St. John's University School of Law
St. John's Law Scholarship Repository

Bankruptcy Research Library | Center for Bankruptcy Studies

2016

The "Prudent Person" Standard in ESOP Breach of Duty of Care Claims

Zien Halwani

Follow this and additional works at: https://scholarship.law.stjohns.edu/bankruptcy_research_library

Part of the Bankruptcy Law Commons

ST. JOHN'S UNIVERSITY
SCHOOL OF LAW

The "Prudent Person" Standard in ESOP Breach of Duty of Care Claims

2016 Volume VIII No. 7

The "Prudent Person" Standard in ESOP Breach of Duty of Care Claims

Zien Halwani, J.D. Candidate 2017

Cite as: *The "Prudent Person" Standard in ESOP Breach of Duty of Care Claims,* 8 ST. JOHN'S BANKR. RESEARCH LIBR. NO. 7 (2016)

I. Fifth Third Bancorp's change to ESOP duty of care claims

Employee stock ownership plans (ESOPs) are a form of statutory pension program designed to invest employee retirement assets in the stock of the employer.[1] Under the Employment Retirement and Income Securities Act of 1974 ("ERISA"), ESOP fiduciaries must discharge their duties "with the care, skill, prudence and diligence under the circumstances prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."[2] This is to say that under ERISA, ESOP fiduciaries are liable for breaches of duty of care, unlike most corporate fiduciaries that are relieved from such liabilities by state exculpation statutes.[3]

Before the Supreme Court decided *Fifth Third Bancorp v. Dudenhoeffer,*[4] this duty of care was applied with an "abuse of discretion" standard by some of the United States Courts of

---

[1] William R. Levin, *The False Promise of Worker Capitalism: Congress and the Leveraged Employee Stock Ownership Plan,* 95 YALE L.J. 148, 148 (1985)
[2] 29 U.S.C § 1104(a)(1)(B).
[3] *Id; Continuing Creditors' Committee of Star Telecommunications, Inc. v. Edgecomb,* 385 F.Supp.2d 449, 463 (D. Delware 2004) (explaining that Delaware exculpation provisions "apply to prevent" duty of care claims).
[4] 134 S. Ct. 2459 (2014).

Appeals.[5] For example, in *Moench v. Robertson*, the Third Circuit explained that (1) ESOPs are consistent with the formulation of a trust because they are formulated with the primary purpose of investing in employer securities and (2) "[w]here discretion is conferred upon the trustee with respect to the exercise of a power, its exercise is not subject to control by the court, except to prevent an *abuse by the trustee* of his discretion." (emphasis added).[6]

In *Fifth Third*, the Supreme Court changed this abuse of discretion standard to the "stricter" "prudent person" standard applied to all ESOP fiduciaries under 29 U.S.C. § 1104.[7] But while *Fifth Third* seemed to create a heavier burden for ESOP fiduciaries, the devil was in the details.[8] The Supreme Court also announced that, in the case of publicly traded stock, absent "special circumstances," the "prudent person" standard would not require an ESOP to recognize from publicly available information alone that the market is over- or undervaluing that stock.[9] Thus, after *Fifth Third*, plaintiffs were left with two options in ESOP breach of duty of care claims: (1) allege a breach based on public information and be forced to plead a "special circumstance" affecting market price reliability and/or (2) allege a breach based on nonpublic information but (a) show an alternative action that could have been taken in compliance with securities laws and (b) show that a prudent fiduciary in the same circumstances would not have viewed this action as more likely to harm the fund than to help it.[10]

---

[5] *Kuper v. Iovenko*, 66 F.3d. 1447, 1459 (6th Cir. 1995); *In re Citigroup ERISA Litigation*, 662 F.3d. 128, 136 (2d Cir. 2011); *Moench v. Robertson*, 62 F.3d 553, 571 (3d Cir. 1995).

[6] *Moench*, 62 F.3d at 566.

[7] *Cf In re Citigroup ERISA Litigation*, 662 F.3d at 136 (applying the abuse of discretion standard instead of a "stricter standard."); *Fifth Third Bancorp*, 123 S. Ct at 2467 ("… because ESOP fiduciaries are ERISA fiduciaries and because § 1104(a)(1)(B)'s duty of prudence applies to all ERISA fiduciaries, ESOP fiduciaries are subject to the duty of prudence just as other ERISA fiduciaries are…"

[8] *In re UBS ERISA Litigation*, No. 08-cv-6696, 2104 WL 4812387, *1,*9 n.11 (S.D.N.Y. 2014) ("It could be argued that the Supreme Court's decision in *[Fifth Third]* has, if anything, *raised* the bar for plaintiffs seeking to bring a claim based on a breach of the duty of prudence."

[9] *Fifth Third Bancorp*, 134 S. Ct at 2471.

[10] *Id.* at 2472.

II. An Application of *Fifth Third Bancorp* and the "prudent person standard"

The "prudent person" standard was applied to ESOP fiduciaries in *In re Lehman Brothers ERISA Litigation*.[11] In that case, the plaintiffs alleged that under ERISA: (1) the Plan Committee breached its fiduciary duty (a) by "failing to consider the prudence of continuing to invest in Lehman" during the 2008 financial crisis (*i.e.* they knew or should have known that investment in Lehman had become increasingly risky during the time) and, alternatively, (b) by "failing to investigate nonpublic information regarding the risks facing Lehman;" and (2) there were special circumstances affecting the reliability of the market price of Lehman stock as an unbiased assessment of Lehman's value.

Relying on *Fifth Third Bancorp*, the district court dismissed the first claims finding that (1) there was not enough public information regarding Lehman during the 2008 financial crisis to trigger ERISA's prudence requirements, *i.e*. that a reasonably prudent fiduciary would not have reconsidered continuing investment in Lehman at that time; and (2) creating a duty to investigate nonpublic information would lead to a constant conflict between fiduciaries meeting that duty and fiduciaries abiding by federal insider trading laws.[12] Applying *Fifth Third*, the district court stressed that a plaintiff must allege "an alternative action that the defendant could have taken that would have been consistent with securities law" in support of a breach of fiduciary duty claim that relies on nonpublic information.[13] However, if a plaintiff does so he must also allege, the district court stressed, that a prudent fiduciary could not have concluded that taking such action would do more harm than good.[14]

[11] *In re Lehman Brothers ERISA Litigation*, 113 F. Supp.3d 745 (S.D.N.Y. 2015) (holding the 2008 investment in Lehman Brothers stock by an ESOP fiduciary was not a breach of fiduciary duty) *aff'd, Rinehart v. Lehman Bros. Holding Inc.*, No. 15-2229, 2016 WL 1077009 (2d Cir. 2016).
[12] *Id.* at 755.
[13] *Id.* at 748.
[14] *Id.* at 756.

The district court dismissed the second claim, holding that, absent “special circumstances,” a company’s stock price is presumptively a valid assessment of its value in light of public information.[15] In other words, in the absence of "special circumstances," fiduciaries of publicly traded companies cannot be liable for failing to act on publicly available information, as that would require them to outsmart the market.[16] Relying on this standard, the district court dismissed the notion that a Securities and Exchange Commission order blocking short trades on Lehman stock was a “special circumstance,” applying the general rule in the fiduciary’s favor.[17]

The “special circumstances” exemption to an ESOP fiduciary’s presumption of prudence is crucial if the plaintiff alleges a breach based on public information.[18] If plaintiffs can cite publically available information indicating that a “special circumstance” affected the reliability of a company’s market price, then their claim should survive a Federal Rules of Civil Procedure 12(b) motion for summary judgment and go to trial.[19] However, if the plaintiff does not allege a “special circumstance” affecting market price reliability, then this would be, in some courts, fatal to any ERISA breach of fiduciary duty claim based solely on public information.[20]

If a plaintiff alleges a breach based on nonpublic information, he must allege an alternate action that could have been taken in compliance with securities laws and that a prudent fiduciary in the same circumstances would not have viewed this action more likely to harm the fund than to help it.

---

[15] *Id.* at 754 (explaining that *Dudenhoeffer* bars claims on public information precisely because market is competent to react to such information).
[16] Guidelines for complying with prudent person rule for investments, 2 Emp. Coord. Benefits § 40:2
[17] *Id*.
[18] *Smith v. Delta Air Lines Inc*., Fed.Appx. 874, 876 (11th Cir. 2015) (dismissing an ERISA breach of fiduciary claim because it did not allege a special circumstance [that rendered] reliance on the market price imprudent).
[19] *See Id.*
[20] *Coburn v. Evercore Trust Company*, N.A., No. 15-49, 2016 WL 632180, *1, *5 (holding that the plaintiffs decision not to plead special circumstances was fatal to her claim that the defendant should have known solely from public information that continued investment in J.C. Penny stock was imprudent).

III. Public and Nonpublic basis for breach

A. The "Special Circumstances" Exemption

In *In re Lehman Brothers*, the Southern District of New York held that a Securities and Exchange Commission order blocking short trades on Lehman stock was not a "special circumstance" under *Fifth Third.*[21] The Supreme Court, however, in *Fifth Third* did not state what constitutes "a special circumstance affecting the reliability of the market price."[22] Still, some district courts and appellate briefs have discussed this issue since the Supreme Court's 2014 *Fifth Third* decision.

Calling it a novel question, the district court in *In re Lehman Brothers* concluded that an SEC order banning short trades of Lehman stock was not such a "special circumstance" because the market would have processed that order like other publicly available information, leaving the market price of Lehman undisturbed.[23] The court also reasoned that even if the SEC order indicated there was some distortion in Lehman's market price, this distortion could have only meant that Lehman's stock price was depressed by short selling to an artificially low level.[24] This would make Lehman's stock less risky, according to the district court.[25]

The decision in *In re Lehman Brothers* was appealed to the United States Court of Appeals for the Second Circuit and the plaintiffs in that case argued, in briefing, that the district court conflated *Fifth Third's* special circumstances exemption with a test that turns on whether the market is able to process the publicly available information the plaintiff pleads as a special

---

[21] *Id.*
[22] *Gedek v. Perez*, 66 F.Supp.3d 368, 375 (W.D.N.Y. 2014).
[23] *In re Lehman Brothers ERISA Litigation*, 113 F. Supp.3d at 759-60, *aff'd, Rinehart v. Lehman Bros. Holding Inc.*, No. 15-2229, 2016 WL 1077009 (2d Cir. 2016).

[24] *Id.*
[25] *Id.*

circumstance.[26] Plaintiffs insisted that such a test does not answer the question of special circumstance.[27]

The Southern District of New York rests *Fifth Third's* "special circumstances" exception on the ability of the market to process information. But, that begs the question, as plaintiffs point out in the Lehman case's appeal, do "special circumstances" only occur when the market is unable to process certain publicly available information? In affirming the District Court's decision, the Second Circuit declined to wade into exactly what a "special circumstance" is, citing *Fifth Third*.[28] Instead, the Second Circuit narrowly held that an SEC order banning short sales was not a "special circumstance" in that case.[29]

In *Allen v. Greatbanc Trust Company*, the Northern District of Illinois did not rest the exemption on the market, calling it a "specific risk *a fiduciary* failed to properly assess (emphasis added).[30] In that case, the plaintiff alleged that Greatbanc Trust Company breached its fiduciary duty when it (1) "paid too much for ... shares that it purchased because the price went down after the transaction" and (2) it "borrowed money to fund this purchase at a rate higher than the market."[31] However, the district court concluded that the plaintiff made no allegation of special circumstances, holding that such an allegation was a requirement in ESOP breach of fiduciary duty claims.

---

[26] Brief and Special Appendix for Plaintiffs-Appellants at 16.
[27] *Id.*
[28] *Rinehart v. Lehman Bros. Holding Inc.*, No. 15-2229, 2016 WL 1077009, *1, *2 ("The Court [in *Fifth Third]* specifically declined to 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' that would make reliance on the market's valuation imprudent.'(quoting *Halliburton Co. v. Erica P. John Fund, Inc.*,134 S.Ct. 2398, 2411 (2014))).
[29] *Rinehart v. Lehman Bros. Holding Inc.*, No. 15-2229, 2016 WL 1077009, *1, *5
[30] *Allen v. Greatbanc Trust Company*, No. 15 C 3053, 2015 WL 5821772, *1, *3 (N.D. Ill. 2015).
[31] *Id.* at *2.

In *Fifth Third*, the Supreme Court refers to a special circumstances *affecting market reliability*. If the assumption, however, is that the market can process all publicly available information then no circumstance would be special. Virtually all information, whether an SEC order that blocks short trades on a stock or a government takeover of a company, would presumptively be reflected in the market price.

B. An Alternate Action Consistent with Securities Law

In *Murray v. Invacare Corp*.[32], the Northern District of Ohio concluded that the plaintiff plausibly alleged (1) an alternative action that would be consistent with securities laws and that (2) a prudent fiduciary in the same circumstances would not have viewed this action more likely to harm the fund than to help it.[33] Plaintiffs, in that case, brought action against Invacare Corp. for allegedly breaching their fiduciary duty of care "when they allowed [ESOP] … participants to acquire more shares of Invacare stock at a time when defendants knew Invacare stock was an imprudent investment."[34]

Notably, plaintiffs relied on nonpublic information they alleged defendants had.[35] Their complaint asserted that defendants knew Invacare was not complying with Food and Drug Administration safety and compliance standards relating to their "most important" products, that Invacare was not addressing those deficiencies and that those deficiencies would lead to harsh penalties that would depress the company's stock price.[36] Plaintiffs also asserted that armed with this nonpublic information, the defendant knew or should have known to prevent Invacare ESOP

---

[32] 125 F.Supp.3d 660 (N.D. Ohio 2015).
[33] *Id.* at 660.
[34] *Id.*
[35] *Id.*
[36] *Id.*

participants from buying more of their companies stock.[37] In other words, Invacare should have known to "clos[e] the stock fund" before plaintiffs purchased more stock.[38]

Acknowledging that closing a stock fund is a "fairly extreme action with significant consequence," the district court held that such an action is not foreclosed as an "alternate action" under *Fifth Third*. It explained that [a]n action [is not foreclosed as an alternate one] if the complaint has plausibly alleged that a prudent fiduciary in defendant's position could have concluded that such an action would not cause more harm than good."[39]

It is clear, however, that pleading a prudent fiduciary in the same circumstances would not have viewed closing a stock fund as more likely to harm the fund than to help it and *plausibly* pleading such are two different things.[40] In *Amgen v. Harris*, the Supreme Court, in a *per curiam* opinion, remanded a decision by the Ninth Circuit that held plaintiffs plausibly alleged an "alternative action" (removing the Amgen Common Stock Fund from the list of investment options) because plaintiffs plead no facts that plausibly indicate that action would not harm the company more than hurt it. *Amgen* is the Courts first application of its *Dudenhoeffer* standard and it makes it very clear how difficult the standard is to meet.

In a terse opinion, the Supreme Court, several times, quoted at length from its *Dudenhoeffer* opinion. At one point it emphasized the plausibility of what is alleged:

> "[L]ower courts faced with such claims should also consider *whether the complaint has plausibly alleged* that a prudent fiduciary in the defendant's position could not have concluded that stopping purchases—which the market might take as a sign that insider fiduciaries viewed the employer's stock as a bad investment—or publicly disclosing negative information would do more harm

[37] *Id.*
[38] *Id.* at 669.
[39] *Allen v. Greatbanc Trust Company*, No. 15 C 3053, 2015 WL 5821772, *1, *7 (N.D. Ill. 2015)

[40] *Amgen Inc. v. Harris*, 136 S.Ct 758 (2016).

> than good to the fund by causing a drop in the stock price and a concomitant drop in the value of the stock already held by the fund." (emphasis in original).[41]

In their amended complaint the plaintiffs in *Amgen* alleged a number of alternative actions Invacare could have taken that were consistent with insider trading laws including:

> "making appropriate disclosures as necessary; divesting the Plan of Company Stock; precluding additional investment in Company Stock; consulting independent fiduciaries regarding appropriate measures to take in order to prudently and loyally serve the participants of the Plan; or resigning as fiduciaries of the Plan to the extent that as a result of their employment by the Company they could not loyally serve participants in the Plan in connection with the Plans' acquisition and holding of Company Stock."[42]

Plaintiffs, however, plead no facts that plausibly indicate taking any one of these actions would not harm the fund more than help it.[43]

IV. Conclusion

According to the Supreme Court, Congress sought to encourage the creation of employee stock option plans by passing ERISA.[44] However, this purpose is in tension with the duty of care standard applied to ESOP fiduciaries under 29 U.S.C. § 1104.[45] If a true prudent person standard, i.e., a stricter standard, was applied to ESOP fiduciaries then Congress' purpose may be hindered.[46] Corporate fiduciaries would be dissuaded from taking the risk of ESOP creation. This indicates that the standard, at least as the Supreme Court has held, is much harder to meet than a true prudent person standard. This may be easier for plaintiffs to meet than an abuse of discretion standard but there is no indication that is the case yet.

---

[41] *Id.* at 759.
[42] First Amended Class Action Consolidated Complaint for Violation of the Employee Retirement Income Security Act ("erisa"), 29 U.S.C. § 1132, No.CV 07-5442-PSG(PLA) 2010 WL11401029, ¶344

[43] *Id.*
[44] *See Amgen*, 136 S.Ct. at 759 (quoting *Fifth Third*, 134 S.Ct 2470).
[45] *Id.*
[46] *See Id.*

What is clear, however, is that there are hurdles for plaintiffs to clear. If a breach on the basis of public information is alleged, than they must plead a special circumstance that affects the reliability of the market price. This test may rest on the ability of the market to process the circumstance or whether a fiduciary properly assessed that circumstance. If they allege a breach on the basis of nonpublic information then they must plausibly plead (1) an alternative action consistent with securities laws and (2) that this action could not have harmed the plan more than it helps it. Thus, the ESOP fiduciary duty of care standard is hard to meet and justifiably so. Any other standard would go against this country's long held policy of deferring to the business judgment of corporate fiduciaries and Congress' purpose of encouraging the creation of ESOPs.