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Recent Case Law Regarding Retirement Plan Investments in Employer Stock: The Presumption of Prudence

Background

Congress created a statutory framework that encourages employee ownership of company stock through retirement plans-- including tax incentives, special dividend and loan provisions, and an exemption from ERISA's duty to diversify plan assets. Beginning in 1995 with the Third Circuit, several courts applied a presumption that employer stock is a "prudent" investment under ERISA.[1] This presumption permitted courts to dismiss stock drop law suits absent fiduciary abuse of discretion (such as a fiduciary who falsifies financial statements).

Supreme Court Case

A June 2014 decision by the U.S. Supreme Court eliminates the presumption of prudence.[2] And so ESOP fiduciaries have a duty to review employer stock along with other investments, and to invest plan assets in employer stock with care, skill, prudence and diligence.[3] The Supreme Court's decision included the following:

a. "[W]here a stock is publicly traded, allegations that a fiduciary should have recognized from publicly available information alone that the market was over- or undervaluing the stock are implausible as a general rule." The implication is courts should dismiss cases that allege a fiduciary should have known, based on public information, that employer stock was improperly valued—the theory that the major public markets provide the best estimate of the value of stocks traded on those markets generally prevails. However, "special circumstances" may be cause for exception.

b. In cases of conflicts between ERISA and other laws, ERISA does not require fiduciaries to violate those laws, including the securities law prohibition on insider trading. It is not always clear, however, in what circumstances ERISA and securities law duties conflict.

c. When securities law would permit a fiduciary to take an action (such as stop trading in or publicly disclose inside information about employer stock), courts "should also consider whether the complaint has plausibly alleged that a prudent fiduciary in the defendant's position could not have concluded that [the action] … would do more harm than good…."[4] Some commenters see the Court's use of the phrase, "could not have concluded" as a restriction on law suits against ESOP fiduciaries.

Since the Court's decision, lower courts have acted accordingly—refusing to grant motions to dismiss based on the pleadings and permitting cases to go forward.

Next Steps

Cases will further develop the implications of the Supreme Court's decision. In the meantime, fiduciaries should:

1. Review employer stock for investment prudence, like other plan investments.
2. Thoroughly document that review.
3. Not cause a retirement plan to trade employer stock and do not disclose inside information, in violation of securities law. However, do consider whether other action should be taken to protect the retirement plan from employer stock investment losses.
4. Review the plan's fiduciary liability coverage. The Supreme Court's decision eliminates one major basis courts used to dismiss law suits against ESOP fiduciaries, which may result in increased litigation.
5. If the employer stock held in a retirement plan is not publicly traded, value it accurately for ESOP purposes (e.g., purchase, sale, distribution). If the stock is publicly traded, there is generally no need to second-guess market value based on public information.

Not intended as legal advice.

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[1] *Moench v. Robertson*, 62 F. 3d 553 (3rd Cir. 1995). Before 2014, the Second, Third, Fifth, Seventh, and Eleventh Circuits applied the *Moench* presumption at the pleadings stage (i.e., before fact finding and trial); the Sixth Circuit applied the presumption applies after pleadings (i.e., at summary judgment and beyond); and the Second and Ninth Circuits applied the presumption only if a plan required or encouraged investment in the plan sponsor's stock.

[2] *Fifth Third Bancorp v. Dudenhoeffer,* 134 S.Ct. 2459 (2014). In rejecting the presumption of prudence, the Court stated, "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."

[3] ERISA 404(a)(1)(B).

[4] For example, the Court explained, by signaling to the market that insiders viewed the stock as overvalued, which could trigger more substantial retirement plan losses.