Supreme Court to Hear Stock-Drop Case

Marcia S. Wagner, Esq.

On April 2, 2014, the U.S. Supreme Court will hear arguments in the case of *Fifth Third Bancorp v. Dudenhoeffer* to decide whether fiduciaries of individual account plans are entitled to a "presumption of prudence" when employer stock is offered as an investment option. The Court's ruling will impact 401(k) plans that offer employer stock as an investment option, as well as employee stock ownership plans that invest primarily in employer stock.

Many employers offering employer stock as an investment option in a 401(k) plan have been subject to class action lawsuits arising from a substantial drop in their stock price causing participants to claim that the employer breached its duty of prudence and loyalty by allowing continued investment in the stock. A key defense for employers in these "stock-drop" lawsuits is the so-called "*Moench* presumption" of prudence, named after the 1995 decision by the Third Circuit Court of Appeals in *Moench v. Robertson*, which has been followed by a majority of the other circuits. Application of the *Moench* presumption means that a plan fiduciary's decision to remain invested in employer securities is presumed to be reasonable, unless the plaintiff can show that the fiduciary abused its discretion in continuing to make employer stock available as an investment alternative.

Policy Reasons for the Moench *Presumption.* The rationale for the *Moench* presumption is based on an attempt to balance competing policy concerns that, on the one hand, would promote employee ownership, and on the other, protect participants against imprudent plan investments. This tension is reflected in the statute. Thus, while statutory language requires fiduciaries to diversify plan assets and to act with prudence in making investment decisions, it also provides that, in the case of plans offering employer stock as an investment, fiduciaries are exempt from the duty to diversify investments and the prudence requirement, but only to the extent that prudence would require diversification.

The *Moench* presumption has not been applied uniformly, and the courts have disagreed as to whether the presumption can be asserted at the pleading stage before discovery or only after development of a full evidentiary record. There are also differences as to how the presumption may be rebutted. For example, to overcome the presumption, some courts require a showing that the employer was on the brink of collapse or undergoing serious mismanagement. However, as discussed below, the Sixth Circuit, which decided the *Dudenhoeffer* case, only requires a showing that a prudent fiduciary acting under similar circumstances would have decided to discontinue the employer stock investment.

Courts also are divided as to whether the presumption applies where the plan language requires that employer stock be offered as an investment option. The reasoning of these courts is that if the plan document requires that employer stock be offered, then there is little need for the presumption as the fiduciary must follow the plan document and has no discretion to decide whether to cease offering employer stock in the investment menu.

A Recent Stock-Drop Case. The *Dudenhoeffer* case involves a 401(k) plan sponsored by Fifth Third Bancorp, which offered the company's stock as a plan investment option. From July 2007 to September 2009, the stock's price dropped 74 percent, causing the plan to lose "tens of millions" of dollars, allegedly as a result of Fifth Third Bancorp's shift from conservative lending practices to being a subprime lender. Participants filed a class action lawsuit in federal district court against Fifth Third Bancorp alleging that plan fiduciaries breached their duty under ERISA by continuing to include Fifth Third Bancorp stock on the plan's investment menu, despite the fact that they knew or should have known that the company's business model put its value in jeopardy.

The district court dismissed the claim on the basis that the fiduciary's decision was presumed to be prudent. On appeal, however, the court of appeals overturned the district court and ruled that the presumption is to be applied at a later stage in the litigation when there is a more fully developed court record. The ruling by the appeals court in *Dudenhoeffer* case is at odds with the majority of courts that apply the presumption in the initial stage of litigation, meaning that in most stock-drop cases participants are denied the opportunity to engage in discovery.

The Sixth Circuit also ruled that to rebut the presumption, participants need only show that a prudent fiduciary acting under similar circumstances would have made a decision that the employer stock was an imprudent investment. This ruling is also a departure from the majority as most courts require that a participant must demonstrate that the company was in "dire circumstances" or facing "impending collapse" in order to rebut the presumption. The court of appeals specifically rejected these "narrowly defined" tests for rebutting the presumption in favor of one that is easier for participants to prove.

Department of Labor's View. Given the differences among the courts

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in applying the presumption, the Supreme Court has agreed to hear the case. Through a series of amicus briefs filed in many stock-drop cases, the DOL has long advocated that the *Moench* presumption be abolished. In its brief filed in *Dudenhoeffer*, the DOL again urges the Court to find that fiduciaries are not entitled to a presumption of prudence and that fiduciaries of plans that hold employer stock should be governed by the same prudence standards that apply to all benefit plans. According to the DOL, ERISA's statutory exemption from the diversification requirement means that a fiduciary cannot be held liable for concentrating plan assets in employer securities, but it does not permit a fiduciary to concentrate plan assets in an imprudent investment. In practical terms, this means that plan sponsors and fiduciaries would be placed in the difficult position of having to decide whether employer stock is an imprudent investment because of short-term swings in its value. Should the decision be made to no longer offer employer stock, conceivably, such decision could expose the fiduciary to claims for lost profits if the value of the stock subsequently increases.

Implications for 401(k) Plan Sponsors. If the Court upholds the *Moench* presumption, it would underscore the importance of employee ownership and resolve the split among the courts. It also may establish rules as to the stage of litigation to which the presumption should be applied and how the presumption is to be rebutted. Allowing the presumption to be raised in a motion to dismiss based on the pleadings would reduce the likelihood of costly discovery and force the plaintiffs' bar to avoid meritless claims that only allege a price-drop and vague assertions of mismanagement. If the Court decides not to recognize the presumption, as the DOL urges, plan fiduciaries could face another wave of stock-drop litigation if the equity markets turn volatile. If the presumption is held to apply at a later stage in the litigation after discovery and development of a factual record, plan sponsors would most certainly face a lengthy and more costly defense of stock-drop suits that, in the end, could convince them to end their support for this type of plan investment. ❖

Marcia S. Wagner, Esq. is the Managing Director of The Wagner Law Group. She can be reached at 617-357-5200 or Marcia@WagnerLawGroup.com.