A Means of Meeting the *Dudenhoeffer* Standard

BY ALLEN BUCKLEY

Much has been written in the past year about the 2014 US Supreme Court decision titled Fifth Third Bancorp v. Dudenhoeffer. *[134 S. Ct. 2459 (2014)] In its decision, the US Supreme Court held that a "presumption of prudence" does not apply to company stock held in an employee stock ownership plan (ESOP). Rather, the ordinary ERISA fiduciary duties apply, except there is no need to diversify assets. Previously, US courts of appeals had issued conflicting rulings on the subject, with some ruling the ESOP fiduciaries are entitled to a presumption of prudence with respect to the ESOP's investment in company stock.*

As background, under Section 404(a)(1)(C) of the Employee Retirement Income Security Act of 1974 (ERISA), a retirement plan fiduciary generally is required to diversify plan assets so as to minimize the risk of large losses. Under ERISA Section 404(a)(1)(B), a plan fiduciary has a duty to act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims. However, under ERISA Section 407(d), a plan that is an eligible individual account plan, including an ESOP, is exempt from the diversification requirement. But, an ESOP is not exempt from the prudence requirement of ERISA Section 404(a)(1)(B).

As noted, US courts of appeals, including the Third Circuit in *Moench v. Robertson* [62 F.3d 553 (3d Cir. 1995)] and the Sixth Circuit in *Kuper v. Iovenko* [66 F.3d 1447 (6th Cir. 1995)], held that ESOP fiduciaries were entitled to a presumption of prudence with respect to their investment in company stock, given that ESOP terms require investment in company stock. Over the years, the presumption had been interpreted as something akin to a "free pass" or an automatic win for ESOP fiduciaries. By the wording of the opinion, *Dudenhoeffer* put an end to the free pass, and basically placed company stock on equal footing with all other non-diversified investments, in terms of the prudence requirement. The US Supreme Court also ruled in *Dudenhoeffer* that plan terms cannot override the duty of prudence. (Presumably, the *Dudenhoeffer* decision relates to all eligible individual account plans, including stock bonus plans and 401(k) components of profit-sharing plans.)

(The "presumption of prudence" has always been somewhat curious and confusing. Plaintiffs in any ERISA lawsuit have the burden of proof, meaning a successful imprudence challenge would necessitate that the plaintiffs prove that the fiduciary acted imprudently. But, as noted, courts tended to essentially interpret the presumption as meaning an automatic win for the fiduciary.)

In *Dudenhoeffer*, the US Supreme Court determined that markets relating to publicly traded stocks are efficient, meaning it is next to impossible to prove a breach of fiduciary duty with respect to a stock drop based on public knowledge. Concerning the very important issue of the conflict between the federal securities laws and ERISA, the Court held that a fiduciary has no duty to break a securities law to comply with ERISA. So, a fiduciary cannot sell company stock if doing so would violate the federal securities laws (for example, due to use of inside information that led the fiduciary to believe the stock would lose value).

Is there a duty to stop purchasing employer stock when inside information shows a loss in value is likely? Does a fiduciary have a duty to make public inside information that would likely cause the stock to drop? With respect to these questions, the Court punted (*i.e.,* it left them to the lower courts to decide). Many

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people fail to realize that the prudence issue relates to *all* ESOPs, not just those of publicly traded companies. Failure to regularly monitor whether an undiversified asset is a prudent investment is a breach of fiduciary duty. The Supreme Court's recent decision in *Tibble v. Edison International* [135 S. Ct. 1823 (2015)], recognizing an ongoing duty to monitor investments, makes this conclusion virtually unquestionable.

While technically ending the free pass of *Moench* and *Kuper*, with the one possible exception noted in the following paragraph, the likely practical end result of *Dudenhoeffer* is that company stock drop cases that allege a breach of fiduciary duty based on facts known to the plaintiffs that are not publicly known should overcome a motion to dismiss, while all other cases should be dismissed. Query how many non-insiders know non-publicly known facts? It would seem the answer is none. Thus, it is hard to imagine how a claim could be brought that would overcome a motion to dismiss. (Note: *Bell Atlantic Corp. v. Twombly* [127 S. Ct. 1955 (2007)], as expanded by *Ashcraft v. Iqbal* [129 S. Ct. 1937 (2009)], basically holds that a federal case should be dismissed if (1) the complaint is based on bogus facts or alleged facts based on conjecture, or (2) the suit is for something for which the law does not provide a remedy.) How could a plaintiff plead facts alleging a breach of fiduciary duty that is based on non-publicly known facts without engaging in conjecture? So, does *Dudenhoeffer* practically imply a sovereign immunity equivalent exists for company stock (an undiversified investment) such as the "free pass" provided by *Moench* and *Kuper*, while diversified portfolios remain subject to ERISA's prudent man standard? ERISA has no specific such "out," and thus there must be a potential avenue for recovery.

A real life example of what is described in the preceding paragraph was handed down by the Eleventh Circuit Court of Appeals in a July 29, 2015, unpublished opinion in *Smith v. Delta Air Lines, Inc.* (Case No. 13-15155). The plaintiffs requested the Court to reexamine its previous unfavorable decision to them. The Court analyzed *Dudenhoeffer* and concluded that the plaintiffs' case fell "squarely within the class of claims the Supreme Court deems 'implausible as a general rule.'" Specifically, the Court stated that the plaintiffs made no allegation that the fiduciaries had material inside information that had not been disclosed to the market, and there was no allegation of any special circumstance that rendered reliance on market price imprudent, such as fraud, improper accounting, or illegal conduct.

It would seem there is at least one situation where participants could sue and win: the 1970s typewriter business situation. In other words, if a company is in a dying industry, and professional investment analysts without inside information determine such is the case, continuing to hold company stock would be imprudent. Of course, as noted in *Dudenhoeffer*, markets are efficient. This should mean that the gloom is already reflected in the stock's value. This begs the question of whether something will change, such as the typewriter coming back into style, gold being found under the company's office building, or a secret new invention in the making that is going to rocket the stock back to the good old days. Only insiders would know about the latter two possibilities, and they would violate securities laws by profiting from the knowledge (or providing for others to profit from the knowledge).

There is no specific definition of a prudent process under ERISA. So, what is a fiduciary to do? For a publicly traded company, the stock of which is tracked by numerous reputable professional analysts, it would seem that making the analysts' aggregate determination the determining factor of prudence could not be questioned, unless the act of moving the decision-making process from an insider or group of insiders (if that is where it resides) to non-insiders is, in itself, an imprudent action under ERISA. For reasons noted below, such an action should not be imprudent.

There is no requirement under ERISA that company insiders be plan fiduciaries. *Dudenhoeffer* essentially said that a fiduciary cannot sell company stock to a third party when the insider has inside information showing the stock will drop (otherwise, securities laws would be broken). Regarding whether a duty exists to stop purchasing, how would cessation of purchasing, in itself, not inform the market that something bad was coming for the stock? Unless the (presumably efficient) public market failed to pick up the news, the stock would presumably drop to some degree. How much it would drop is anyone's guess. Disclosing bad information before any purchases or sales would, assuming public markets are efficient, adjust the stock downward to market value.

Having lived through two publicly traded company stock lawsuits in the late 1990s (one a direct case in which I had advised the fiduciaries and was the first person deposed and the other a sub-issue in an ESOP interpleader action), I experienced firsthand the issues presented in *Dudenhoeffer*. I summarized my thoughts in an autumn 2001 *Journal of Pension Benefits* article titled "Eligible Individual Account Plans and ERISA's

Fiduciary Duties." In the late 1990s, *Kuper* and *Moench* were virtually the only court decisions relating to the standard of care required of ESOP fiduciaries with respect to investment in company stock. Over the years, I have watched the law develop. I do not think it has developed much. I thought the securities laws issues would have been resolved by now. Only one of those issues has been resolved, and it was resolved in *Dudenhoeffer*.

The autumn 2001 *Journal of Pension Benefits* article noted the issue of whether an insider decision-maker violates ERISA if it transfers responsibility to an outsider for determining whether the holding of employer stock is prudent. That article notes a real-life situation in which Chrysler's stock lost a tremendous amount of its value, only to later regain it (thus noting the predicament in which an ESOP fiduciary can find itself). On page 35, the 2001 article provides: "Although nothing in ERISA technically prohibits a third party from acting as the sole fiduciary with respect to investment oversight, the independent fiduciary approach may raise the issue of a potential ERISA violation simply because of the transfer of the decision-making process from someone with superior knowledge to someone with inferior knowledge." The article then discusses the potentially large costs of paying a third party to deal with the matter. On further reflection in light of *Dudenhoeffer*, the decision-making process potentially could be handled in-house by a non-insider for little cost. And, there should be no fiduciary breach for making such a transfer of responsibility and authority. Superior knowledge is of no value if it cannot be lawfully used to benefit participants.

It should be lawful and prudent to satisfy the prudence standard with respect to publicly traded employer securities if the plan selects reputable analysts to track the stock and then uses the analysts' majority opinion as the prudence determination. For example, Charles Schwab's Web site lists the analysts that track companies' stocks. The named fiduciary or a hired professional could determine an odd number of analysts (preferably five, if available, but at least three). If a majority of the selected analysts rated the stock as a "hold" or better, it would be deemed a prudent investment. If most rated the stock as less than a hold (*i.e.*, "sell" or "underperform"), the stock would not be deemed a prudent investment. A non-insider employee (for example, someone from human resources) could be required to track the results as of a date in each quarter, and report those results to the investment fiduciary or fiduciaries. An interim analysis could be performed if an unusual event occurred that caused a sudden stock value drop.

The plan at issue could be drafted to provide for the system of analysis described in the preceding paragraph. If the stock investment was determined to be imprudent, then the stock could be gradually sold pursuant to plan terms over a period of months, subject to a reversal of the sales and reinvestment in company stock if the majority rule transitioned back to a prudent investment determination.

The 2001 article noted the potential problem if insider fiduciaries begin selling company stock of an eligible individual account plan—the market could take it is a signal that the stock is going to drop, thus causing the stock to drop. Using the objective system outlined above avoids this conundrum.

Under Code Section 4975(e)(7), ESOPs must be designed to invest primarily in employer securities. However, as the *Dudenhoeffer* court ruled, company stock investments of ESOPs are subject to ERISA's prudence requirements. Presumably, a plan drafted in a manner described in the preceding paragraph would pass muster under Code Section 4975(e)(7). In this regard, just as ERISA does not require the securities laws relating to insider trading to be violated, Code Section 4975(e)(7) should not permit ERISA's prudence rule to be violated. Thus, an ESOP could be "designed to investment primarily in employer securities" while being subject to override by ERISA's prudence requirement.

The foregoing means of dealing with the prudence issue does not work for companies whose stock is not publicly traded. For them, it would seem that constantly being open to purchase offers and prudently entertaining offers that are close to the most recent annual valuation (whether below or above) would meet the standard. It would seem that such companies would not need to be constantly on the sales block, as being so suggests desperation (likely producing a lower offer price). ■