

## THE MOENCH PRESUMPTION IS DEAD - LONG LIVE THE DUDENHOEFFER PRESUMPTION

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On June 25, 2014, a unanimous United States Supreme Court weighed in on the legal standards applicable in stock drop cases in Fifth Third Bancorp v. Dudenhoeffer.

**Facts.** Beginning in 2007, Fifth Third Bank began experiencing a large number of mishaps, most of them associated with borrowers not repaying their loans when due. As a result, Fifth Third's stock price suffered the same phenomenon as that of virtually every other publicly traded financial institution in the world during the great recession: it dropped precipitously, falling 74% from July 2007 to September 2009. With the benefit of hindsight, plaintiffs brought a class action lawsuit against the fiduciaries of the Fifth Third 401(k) Plan, alleging that all of this should have been patently obvious based on public and nonpublic information allegedly possessed by the fiduciaries. The plaintiffs asserted that the fiduciaries should have taken one or more of the following actions with respect to the company stock fund in the 401(k) Plan: (1) sell the stock before it declined; (2) refrain from purchasing any more Fifth Third stock; (3) cancel the Plan's company stock option; and (4) disclose the inside information allegedly in their possession so that the market would appropriately adjust its valuation of Fifth Third stock downward and the Plan would as a result no longer be overpaying for it.

**The Supreme Court's Ruling.** Much of the decision focuses on whether the so-called "Moench" presumption of prudence attaches to a fiduciary's decision to allow or continue the investment of plan assets in company stock when the governing plan documents direct that such investment shall be made. This presumption was originally articulated by the Third Circuit in the case of Moench v. Robertson, and was subsequently adopted by every circuit which had considered the matter, although there was some disagreement regarding whether the presumption applied at the pleading or evidentiary phase. The Supreme Court Justices read and reread ERISA's statutory language, looked in every nook and cranny, and directed their law clerks to do the same, but ultimately they were unable to find even a single word in the statute which accorded such a presumption of prudence. The Court then concluded that the Circuit Courts had made it all up, and that no such presumption existed.

Rather than stopping at the point of simply deciding the issue presented, the Court elected to offer some advice to the lower courts regarding how meritless stock drop cases might be weeded out, perhaps because the lower courts, at least in the eyes of the Supreme Court, had gotten the law in this area so wrong for so long. The Court stated that, in the case of a publicly traded security, allegations that a fiduciary should have recognized from publicly available information alone that the market was over- or under-valued are “implausible”, at least in the absence of special circumstances. The Court noted that ERISA fiduciaries have little hope of outperforming the market, and so may, as a general matter, prudently rely on market price.



Under this standard, is it even possible to plead a breach of fiduciary prudence as it relates to investment decisions involving a publicly-traded company stock fund? The Court left this question open with the following observation: “We do not here consider whether a plaintiff could nonetheless plausibly allege imprudence on the basis of publicly available information by pointing to a special circumstance affecting the reliability of the market price as ‘an unbiased assessment of the security’s value in light of all public information.’” To even have a chance of succeeding in stock drop litigation based solely on publicly available information, therefore, plaintiffs would have to prove that the plan fiduciaries were aware or should have been aware of a special circumstance which would lead to the conclusion that the most efficient market in the history of mankind was not operating efficiently with respect to the value of the company’s stock. The Moench presumption of prudence has been replaced with the Dudenhoeffer presumption of an efficient public market. Unlike the Moench presumption, which was rebuttable, the Dudenhoeffer presumption appears to

be virtually irrebuttable. To our brethren in the plaintiffs' bar who make their living handling stock drop cases, we offer the following words of encouragement: Good luck with that.

The Court next moved to a discussion of the plaintiffs' allegations that the plan fiduciaries failed to act on the basis of nonpublic information. The Court noted that the duty of prudence does not require a fiduciary to break the law. Presumably, therefore, litigation premised on the theory that fiduciaries should have taken action which would have violated the securities laws should be dismissed. The Court also instructed the lower courts faced with stock drop claims to consider whether the suggested fiduciary action (e.g., deciding to liquidate a company stock fund or disclose material nonpublic information) might do more harm than good by causing a drop in the value of the stock already held by the plan.

**Reaction from the Department of Labor.** The Department of Labor, which had filed an amicus brief in support of the plaintiffs' position, immediately declared victory, once again proving the ability of Washington bureaucrats to put a positive spin on any defeat.

**Lessons from Dudenhoeffer.** The Dudenhoeffer decision suggests that fiduciaries in charge of monitoring a company stock fund should not only review and analyze press releases, SEC filings, and other publicly available information, but should also build the following considerations into their fiduciary process:

1. In considering publicly available information with respect to company stock, fiduciaries should determine whether any special circumstance exists affecting the reliability of the stock's market price as an unbiased assessment of the stock's value that would make reliance on the market's valuation imprudent.
2. It is still a bad idea to have insiders serve on the committee which oversees the company stock fund. Consider removing insiders from the investment committee, or at least consider vesting sole authority to oversee the company stock fund in a subcommittee consisting solely of non-insiders.
3. In the event an insider does serve on the committee tasked with overseeing the company stock fund, and the insider comes into possession of material nonpublic information suggesting the company's stock is overvalued, the insider should consider whether he or she could take action with respect to the company stock fund consistent with the securities laws that a prudent fiduciary in the same circumstances would not view as more likely to harm the fund than to help it.

The decision also suggests a possible change to the historical approach to drafting plan language relating to plan investments in company stock. Many practitioners had hardwired language into the plan document mandating investments in company stock in order to place the fiduciaries in the best position to claim the Moench presumption of prudence. Given the demise of the Moench presumption, such language would no longer appear to be helpful, and may even prove detrimental in the situation in which the plan fiduciaries desire to discontinue the company stock fund. Assuming the portion of the plan which invests in company stock is an employee stock ownership

plan (“ESOP”), consider language which simply recites that the ESOP portion of the plan has been designed to invest primarily in employer securities.

## MEET THE TEAM



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