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Employer Update

U.S. Supreme Court Rules that Employee Stock Plan Fiduciaries are Not Entitled to a "Presumption of Prudence"

By Paul Wessel and Jeff Lieberman

In This Issue

On June 25, 2014, in a highly anticipated decision, the U.S. Supreme Court unanimously held in *Fifth Third Bancorp v. Dudenhoeffer* that employee stock ownership plan (ESOP) fiduciaries (as well as fiduciaries of other plans that hold employer stock) are not entitled to a "presumption of prudence" with respect to plan investments in employer stock.[1] However, the Court also held that (i) allegations that publicly available information should have caused fiduciaries to recognize that the market was over- or undervaluing stock are generally implausible, absent "special circumstances," and (ii) ERISA does not require fiduciaries to divest a plan's employer stock holdings based on nonpublic information because fiduciaries are not required (or even permitted) to commit insider trading to comply with their ERISA fiduciary duties. The Court directed lower courts to consider whether plaintiffs can state a breach of fiduciary duty claim at all based on a fiduciary's failure to act on nonpublic information, taking into account certain key considerations.

Background

A fundamental principle under the Employee Retirement Income Security Act of 1974, as amended (ERISA), is that the fiduciaries of an ERISA-governed plan must act with the "care, skill, prudence, and diligence" of a prudent person acting under the circumstances. Over the years, there has been debate about how that standard should be applied to a fiduciary of a plan, such as an ESOP, that provides for investment in the plan sponsor's (or a related entity's) stock. Courts in many federal districts held that because such a plan is designed to hold employer stock, the fiduciaries of the plan are entitled to a presumption that they acted prudently by retaining the plan's investment in such stock and continuing to offer the stock fund as an investment option in self-directed plans. For nearly two decades, this presumption of prudence served as the basis of a defense for plan sponsors and fiduciaries in "stock drop" cases, in which plan participants allege that their plan's fiduciaries violated their ERISA obligations by allowing participants to continue investing in employer stock when the fiduciaries knew or should have known that doing so was imprudent. While the presumption of prudence generally permitted fiduciaries to continue to allow investment in employer stock, the circuit courts were split over when the presumption should apply and how the presumption could be overcome.

The U.S. Supreme Court unanimously held that employee stock ownership plan fiduciaries (as well as fiduciaries of other plans that hold employer stock) are not entitled to a "presumption of prudence" with respect to plan investments in employer stock.

Facts

Defendant Fifth Third Bancorp (Fifth Third) maintained a defined contribution plan that permitted eligible Fifth Third employees to make voluntary contributions to the plan and direct them to any of the plan's investment options. The plan designated an employer stock fund as an investment option and stated that the fund shall be primarily invested in shares of common stock of Fifth Third. Fifth Third made matching contributions that were initially invested in the plan's employer stock fund, provided that employees could choose to transfer investments to another investment option.

Participants in the Fifth Third plan filed suit in the Southern District of Ohio after Fifth Third's stock price fell by 74% between July 2007 and September 2009, alleging that the plan fiduciaries knew or should have known that Fifth Third's stock was overvalued and excessively risky because (i) publicly available information provided "early warning signs" that the subprime lending industry (which formed a large part of Fifth Third's business) would "leave creditors high and dry," and (ii) nonpublic information indicated that Fifth Third officers had "deceived the market by making material misstatements about [Fifth Third's] financial prospects."

The District Court dismissed the plaintiffs' complaint and held that Fifth Third's decision to maintain the plan's investment in (and not divest the fund of) Fifth Third common stock was entitled to a presumption of prudence that the plaintiffs had not overcome.

On appeal, the Sixth Circuit reversed in part based on procedural issues, but held that the presumption of prudence does not apply at the pleading stage of a case.

Supreme Court Holding

As noted above, the Supreme Court rejected the application of the presumption of prudence altogether, holding that there is no presumption that follows from ERISA with respect to ESOPs and other plans that hold employer stock.[2] The Court remanded the case back to the Sixth Circuit for reconsideration and in doing so made some statements that may nonetheless provide favorable arguments for fiduciaries.

First, the Court distinguished complaints alleging a breach of the duty of prudence based on publicly available information alone from those alleging a breach of the duty of prudence based on insider information. It noted that in the first instance, such allegations are "implausible as a general rule, at least in the absence of special circumstances." The Court noted that investors may rely on a security's market price as an unbiased assessment of the security's value in light of all public information, and stated that ERISA fiduciaries could prudently rely on market price. Importantly, the Court held that the Sixth Circuit had failed to identify any "special circumstances," and noted that its reversal of the district court's dismissal of the complaint appeared to have been based on "an erroneous understanding of the prudence of relying on market prices."

Allegations that publicly available information should have caused fiduciaries to recognize that the market was over- or undervaluing stock are generally implausible.

Secondly, with respect to any obligation to act on the basis of inside information, the Court stated that a plaintiff must plausibly allege an alternative action that a fiduciary could have taken, and that any such action must be (i) consistent with securities laws and (ii) an action that a prudent fiduciary would not have viewed as more likely to harm the fund than help it. Recognizing that fiduciaries cannot be required to break the law and that divesting a fund's employer stock holdings based on inside information would violate the federal securities laws, the Court held that the Sixth Circuit erred to the extent that its decision was based on the theory that the duty of prudence in effect takes precedence over the securities laws and therefore requires fiduciaries to sell the fund's employer stock based on nonpublic information to comply with their ERISA fiduciary duties. The Court also held that "where a complaint faults fiduciaries for failing to decide, on the basis of inside information, to refrain from making additional stock purchases or for failing to disclose that information to the public so that the stock would no longer be overvalued," lower courts should consider

> the extent to which an ERISA-based obligation either to refrain on the basis of inside information from making a planned trade or to disclose inside information to the public could conflict with the complex insider trading and corporate disclosure requirements imposed by the federal securities laws or with the objectives of those laws.

Finally, the Court held that lower courts faced with such claims should also consider whether such action "would do more harm than good" by either directly or indirectly signaling that the employer's stock is a bad investment, which would "caus[e] a drop in both the stock price and a concomitant drop in the value of the stock already held by the fund."

Implications for Employers

The *Fifth Third* decision settles a dispute among lower courts about whether fiduciaries of ESOPs and other plans holding employer stock are entitled to a presumption of prudence. While many plan sponsors and fiduciaries may be disappointed that they can no longer rely on the presumption of prudence to defend against "stock drop" claims, the Supreme Court's opinion includes several important holdings that may prove helpful to fiduciaries at publicly traded companies regarding how lower courts should evaluate prudence claims based on public and/or nonpublic information.

1. This presumption is often referred to as the "*Moench* presumption," after the Third Circuit's decision in *Moench v. Robertson*, 62 F.3d 553 (3d Cir. 1995), where it held that ESOP fiduciaries are presumed to be acting consistently with ERISA in investing plan assets in employer stock.
2. In its brief for the United States as amicus curiae, the Department of Labor likewise argued that ERISA's "text and purposes do not call for application of a presumption at any stage of the proceedings."

New Jersey Joins a Growing List of State and Local Governments to Enact "Ban-the-Box" Laws

By Lawrence J. Baer and Kendra Okposo

In August 2014, New Jersey joined a growing list of states and municipalities to adopt a so called "ban-the-box" law. Such laws delay employer inquiries about applicant conviction histories until the later stages of the hiring process. The statute's moniker is derived from a "ban of the box" that a prospective employee otherwise would be required to check on a job application form if he or she had been previously convicted of a crime. In the past, these laws have been mostly limited to public sector employment. Now, state and local governments have turned their attention to the private sector. Ban-the-box laws do not completely prohibit employers from asking about a job applicant's criminal history. Rather, under such laws, inquiries about criminal histories are delayed in the hiring process until the candidate is considered at least minimally qualified for the job.

Such laws delay employer inquiries about applicant conviction histories until the later stages of the hiring process.

A total of 13 states and 69 local governments, including New York City[1], have adopted ban-the-box laws. In the past two years alone, the following eight states have enacted ban-the-box laws: California, Delaware, Illinois, Maryland, Minnesota, Nebraska, Rhode Island and New Jersey. Ten additional states have introduced legislation in the past two years: Florida, Georgia, Louisiana, Michigan, New Hampshire, North Carolina, Ohio, South Carolina, Virginia and Washington. The recent surge in ban-the-box legislation is due to employers' increasing reliance on criminal background checks in the hiring process and the issuance, in April 2012, by United States Equal Employment Opportunity Commission (EEOC) of enforcement guidelines relating to potential unlawful discrimination in hiring arising from pre-employment criminal background checks. In order to ameliorate the potential discriminatory consequences of such checks, the EEOC has stressed that hiring decisions should be made based upon an individual candidate's job qualifications, rather than an automatic elimination due to a criminal history.

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Proponents of ban-the-box legislation argue that employers' reliance on criminal histories to automatically eliminate job applicants blocks rehabilitated former offenders from the job market and causes employers to lose otherwise qualified, hard-working candidates for employment. Supporters also argue that because incarceration rates are higher among African American and Hispanic populations, automatic disqualification due to prior convictions disproportionately affects minority candidates. The EEOC enforcement guidelines advise that about 1 in 17 Caucasian men are expected to serve time in prison during their lifetime, compared with 1 in 6 Hispanic men and 1 in 3 African American men.[2]

Opponents of ban-the-box laws argue the laws place undue burdens on employers during the hiring process. Further, opponents argue that employers have an interest in effectively and efficiently evaluating a potential employee's suitability for a position. Accordingly, they argue, employers should have early access to any and all information about a candidate that may be relevant in their initial assessment of the candidate's ability to safely perform the available job.

There are three general variations to the form of ban-the-box laws adopted by state and local governments. First, some laws prohibit criminal history inquiries until after the employer determines the applicant meets the minimum job requirements based on the job application. Second, and most commonly, ban-the-box laws prohibit criminal history inquiries until after the completion of a first interview. Third, some ban-the-box laws prohibit criminal history inquiries until after a conditional offer of employment has been made. Ban-the box laws in this third category generally provide that an offer may be withdrawn after careful consideration of the nature of the conviction, rehabilitation efforts, time elapsed since the conviction, and whether the applicant's conviction is directly or rationally related to the duties and responsibilities of the position sought. Typically, violations of ban-the-box laws will result in civil penalties, which vary depending on the jurisdiction.

Every rule has its exceptions. Ban-the-box laws typically do not apply to employers in law enforcement, corrections, the judiciary, homeland and security or emergency management. Further, employers with statutory duties to conduct a criminal history record background check during the hiring process are generally exempted from ban-the-box laws.

New Jersey's Opportunity to Compete Act

Last month, with the passage of the New Jersey Opportunity to Compete Act, New Jersey became the sixth and most recent state to extend the application of ban-the-box legislation to private employers.[3] The statute will go into effect on March 1, 2015. The New Jersey Opportunity to Compete Act applies to private employers that employ 15 or more employees over a

20 calendar week period, doing business, employing persons, or taking applications for employment within the state of New Jersey. The New Jersey Act prohibits employers from inquiring about an applicant's criminal record until the employer has completed the "initial employment application process," which begins with an initial inquiry by the applicant and ends following an employer's conduct of a first interview. If an applicant voluntarily discloses his or her conviction history during the initial steps described above, an employer is free to make any follow-up inquiry.

Further, an employer may freely inquire about an applicant's criminal background following the completion of the initial employment application process. Most significantly, nothing in the new law would prohibit an employer from refusing to hire an applicant based upon the applicant's criminal record, unless such record has been expunged or erased through executive pardon and provided such refusal is consistent with other applicable laws.

The New Jersey Act provides for civil penalties in the event of a violation. For a first violation, employers may be fined up to $1,000. A second violation increases the penalty up to $5,000. Thereafter, for each additional violation, employers may face fines up to $10,000. The law does not provide a private right of action for aggrieved applicants.

Suggestions for Employers

As more and more state and local governments enact ban-the-box laws, employers should review their hiring policies and practices and consider the following steps:

- determine whether any state or local ban-the-box laws apply to their business operations;
- review hiring processes and identify at what stage, if any, in the hiring process candidates are required to disclose criminal history;
- train human resources personnel and other employees who conduct interviews on applicable ban-the-box law requirements;
- review job postings for statements regarding applicants' criminal backgrounds; and
- review employment application forms to identify any requirements that an applicant disclose his or her criminal history and remove such inquiries as necessary.

1. New York City's Executive Order No. 151 prohibits city agencies from asking about an applicant's criminal conviction history on initial job application documents or during the initial interview. The Executive Order also prohibits any contractors doing business with the City's Human Services Department from inquiring about an applicant's conviction until after a first interview is conducted. Additionally, the Fair Chance Act is pending in the New York City Council. The Fair Chance Act would expand the Executive Order to prohibit *all* employers from inquiring into an applicant's conviction record until the employer extends a conditional offer of employment.
2. U.S. Equal Employment Opportunity Commission, *EEOC Enforcement Guidance*, April 25, 2012, available at http://www.eeoc.gov/laws/guidance/arrest_conviction.cfm.
3. Other states applying such laws to private sector employers are Hawaii, Minnesota, Illinois, Massachusetts and Rhode Island.

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