IESOP Law Group

U. S. Supreme Court Rules on Moench Presumption of Prudence in Important Case for ESOP Fiduciaries

After much anticipation by the ESOP community, the U. S. Supreme Court announced its decision in *Fifth Third Bancorp v. John Dudenhoeffer,* 573 U. S. ____ (2014*)* holding that ESOP fiduciaries are not entitled to a "defense-friendly" special presumption of prudence with respect to their decision to invest in employer stock in accordance with the ESOP plan document. The Court unanimously held that there is no such presumption in the statutory language of ERISA and the Court ruled that courts are not free to invent such a presumption.

All is not lost, however. The Court held that although ESOP fiduciaries are not entitled to a special presumption of prudence, any plaintiff seeking to show that a fiduciary should have sold employer stock (or refrained from purchasing employer stock) will need to plausibly allege "special circumstances" beyond a simple claim that the price of the stock declined in value or that it was imprudent to purchase or hold the stock. A price drop is not evidence of imprudence. This is a very high bar for plaintiffs to meet.

The Court held that the U.S. Court of Appeals for the Sixth Circuit had not required the *Dudenhoeffer* plaintiffs to plausibly plead such special circumstances and sent the case back to the Sixth Circuit to determine whether the plaintiffs can get over this higher threshold for stating a claim.

The *Dudenhoeffer* opinion addresses the interaction of the federal securities laws and ERISA, and considers the range of appropriate fiduciary actions where there is a public market for the ESOP's stock. To a large extent, these aspects of the *Dudenhoeffer* opinion will have little effect on ESOP's with privately held stock. Nonetheless, courts analyzing investment decisions by private company ESOP fiduciaries will be guided by *Dudenhoeffer*.

So, although plaintiffs' lawyers and the DOL can celebrate that the *Moench* presumption is dead, defendant fiduciaries can take comfort that the higher pleading standard required of plaintiffs will more than take the place of the prudence presumption.

The Court recognized that ESOP fiduciaries are concerned that without a presumption of prudence, they can easily be subjected to expensive meritless litigation by a class of plaintiffs, while plaintiffs are worried that with a presumption of prudence favoring defendant fiduciaries, even meritorious claims might not get past a motion to dismiss meaning their case would never be heard. The Court articulated a standard will help protect fiduciaries from the "meritless goats" while allowing the "plausible sheep" to have their day in court.

> [W]e do not believe that the presumption at issue here is an appropriate way to weed out meritless lawsuits or to provide the requisite 'balancing.' The proposed presumption makes it impossible for a plaintiff to state a duty-of-prudence claim, no matter how meritorious, unless the employer is in very bad economic circumstances. Such a rule does not readily divide the plausible sheep from the meritless goats. That important task can be better accomplished through careful, context-sensitive scrutiny of a complaint's allegations. We consequently stand by our conclusion that the law does not create a special presumption of prudence for ESOP fiduciaries.

The Court noted that "[i]n applying a 'presumption of prudence' that favors ESOP fiduciaries' purchasing or holding of employer stock, the lower courts have sought to reconcile congressional directives that are in some tension with each other."

"On the one hand, ERISA itself subjects pension plan fiduciaries to a duty of prudence. … On the other hand, Congress recognizes that ESOPs are 'designed to invest primarily in' the stock of the participants' employer, §1107(d)(6)(A), meaning that they are *not* prudently diversified. And it has written into law its 'interest in encouraging' their use."

The Court cites the following statutory provision to demonstrate this point:

> INTENT OF CONGRESS CONCERNING EMPLOYEE STOCK OWNERSHIP PLANS.—The Congress, in a series of laws [including ERISA] has made clear its interest in encouraging [ESOPs] as a bold and innovative method of strengthening the free private enterprise system which will solve the dual problems of securing capital funds for necessary capital growth and of bringing about stock ownership by all corporate employees. The Congress is deeply concerned that the objectives sought by this series of laws will be made unattainable by regulations and rulings which treat [ESOPs] as conventional retirement plans, which reduce the freedom of the employee trusts and employers to take the necessary steps to implement the plans, and which otherwise block the establishment and success of these plans. Tax Reform Act of 1976.

The Court also adds that in keeping with this statement of intent, Congress has exempted ESOP fiduciaries from some of the duties imposed on ERISA fiduciaries. "ERISA specifically provides that, in the case of ESOPs and other eligible individual account plans, 'the diversification requirement of [§1104(a)(1)(C)] and the prudence requirement (only to the extent that it requires diversification) of [§1104(a)(1)(B)] [are] not violated by acquisition or holding of [employer stock].' §1104(a)(2). Thus, an ESOP fiduciary is not obliged under §1104(a)(1)(C) to 'diversif[y] the investments of the plan so as to minimize the risk of large losses' or under§1104(a)(1)(B) to act 'with the care, skill, prudence, and diligence' of a 'prudent man' insofar as that duty 'requires diversification.' ESOP fiduciaries, unlike ERISA fiduciaries generally, are not liable for losses that result from a failure to diversify. But aside from that distinction ESOP fiduciaries are subject to the duty of prudence just as other ERISA fiduciaries are."

Background

Dudenhoeffer is a class action lawsuit brought against Fifth Third Bancorp by participants in the Fifth Third Bancorp Master Profit Sharing Plan alleging that Fifth Third plan fiduciaries continued to allow plan participants to invest in Fifth Third stock during a period of time when the company "switched from being a conservative lender to a subprime lender" and that the Fifth Third fiduciaries had "either failed to disclose the resulting damage to the company and its stockholders or provided misleading disclosures." The District Court for the Southern District of Ohio dismissed the case, finding that the Fifth Third fiduciaries were entitled to a presumption of prudence with respect to their decision to invest in employer stock in accordance with the terms of the plan (what is commonly referred to as the "*Moench* presumption"). To overcome that presumption, the plaintiffs were required to plead facts sufficient to justify a finding of abuse of discretion, which they failed to do.

Under the *Moench* presumption, formulated by the U.S. Court of Appeals for the Third Circuit in 1995 for evaluating employer stock drop cases under ERISA, an ESOP fiduciary who invests in employer stock in accordance with the terms of the plan is presumed to have acted prudently under ERISA unless the fiduciary reasonably believed that continuing with the ESOP's investment in employer stock was not within the realm of the settlor's intended purpose of the trust. Six other circuit courts subsequently adopted the *Moench* presumption, but not the Sixth Circuit, thereby causing a split among the circuit courts.

Instead of finding that the Fifth Third fiduciaries in *Dudenhoeffer* were entitled to a presumption of prudence, the Sixth Circuit reversed the lower court's ruling. The other circuit courts have held that fiduciaries are presumed to have acted prudently in continuing to invest in employer stock unless the company is facing imminent collapse or dire circumstances. But, the Sixth Circuit held that the class of participants needed to show only that a prudent fiduciary acting under similar circumstances would have made a different investment decision. So, in the Sixth Circuit any group of plaintiffs is free to second guess any fiduciary. Any fiduciary can be hauled into court simply because another fiduciary might have made a different investment decision.

But the Sixth Circuit did not stop there. The Sixth Circuit also found that if there was a presumption of prudence, then it does not apply at the motion-to-dismiss stage. The Sixth Circuit reasoned that presumptions are evidentiary, not standards of review, and as such require a fully developed evidentiary record that does not exist at the pleading stage. In the Sixth Circuit, even if a presumption of prudence did apply, fiduciaries will be forced into expensive litigation before they ultimately are able to prevail simply because some fiduciary somewhere might have made a different investment decision.

Over a period of almost 20 years, all of the circuit courts other than the Sixth Circuit have held that plaintiffs seeking to overcome the *Moench* presumption of prudence had to allege and prove that the employer faced "impending collapse" or "dire circumstances" that could not have been foreseen by the settlor of the plan and that such circumstances required plan fiduciaries to sell company stock held by the plan. Furthermore, the evidence needed to be publically available information and not information that would be considered "insider" information. If the plaintiffs failed to present such evidence at the motion to dismiss phase, the case would be dismissed.

In *Dudenhoeffer*, the Sixth Circuit turned on its head all of the developed case law recognizing Congressional support for ESOPs that is codified in ERISA and recognizing that fiduciaries acquiring or holding employer stock in accordance with the ESOP plan provisions are entitled to a presumption that they acted prudently in following the plan's terms.

U. S. Supreme Court Takes the Case

The U. S. Supreme Court agreed to take the *Dudenhoeffer* case to decide whether the Sixth Circuit erred in not applying the *Moench* presumption in the same manner as had the other circuit courts, and to thereby resolve the split in the circuit courts over whether ESOP fiduciaries are entitled to a presumption of prudence when investing or continuing to invest in employer stock and, if so, how to apply such a presumption.

ESOP Law Group co-wrote a brief of Amicus Curiae on behalf of The ESOP Association in support of Fifth Third. Fifth Third and The ESOP Association argued that in order to promote its goal of employee ownership, Congress carved out specific exceptions to certain fiduciary duties for ESOPs. Section 404(a)(2) of ERISA provides that the diversification requirement and the prudence requirement (only to the extent it requires diversification) do not apply to ESOPs that acquire and hold employer securities. ESOPs are designed to hold employer stock and should not be penalized for doing exactly what Congress intended and what the plan document requires. The ESOP Association urged the Court to uphold the *Moench* presumption and find that the Sixth Circuit erred in failing to do so.

The DOL filed a brief arguing that the Court should rule that an ESOP is an investment that is subject to divestment and prudence review in the same manner as other investments, rule that a

presumption of prudence does not exist at the initial pleading stage, and rule that the presumption of prudence does not exist at all.

The U.S. Supreme Court now has had the final word. The circuit courts, other than the Sixth, set the bar too high for plaintiffs. Under the *Moench* presumption, too many "plausible sheep" could be prevented from having their claims heard. Under the Sixth Circuit, too many "meritless goats" could get past the motion to dismiss stage thereby dragging ESOP fiduciaries to court at great and needless expense.

Instead of either of the above approaches, the Court held that defendant fiduciaries are not entitled to a special presumption of prudence, but plaintiffs must plausibly allege the special circumstances that show that a prudent fiduciary could not have made the decision it made. This standard will help protect fiduciaries from the "meritless goats" while allowing the "plausible sheep" to have their day in court.

For those wondering how the DOL will interpret this ruling, it is important to note that the Court went to great length to write out (and not simply cite to) the Congressional intent to promote employee ownership through ESOPs. Nowhere in the opinion does the Court attempt to undermine ESOPs. Rather, the Court recognized that if the Sixth Circuit had its way, ESOP fiduciaries could find themselves between a rock and a hard place—sued for selling stock too cheaply or sued for not selling before a collapse.

Employee ownership and ESOPs are alive and well. Again, although plaintiffs and the DOL can celebrate that the *Moench* presumption is dead, defendant fiduciaries can take comfort that the higher pleading standard required of plaintiffs will more than take the place of the lost presumption.

Click here for the full opinion.