstances. The market price is presumed to incorporate all publicly available information, so requiring plan fiduciaries to somehow outguess the market is not viable. Instead, the Court held that plan fiduciaries generally act prudently by relying on a stock’s market price. The only exception the Court articulated was if a plaintiff could point to a “special circumstance affecting the reliability of the market price.” The Court did not provide any guidance on what sort of allegations would be sufficient to show such special circumstances, but we would expect that such allegations could rarely be made.

The Court also provided guidance with respect to claims based on a failure to act on non-public, insider information. The Court first acknowledged that there is a potential conflict between the federal securities laws and ERISA. For example, an ESOP fiduciary who has inside information about a company cannot act on this information by selling employer stock without being subject to prohibitions on insider trading, even though ERISA may require a prudent fiduciary to stop investing in an artificially inflated employer stock.

Where the complaint alleges that a fiduciary was imprudent by failing to act on non-public information, the analysis should be guided by three considerations.

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6 Dudenhoefer, 692 F.3d at 418-420.
7 No. 12-751, 573 U.S. ___ at 7-8.
9 Id. § 1104(a)(2).
10 Id. at 18.
11 Id. at 19-20.
First, because ERISA does not require fiduciaries to break the law, including insider trading laws, a fiduciary does not violate the duty of prudence by declining to divest the plan’s holdings or prohibiting additional stock purchases on the basis of insider information. Second, where a complaint faults fiduciaries for failing to decide, on the basis of non-public information, to refrain from making additional stock purchases or for failing to disclose that information to the public, courts should consider whether an ERISA-based obligation could conflict with complex insider trading and corporate disclosure requirements under the federal securities laws. Third, courts should consider whether the complaint has plausibly alleged that a prudent fiduciary could not have concluded that stopping the purchase of employer stock, disclosing adverse information to the public, or taking any other action suggested by plaintiffs would do more harm than good to plan assets.

The Court did not provide any guidance on this critical third consideration, and it is far from clear what the Court has in mind. The Court appears to have acknowledged that having plan fiduciaries suspend purchase of company stock is likely to have a highly negative impact on market price and thereby harm the interests of participants who already hold the stock. However, the opinion does not make clear when a fiduciary can decide that such an impact is outweighed by allowing continued purchases of company stock that may be overvalued. We expect that lower courts’ opinions will attempt to interpret this portion of the opinion and those interpretations will have a major impact on the future of ERISA stock drop cases.

As is clear from the above, we expect that this opinion will reshape the landscape in ERISA stock drop litigation, but precisely what the new landscape will look like is far from clear.

If you have any questions regarding this update, please contact one of the following Sidley lawyers:

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