BLOG

Supreme Court Rejects Special Presumption of Prudence for ESOP Fiduciaries in Stock Drop Case

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This week, in *Fifth Third Bank Corp. v. Dudenhoeffer*, the U.S. Supreme Court rejected a widely accepted presumption of prudence favoring fiduciaries of qualified retirement plans designed to invest primarily in employer stock (employee stock ownership plans or ESOPs). The plaintiffs in this case alleged that in 2007, Fifth Third and several officers breached fiduciary duties to the Fifth Third ESOP because they knew or should have known that Fifth Third's stock was overvalued and excessively risky. The plaintiffs alleged that Fifth Third and the ESOP fiduciaries should have taken a number of steps to prevent the ESOP from overpaying for employer stock that eventually lost 74% of its value between 2007 and 2009.

ERISA requires that plan fiduciaries act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity would act. Because of the restrictive nature of ESOPs, many courts have found that ESOP fiduciaries start out with a presumption that their decision to remain invested in or acquire more employer securities is reasonable. This "presumption of prudence" has been applied in a manner that requires plaintiffs to allege extraordinary circumstances, including that the ESOP's sponsor is facing dire circumstances or is on the verge of collapse. The U.S. Supreme Court rejected this approach based on the language in ERISA. Instead, the Court held that ESOP fiduciaries are subject to the same duty of prudence that applies to fiduciaries of other ERISA plans. The only difference is that ESOP fiduciaries are not required to diversify plan assets. Therefore, ESOP fiduciaries are not liable for losses resulting from a failure to diversify, but they are otherwise subject to the same duty of prudence as other ERISA fiduciaries.

However, the news is not all bad for ESOP fiduciaries. In remanding the case, the U.S. Supreme Court held that when alleging that a fiduciary is imprudent, plaintiffs will need to allege an alternative action that could have been taken, that would have been legal, and that a prudent fiduciary in the same circumstances would not have viewed as more likely to harm the ESOP than to help it. In addition, the Court set out guidelines for lower courts that will prove useful to fiduciaries of ESOPs invested in publicly traded stock, including:

- Where publicly traded stock is implicated, allegations that fiduciaries should have recognized that the stock was overvalued or undervalued should not survive.
- ESOP fiduciaries are not required to take actions in violation of insider trading laws.

- Where allegations are made that ESOP fiduciaries should have refrained from purchasing additional stock based on negative information, or that ESOP fiduciaries should have publicly disclosed negative information to avoid purchasing over valued stock, courts must examine any conflicting insider trading and corporate disclosure requirements set forth by the federal securities laws that may be present.
- Finally, courts will need to consider whether a prudent fiduciary could have concluded that stopping the ESOP from continuing to purchase stock or publicly disclosing negative information would do more harm than good for the ESOP by causing the price of the ESOP's existing stock holdings to drop.

This decision will likely lead to some rethinking on the monitoring policies and procedures in place for ESOPs. In addition, this decision makes it even more important that plan sponsors and fiduciaries follow the administration and participant communication best practices and plan design strategies that we have described in the past.

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