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End of prudence presumption raising employer stock questions

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The court ruled that employee stock ownership plans have no special presumption of prudence in offering employer stock, erasing a 19-year legal principle — called the Moench presumption — that many plans had used as a defense in participant lawsuits that claimed a breach of fiduciary duty when company stock prices fell.

However, the court also provided guidelines for lower courts to assess whether such stock-drop complaints were sufficient to merit a trial. These guidelines discuss plan fiduciaries' responsibilities relating to public information about stocks, insider information, securities laws and plausible alternative actions in the face of a falling stock price.

The ruling's impact goes beyond ESOPs.

“The decision governs qualified retirement plans that are governed by ERISA that offer company stock of the employer, whether publicly traded or closely held, regardless of the plan design,” said Thomas E. Clark Jr., a partner with The Lowenbaum Partnership LLC, St. Louis, and outside ERISA counsel to FRA PlanTools LLC, a fiduciary consulting firm.

DC consultants, attorneys and trade group representatives say the ruling will encourage more plan executives to review how they administer and monitor company stock within DC

plans — or question if they want to add company stock to their investment menu. They said it is too early to determine if the decision will lead to more lawsuits or settlements.

“There's a lot of sorting out to do,” said Lori Lucas, the Chicago-based executive vice president and defined contribution practice leader at Callan Associates Inc.

Fifth Third Bancorp, a publicly traded company that offers participants a 401(k) plan with many investment options, one of which is company stock via an ESOP. The participants sued, saying fiduciaries breached their duties by failing to act when the company stock price fell 74% between July 2007 and September 2009.

In the 9-0 decision, Justice Stephen Breyer wrote that “ESOP fiduciaries are subject to the same duty of prudence that applies to ERISA fiduciaries in general, except that they need not diversify the (ESOP) fund's assets.”

Instead of relying on the “defense-friendly” presumption of prudence, courts should evaluate stock-drop cases “through careful, context-sensitive scrutiny of a complaint's allegations,” Mr. Breyer wrote.

The Department of Labor hailed the ruling that overturned the presumption of prudence standard established in 1995 by the 3rd Circuit Court of Appeals, Philadelphia, in Moench vs. Robertson. “The Supreme Court's decision will restore the ability of ESOP participants to have their day in court when plan trustees overpay for company stock,” Deborah Greenfield, deputy solicitor of labor, wrote in the DOL's blog June 27.

Although the presumption of prudence “was a reasonable tool” for courts to assess the validity of stock-drop lawsuits early, the new guidelines appear to offer protection against meritless lawsuits, said Scott Macey, president and CEO of the ERISA Industry Committee, Washington. If he were a DC plan executive, Mr. Macey said, “I wouldn't take any precipitous action.”

If DC plans don't have company-stock in their investment lineups now, he added, “I doubt they'll consider adding it” given the uncertainty of how courts will interpret the Supreme Court's decision.

“It's very challenging” to eliminate company stock from an investment menu under any circumstances because sponsors fear participants might think there's something wrong with the company, said Callan's Ms. Lucas.

Be careful

As for plans contemplating adding company stock, “I tell clients: "Don't do something that will be difficult to unwind,'” Ms. Lucas said. If there's extra oversight due to the Fifth Third Bancorp case, “that could discourage sponsors from adding company stock” to the investment lineup, she said.

A Callan survey of DC executives, issued in January, reported that 16% would eliminate company stock as an option this year, “a notable increase from prior years,” said a report on the survey.

The Supreme Court's ruling will require greater vigilance among DC plan sponsors, said Robyn Credico, Arlington, Va.-based defined contribution practice leader for Towers Watson & Co. “If you have company stock in the plan, you need to monitor it like any regular investment because it's not protected by the presumption of prudence anymore,” she said.

Even before the ruling, Ms. Credico was advising clients against adding company stock to their investment lineups over concerns about having adequate diversification. “Now, you have more potential of fiduciary risk,” she said.

The decision also might encourage more DC plan executives to examine steps already taken by some peers to reduce fiduciary risk. “Now, you have to prove your prudence,” said Marcia Wagner, an ERISA law specialist and managing director of the Wagner Law Group, Boston. The Supreme Court's ruling will require plan officials to “increase their knowledge that procedural and substantive prudence is important in menu selection.”

One possible strategy for companies is to assign management of the employer-stock option to an independent fiduciary. In Callan's survey of DC plan executives, 19.2% said they outsourced oversight of company stock to limit potential liability.

“I suspect a good number of fiduciaries will consider this option if they hadn't considered it before,” said Jeremy Blumenfeld, a Philadelphia-based partner with Morgan, Lewis & Bockius LLP who represents companies in ERISA cases. One drawback is that this approach raises costs.

Another consideration for DC plans is that independent fiduciaries might be less aware of the “big picture” — corporate culture and employee demographics — than in-house managers, he said.

Another possible strategy is to remove insiders, such as the chief financial officer or CEO, from the committee overseeing company stock. In the Callan survey, 15.4% of executives

cited this strategy to reduce liability. “I would not be surprised if more of those discussions will occur,” said Ms. Lucas.

Insulating top executives from company-stock investing “reduces the chance of having non-public information” affecting decisions, Mr. Blumenfeld said.

He added that the end of the Moench presumption will put pressure on the plans that have used the “hard-wire defense” to limit liability. Many plans — 38.5% according to the Callan survey — write into their plan documents, or hard-wire them, that company stock is required as an option.

“Hard-wiring isn't going to be the bullet-proof approach that some folks thought it would be,” thanks to the Supreme Court ruling, said James P. McElligott Jr., a Richmond, Va.-based partner with McGuireWoods LLP, who represents companies with DC plans.

In the Supreme Court ruling, Mr. Breyer wrote: “The duty of prudence trumps the instructions of a plan document, such as an instruction to invest exclusively in employer stock even if financial goals demand the contrary. … This rule would make little sense if, as petitioners argue, the duty of prudence is defined by the aims of the particular plan as set out in the plan documents, since in that case the duty of prudence could never conflict with a plan document.”

The Fifth Third Bancorp decision “is a mixed bag,” said Mr. Clark, of The Lowenbaum Partnership, as it tried to balance federal laws that encourage the use of ESOPs with laws that demand prudence of fiduciaries. Although fiduciaries lost a big weapon against stock-drop suits, it will take time for lower courts to interpret the new standards about whether stock-drop complaints should go to trial, Mr. Clark said. “Some plaintiffs and defendants may wind up in the Supreme Court again,” he said.

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