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Stakes Are High For ERISA Fiduciaries

Law360, New York (February 12, 2014, 1:49 PM ET) -- In April, the U.S. Supreme Court will hear arguments in a case that could revitalize efforts by the plaintiffs bar to use “stock-drop” claims brought under the Employee Retirement Income Security Act to evade the heightened pleading standards applicable to claims under federal securities laws.

A decision favorable to the plaintiffs bar could mean renewed exposure for ERISA fiduciaries — including company retirement plan committees — to vexatious, costly and burdensome litigation of precisely the sort that Congress believed it was cracking down on when it passed the Private Securities Litigation Reform Act in 1995.

Stock-drop cases are typically brought against ERISA fiduciaries when the price of company stock held in employee stock ownership plans, 401(k) plans, or other stock funds declines and they routinely allege that the plan fiduciaries should have foreseen the decline and protected plan members from resulting losses.

The issue the court will consider in Fifth Third Bancorp v. Dudenhoeffer et al. is what plaintiffs in ERISA stock-drop cases must plead in order to defeat motions to dismiss in light of a well-recognized presumption that holding company stock in an ESOP (or similar company stock fund) is prudent and reasonable.

Plaintiffs See Opportunity and Courts React

Over the last several years, plaintiffs’ attorneys have filed such cases alleging that companies and plan fiduciaries breached their fiduciary duties to ERISA plan members by continuing to offer company stock as a retirement investment option and/or refusing to divest such stock from ERISA plans.

Because ERISA imposes upon plan fiduciaries a duty of prudence, these cases contend that the company stock was an imprudent investment. At the same time, these cases routinely claim that plan fiduciaries committed actionable misrepresentations because the company’s securities filings, which were incorporated by reference into ERISA plan documents such as summary plan descriptions, were misleading with respect to whatever corporate practices or events allegedly caused the stock price to decline.

In other words, the same kinds of “bad news” that have historically prompted federal securities fraud class actions have been used as the basis for class actions on behalf of ERISA plan participants whose accounts held company stock.

While such claims do not pose the same potential liability as a federal securities fraud class action because the universe of allegedly injured class members is smaller in these ERISA cases, an ERISA stock-drop case that survives a motion to dismiss opens companies and ERISA fiduciaries to the same potentially expansive and distracting discovery. And even if potential damages are smaller, some large companies have ESOPs holding hundreds of millions of dollars of company stock.

ERISA fiduciaries face an additional risk in the absence of a deferential standard of review. They can find themselves in a true “no win” situation when confronted with decisions about company stock: buy (or continue to hold) and be sued by beneficiaries alleging that was imprudent, or sell and be sued by beneficiaries alleging that decision was imprudent when the stock price rebounds. Thus, the stakes for companies and ERISA fiduciaries in the Fifth Third Bancorp case are significant.

For the plaintiffs bar, ERISA stock-drop cases initially appeared attractive because they were not subject to the heightened pleading standards established under the PSLRA, including the requirement that federal securities class actions be dismissed unless the plaintiff pleads a strong inference of scienter.

The PSLRA resulted in fewer securities class actions surviving motions to dismiss and, thus, fewer opportunities for the plaintiffs bar to exert the leverage they enjoy as a result of the generally one-sided discovery they can impose upon corporate defendants.

However, many courts have cut back on these ERISA stock-drop claims by holding that ESOP fiduciaries are entitled to a presumption that their investment decisions with respect to company stock are prudent and reasonable. In so doing, courts have been prompted by the fact that Congress sought to favor ESOPs and employee ownership of company stock and that ESOPs are not, in all respects, equivalent to other retirement plans.

For example, courts have recognized that Congress created ESOPs specifically to encourage employee ownership of company stock. See, e.g., Kuper v. Iovenko, 66 F.3d 1458 (6th Cir. 1997); H.R. Rep. 93-1280, at 313 (1973), reprinted in 1974 U.S.C.C.A.N. 5038, 5093.

Courts also have noted that ESOPs are not designed to guarantee retirement benefits because the nondiversified investment in employer stock, which they entail necessarily, carries more risk than investment in a diversified portfolio of a non-ESOP plan. See Kuper, 66 F.3d at 1457. Indeed, Congress warned against court action that would “treat employee stock ownership plans as conventional retirement plans.” S. Rep. No. 93-127, at 32 (1973), reprinted in 1974 U.S.C.C.A.N. 4838, 4869.

District Court Applies Recognized Presumption to Pleadings

Fifth Third sponsored a defined contribution plan with a 401(k) feature. The plan required that one investment option be the Fifth Third stock fund, which the plan defined as an ESOP required to invest primarily in company stock. For Fifth Third employees who participate in the retirement plan, the company matched up to the first 4 percent of the employee’s contribution. Initially, Fifth Third’s matching funds were invested in the Fifth Third stock fund, though employees could direct that the funds be moved to other investments.

The complaint in the Fifth Third case alleged that the defendants, including Fifth Third itself and members of the plan committee, violated their fiduciary duties under ERISA by continuing to offer Fifth Third stock when it was imprudent to do so because the fiduciaries knew that the company had “switched from being a conservative lender to a subprime lender, its loan portfolio became increasingly at risk due to defaults, and it either failed to disclose the resulting damage to the company and its stock or provided misleading disclosures."

The district court dismissed, holding that because the Fifth Third stock fund is an ESOP, the fiduciaries were entitled to a presumption of reasonableness with respect to their decision to invest in employer stock. The district court cited Kuper, 66 F.3d 1447, for the presumption.

It held that, "[w]hile the court must accept that Fifth Third embarked on an improvident and even perhaps disastrous foray into subprime lending, which in turn caused a substantial decline in the price of its common stock, the complaint fails to establish that Fifth Third was in the type of dire financial predicament sufficient to establish a breach of fiduciary duty under Kuper" and the Third Circuit decision, Moench v. Robertson, 62 F.3d 553 (3d Cir. 1995). Dudenhoeffer v. Fifth Third Bancorp, 757 F.Supp.2d 753, 762 (S.D. Ohio 2010).

While the language expressing the Kuper/Moench presumption relied upon by the District Court has varied somewhat, it typically holds that the presumption applies so long as the company is not in a "dire situation" and there is no indication that the company's "viability as a going concern" is threatened. See, e.g., In re Citigroup ERISA Litigation, 662 F.3d 128, 140 (2d Cir. 2011); Kirschbaum v. Reliant Energy Inc., 526 F.3d 243, 255 (5th Cir. 2008); Quan v. Computer Sciences Corp., 623 F.3d 870, 882 (9th Cir. 2010).

Under this long line of cases, ERISA fiduciaries are not liable for investing ESOP funds in company stock unless they abused their discretion, a level of deference that helps protect fiduciaries from frivolous lawsuits every time company stock prices dip.

The district court also held that mere incorporation of U.S. Securities and Exchange Commission filings into ERISA plan documents does not sufficiently state a claim for a breach of fiduciary duty based on allegedly misleading statements or omissions in those filings.

Sixth Circuit Says No Special Treatment for ESOP Fiduciaries

The Fifth Third employee stockholders appealed to the Sixth Circuit, challenging the notion that the presumption should be applied at the motion-to-dismiss stage, rather than later in the case, and the district court's ruling with respect to the incorporation of SEC filings.

The Sixth Circuit reversed and remanded, becoming the only court of appeals to hold that the Moench/Kuper presumption does not apply at the motion-to-dismiss stage. According to the Sixth Circuit, the Moench/Kuper presumption was simply evidentiary and required a fully developed evidentiary record not available at the pleading stage.

The Sixth Circuit also rejected the abuse-of-discretion standard, holding instead that a plaintiff need only allege that "a prudent fiduciary acting under similar circumstances would have made a different decision." Dudenhoeffer v. Fifth Third Bancorp, 692 F.3d 410, 418 (6th Cir. 2012).

The Sixth Circuit explicitly rejected the notion that ESOP fiduciaries were somehow different from other ERISA fiduciaries, imposing upon both "identical standards of prudence and loyalty." Id. at 419. Thus, the Sixth Circuit effectively turned its back on the authority cited above indicating that ESOPs should not be treated as conventional employee retirement plans.

Supreme Court Narrows Issues, Agrees to Hear Appeal

Fifth Third and the other defendants in the district court filed a certiorari petition with the Supreme Court, asking the court to hold that plaintiffs must allege an abuse of discretion by ESOP fiduciaries in order to overcome the presumption that such fiduciaries do not breach their duty by remaining invested in company stock.

The defendants also sought review by the court of the Sixth Circuit's holding that SEC filings can be actionable under ERISA merely by their incorporation in to ERISA plan documents.

While the plaintiffs opposed certiorari in order to protect their victory at the Sixth Circuit, the Supreme Court also invited the solicitor general to weigh in. The government argued in favor of granting certiorari only with respect to the first question, but proposed a rephrasing of the question.

Specifically, the government suggested that the court should first answer whether ESOP fiduciaries should enjoy a presumption of reasonableness at all and, only if that question were answered in the affirmative, the court should address whether the presumption applies at the pleading stage (as opposed to after the evidentiary record is developed) and what a plaintiff must allege to address it.

In the view of the government, the court should never get to the second question, however, because courts should not apply the Moench/Kuper presumption at all.

One issue likely to attract the court's attention is what role plan language has on the availability and strength of the presumption. Unlike the plans at issue in some cases, the Fifth Third plan did not limit the ability of ESOP fiduciaries to remove the Fifth Third stock plan as an option or divest its holdings of Fifth Third stock.

Some courts, including the Second Circuit, have held that the presumption of prudence applies even in the face of such provisions permitting plan fiduciaries to shut down employer stock funds. See, e.g., Taveras v. UBS AG, No. 12-1662, at *17-19 (2d Cir. Feb. 17 2013); Gearren v. The McGraw Hill Cos. Inc., 660 F.3d 605, 610 (2d Cir. 2011).

The Supreme Court might conclude that permitting the pleading standard (and ultimately, the required factual showing) to be determined by plan language would be consistent with ERISA's requirement that the prudence of investments by ERISA fiduciaries be determined with an eye toward the "character" and "aims" of the plan, 29 U.S.C. § 1104(a)(1)(B), and with common law trust principles requiring fiduciaries to act as a prudent investor would, light of the purpose [and] terms ...." of the trust. Restatement (Third) of Trusts § 90.

While the weight of authority would appear to suggest that the Supreme Court should reverse the Sixth Circuit's decision, effectively affirming the dismissal by the district court, it is possible that the Supreme Court will accept the Sixth Circuit's watered-down version of the presumption and hold that it only applies after the evidentiary record is developed. This would be a disappointing result for corporations and fiduciaries and a major win for the plaintiffs bar.

Alternatively, the Supreme Court could stake out a middle ground. For example, the court could hold that where plan documents give the plan committee the ability to shut down an employer stock fund, such decisions will be subject to ordinary prudence standards. However, where governing documents mandate a company stock fund and do not expressly grant fiduciaries the ability to shut down such funds, the court could hold that the decision will be subject to a presumption of prudence rebutted only by a showing of abuse of discretion.

In granting certiorari, the Supreme Court appears to have rejected the government's invitation to a potentially significant reversal of more than 10 years of established precedent protecting ESOP fiduciaries. It agreed only to hear the first question posed by Fifth Third and the other defendants, evidently signaling that the presumption will survive, but that the stage at which it applies and the nature of the showing required to defeat it are on the table.

The stakes are significant for the plaintiffs bar and ERISA plan fiduciaries, each of whom will be watching closely to see how the court's decision impacts the drafting of complaints and ERISA plan documents.

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