The U.S. Supreme Court Overrules the *Moench* Presumption

How should plan sponsors and their advisors navigate the post-*Dudenhofer* world?

BY JOHN MICHAEL MAIER

In most civil litigation, the plaintiff has the burden to prove the allegations that are made in the complaint. In cases alleging breach of fiduciary duty under ERISA, once the plaintiff has made facts that, if proved, would create liability, the fiduciary defendants have the burden to prove that their conduct was prudent.

Until recently, in ERISA cases involving a drop in the value of employer stock held as an investment in the plan, the fiduciary defendants were entitled to a presumption of prudence for investing in employer stock if the plan document stated that the plan was designed to invest in employer securities. If so, the plaintiff would have the burden to prove that the defendant fiduciaries were imprudent to invest in employer stock. This was known as "the *Moench* presumption," after a 1995 3rd Circuit case that was followed by many other circuits.

In a June 2014 decision, *Fifth Third Bank v. John Dudenhoeffer*, 134 S. Ct. 2459 (2014), the U.S. Supreme Court unanimously overruled a federal appeals court that denied use of the *Moench* presumption. In doing so, the high court ruled that there is no such presumption in the language of ERISA and that federal courts are not free to create such a presumption.

The Court also held, however, that a plaintiff must allege more than the fact that the stock price dropped to stay in court on a breach of prudence theory. Indeed, the Court ruled that plaintiffs need to allege "special circumstances" that a prudent fiduciary could not have made the decision it did. There needs to be more allegations than simply that the stock price fell and the fiduciaries were imprudent in retaining the employer stock or in continuing to buy employer stock such as in a 401(k) plan.

The Supreme Court remanded the case back to the U.S. Court of Appeals for the 6th Circuit to determine whether the plaintiffs can supply such "special circumstances" in stating a claim.

The case is of major interest to plan fiduciaries and their advisors as well as ERISA litigation attorneys. The stakes are highest for fiduciaries of plans invested in publicly held employer stock such as a 401(k) plan sponsored by a publicly held company that offers company stock as an option in a participant-directed fund menu. Fiduciaries of ESOP plans and stock bonus plans also have significant concerns.

> "The Court also tried to balance the tension between acting prudently under ERISA and complying with SEC insider trading rules."

NEW CALCULUS FOR MOTION TO DISMISS

Once litigation has commenced, there are four main stages at which a defendant can try to resolve a case:

- Motion to dismiss for failure to state a claim on which relief can be granted. In other words, the plaintiff has failed to allege facts which even if true would state a legal case for liability. This is also known as judgment on the pleading.
- Motion for summary judgment.
- Trial on the merits.
- Appeal of a final ruling.

At each stage, the expense of prosecuting the case goes up significantly. Of course, at any stage, the parties involved may agree to settle the case on their own terms, subject to a judge approving the proposed settlement. *Dudenhofer* changes the calculus for the motion to dismiss.

In the *Moench* world, if a public company wanted to offer employer stock as an option in a plan, the plan document would state that the plan was designed to invest in employer securities. The plan sponsor would also ensure that if the plan had participant-directed investments, it was administered in compliance with ERISA 404(c).

Recent changes to ERISA and the tax qualification rules also require that a participant must have the ability to diversify out of employer stock and have the opportunity to vote any company stock allocated to his or her account. Legal counsel would review the plan design and tell the plan sponsor to worry a little less.

If the stock value dropped after being acquired by the plan as the result of company underperformance, targeting by short sellers, general recession or changes in markets, fiduciaries might conclude that they could hang on to the stock, ride out market volatility and take some reassurance that the plan document stated that it was intended to invest in employer stock. The *Moench* presumption would come to the rescue or at least increase the odds of an early and less painful end to litigation.

Fiduciaries would argue that absent knowledge of bankruptcy or liquidation, it was prudent for them to hold onto the employer stock for a potential recovery instead of selling out and realizing an actual loss.

This strategy was employed by many fiduciaries in the spate of plaintiffs' class action stock drop suits following the Great Recession. Some cases were resolved before trial and at less expense to the parties.

> "The Court held that a plaintiff must allege more than the fact that the stock price dropped to stay in court on a breach of prudence theory."

SHEEP V. GOATS

In ruling that there is no presumption of prudence regarding investing in company stock, the Supreme Court addressed the specter that too many weak lawsuits will get beyond the pleading stage at needless expense to all parties. The Court ruled that the *Moench* presumption was too high a bar and that too many "plausible sheep" could be prevented from having their claim heard. They also ruled that the 6th Circuit's approach of simply denying the *Moench* presumption might allow too many "meritless goats" to go forward. The Court articulated a standard to balance these competing tensions. Rather than a presumption, the Court favored a "careful, context-sensitive scrutiny of the complaint's allegations."

This standard for investing in employer stock means that a plaintiff must show that an alternative action would have been more prudent. This is a high bar — at least with regard to publicly traded stock. The Court noted that the 6th Circuit may have based its decision "on an erroneous understanding of the prudence of relying on market prices."

The Court also tried to balance the tension between acting prudently under ERISA and complying with SEC insider trading rules. The Court stated that ERISA does not require fiduciaries to make decisions based on insider information and in violation of public disclosure obligations. Furthermore, fiduciaries can consider whether selling employer stock, or ceasing to buy employer stock, would do more harm than good by driving down the stock price and impairing the value even further.

WHAT LIES AHEAD?

How do plan sponsors and their advisors navigate the post-*Dudenhofer* world? The Court was most focused on plans with publicly held employer stock. Arguably, plans with closely held stock, such as ESOPs and stock bonus plans, did not really benefit from the *Moench* presumption. Litigation tended to center on prudent processes and potential conflicts of interest. Fiduciaries rely on valuations required to be done by independent appraisers.

The application of *Dudenhofer* to the 401(k) market with public employer stock will evolve over the next few years as a variety of cases are remanded back to lower courts for consideration under the *Dudenhofer* standards.

Based on what we know so far, plan sponsors of plans with publicly held employer stock and their advisors should consider:

- Ensuring that employer securities are benchmarked against an appropriate index for the employer's market segment. Regular consideration should be made as to whether it is prudent to continue holding or investing in the stock given a participant's ability to diversify out of the stock at any time.
- Separating the members of the plan fiduciary committees from the SEC insiders. While the Court stated that ERISA does not oblige a fiduciary to violate SEC rules regarding insider trading or disclosure of information, it does not make sense to put people with SEC insider information in a fiduciary conflict position. The day-to-day fiduciary decisions are not on the strategic critical path of maximizing shareholder value.
- Consulting with legal counsel as to whether to remove language from the plan document stating that the plan is designed to invest in employer stock. If there is no presumption of prudence based on this language, then why risk a potential claim that the fiduciary violated the terms of the plan document by divesting of employer stock? The prudence of investing in employer stock can stand on its own merits. Employees receive value they did not previously have and employers can contribute value to the plan without affecting cash flow (increased cash flow improve stock value). PC

John Michael (Mickey) Maier, JD, is the president of Professional Fiduciary Services LLC. He services as trustee, independent fiduciary or fiduciary advisor to ESOP and other plans that hold employer securities. Maier co-authored the Participant Directed Investment Answer Book *and was one of the original co-authors of the* 401(k) Answer Book *series published by Wolters Kluwer.*