CLIENT UPDATE

SUPREME COURT DECISION IN STOCK DROP CASE: ARE FIDUCIARIES NOW VULNERABLE OR BULLETPROOF?

NEW YORK
Lawrence K. Cagney
lkcagney@debevoise.com

Jonathan F. Lewis
jflewis@debevoise.com

Elizabeth Pagel Serebransky
epagel@debevoise.com

Charles E. Wachsstock
cewachss@debevoise.com

The Supreme Court recently rejected the long and widely accepted axiom that fiduciaries of "employee stock ownership plans" or "ESOPs" – retirement plans that invest primarily in the stock of the participants' employer – and other defined contribution plans offering employer stock as an investment option are entitled to a "presumption of prudence" under the Employee Retirement Income Security Act ("ERISA"), when causing the plan to invest in employer stock.[1] Although the Supreme Court rejected the presumption, the Court established a new, higher burden of proof for claims and provided plan fiduciaries with important new defenses. The question regarding the Supreme Court's decision is whether the Supreme Court simply replaced the fiduciaries' shield of presumed prudence with the club of an insurmountable burden of proof.

THE FORMER PRESUMPTION OF PRUDENCE

The "presumption of prudence" was a judicially created standard under which fiduciaries, who are frequently corporate insiders, were presumed to have acted appropriately with regard to decisions furthering the investment in employer stock.

Until the Supreme Court's decision in *Dudenhoeffer*, the presumption of prudence often came into play when the employer's stock experienced a precipitous drop in value, causing an ESOP's participants to sue the officers and directors who administer the plan

[1] *Fifth Third Bancorp v. Dudenhoeffer*, 134 S.Ct. 2459, 58 EBC 1405 (2014).

based on the claim that they were responsible for, but they failed to, act prudently and solely in the interest of the participants. Plaintiffs in such cases inevitably argue – as they did in *Dudenhoeffer*, in which the value of the stock fell by 74% – that the corporate insiders knew or should have known that the employer's stock was over-valued and too risky to continue to be bought and held by the ESOP. The claim usually stated that the insider fiduciaries should have therefore sold the employer stock before its value declined, refrained from buying any more employer stock, and disclosed relevant negative inside information about the company so that the market could adjust to properly account for the bad news. The presumption of prudence typically defeated these claims – and it is this presumption that the Supreme Court rejected.

THE NEW HURDLES FOR PLAINTIFFS TO OVERCOME

While it stripped away the powerful cloak of the prudence presumption, the Supreme Court did not leave fiduciaries defenseless in the face of a precipitous decline in the value of the employer stock. Rather, it offered two legal conclusions that fiduciaries will find most beneficial in stock drop cases:

- Absent extenuating circumstances, it is not imprudent for a fiduciary to rely on the public market as providing the best indicator of the stock price; and
- A fiduciary is not required to use insider information to break the law (such as by selling stock based on insider information).

These conclusions reject theories universally advanced by plaintiffs that were sometimes persuasive at the pleadings stage of the litigation, and which therefore afforded the plaintiffs leverage in settlement negotiations.

The Supreme Court also established a new, higher burden for claimants to overcome in pursuing a fiduciary breach claim against an ESOP's fiduciaries. It directed that, on remand, the Court of Appeals for the Sixth Circuit evaluate the efficacy of the plaintiff's fiduciary breach claims based on whether the plaintiffs have "plausibly alleged that a prudent fiduciary in the defendant's position could not have concluded that stopping purchases – which the market might take as a sign that insider fiduciaries viewed the employer's stock as a bad investment – or publicly disclosing negative information would do more harm than good to the fund by causing a drop in the stock price and a concomitant drop in the value of the stock already held by the fund." This standard, taken at face value, would mean that the claim could not proceed if there is a reasonable basis for the fiduciaries to have concluded that the decision that they made was in the participants' best interests under the circumstances then prevailing.

WHAT ARE ESOP FIDUCIARIES TO DO?

Practitioners have already begun to debate whether *Dudenhoeffer* gives plaintiffs an easier path to sue plan fiduciaries than before the decision or whether the alternative standard enunciated by the Supreme Court imposes an (at least) equally formidable hurdle for plaintiffs to overcome. In addition to *Dudenhoeffer*, several other cases are currently being reconsidered in light of the Supreme Court's new standard of review. While we believe that the Supreme Court's decision is actually helpful to fiduciaries, the true effect of the decision will become apparent as these cases are decided.

Pending these further decisions, ESOP fiduciaries should adhere to the mantra that a proper process is the best defense against potential claims, and abide by the following prescription for minimizing or avoiding liability:

- Periodically review the performance of the company's stock;
- Meet when the stock price drops significantly or when the fiduciaries become aware of negative news that could affect the stock's value to consider whether, in light of these developments, it is in the best interest of the participants to continue to offer company stock as an investment alternative;
- When considering the viability of the stock as an investment option, obtain the advice of professional investment advisors regarding the prospects for the company's stock and/or find out what recommendations (*e.g.*, buy, sell and hold) the analysts who follow the company stock are making;
- Discuss these independent judgments regarding the stock when considering what course of action is in the best interests of the participants (in light of the Supreme Court's directive to the lower court in *Dudenhoeffer*, it may be impossible to prove the fiduciaries who stay the course were imprudent if some independent investment professionals or analysts were then recommending that investors hold the employer stock); and
- Document all meetings and all decisions taken (including the reasons for not taking any action, if that is the decision reached by the fiduciaries).

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Please do not hesitate to contact us with any questions.

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