Supreme Court Rebukes Ninth Circuit's Disregard of Prudence Precedent for Employee Stock Ownership Plans

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Providing a specific, stringent pleading standard for claims alleging breach of the duty of prudence against fiduciaries who manage employee stock ownership plans (ESOPs), the U.S. Supreme Court again has reversed the Ninth Circuit Court of Appeals, in *Amgen Inc. v. Harris*, No. 15-278 (Jan. 25, 2016), because of its failure to apply the proper pleading standard for such claims.

How strictly lower courts will interpret the Court's standard remains an open question. However, the opinion shows that it will be strategically beneficial for defendants to attack claims against ESOP fiduciaries at the pleading stage.

Background

The plaintiffs were former Amgen employees who participated in an ESOP holding Amgen's common stock. After the value of Amgen's stock dropped, the employee-stockholders filed a class action suit alleging that the plan's fiduciaries had breached their duty of prudence under the Employee Retirement Income Security Act (ERISA). They alleged that the plan's fiduciaries had inside information that investing in Amgen's stock was imprudent, but nevertheless (1) allowed the plan's participants to continue investing, and (2) failed to disclose the inside information to the public.

The district court dismissed the complaint for failure to state a claim, but the Ninth Circuit reversed. The plan fiduciaries petitioned the U.S. Supreme Court for review.

Dudenhoeffer

While that petition was pending, the Supreme Court issued its decision in *Fifth Third Bancorp v. Dudenhoeffer*, 134 S. Ct. 2459 (2014), addressing the duty of prudence owed by ERISA fiduciaries who manage ESOPs. In *Dudenhoeffer*, the Supreme Court held that ESOP fiduciaries are not entitled to a presumption of prudence. The elimination of this presumption was widely viewed negatively by those who manage and represent ESOPs. However, in *Dudenhoeffer*, the Court also included fiduciary-friendly language, recognizing the unique challenges facing ESOP fiduciaries who are blamed for failing to act on inside information about the employer's stock. The Court stated:

> To state a claim for breach of the duty of prudence on the basis of inside information, a plaintiff must plausibly allege an alternative action that the defendant could have taken that would have been consistent with the securities laws and that a prudent fiduciary in the same circumstances would not have viewed as more likely to harm the fund than to help it.
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> [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 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.

This pleading standard acknowledges that freezing investments into an ESOP and disclosing negative information to the public about company stock usually will do more harm than good. The Court intended the standard to separate plausible from meritless claims.

Amgen I

Following *Dudenhoeffer*, the Supreme Court in 2014 granted the fiduciaries' petition for review in *Amgen*

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I, vacated the judgment, and remanded the case for further proceedings consistent with *Dudenhoeffer*. On remand, the Ninth Circuit again reversed dismissal of the complaint against Amgen and denied rehearing *en banc* over a strong dissent by Judge Alex Kozinski. The fiduciaries again petitioned for Supreme Court review.

Amgen II

In a short, *per curiam* decision *(Amgen II),* the Supreme Court on January 25, 2016, held that the *Amgen* complaint did not contain sufficient factual allegations to state a claim for breach of the duty of prudence against the ESOP fiduciaries.

The Court emphasized that the Ninth Circuit did not correctly apply the *Dudenhoeffer* standard. The Ninth Circuit assumed it was plausible that freezing investments into Amgen's ESOP would not harm plan participants, the Court noted. However, the complaint did not allege that a prudent fiduciary "could not have concluded" that freezing the investments into the ESOP would have done more harm than good. Accordingly, the Court reversed and again remanded the case. The Supreme Court noted the district court could decide whether to allow the plaintiffs to amend the complaint to attempt to meet this standard.

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The plaintiffs on remand following *Amgen II,* as well as plaintiffs in other actions, might simply allege a prudent fiduciary "could not have concluded" that alternative actions, such as freezing investments into the ESOP and public disclosure of negative inside information, would have done more harm than good. Whether such a conclusory allegation, devoid of a factual basis, will pass muster under *Amgen II* is uncertain. A strong argument exists that the Supreme Court intended to require the allegation of specific facts demonstrating how a prudent fiduciary could not have reached such a conclusion. As public disclosure of negative insider information, even if permitted by securities laws, and freezing ESOP investments typically will do harm, causing the value of the employer's stock to drop, the lower courts also will have to decide what types of factual allegations and special circumstances will suffice under this stringent standard.

While decided in the context of an ESOP, *Amgen I* and *II* also are important decisions for 401(k) plans that offer employer stock as an investment option, particularly plans with ESOP features. Although only future litigation can provide certainty, *Amgen* pleading standards likely will apply in 401(k) plan stock drop litigation. Fiduciaries of 401(k) plans should continue to monitor company stock carefully as a prudent investment option for their participants and be prepared to substantiate compliance (through appropriate documentation and otherwise) with the fiduciary duty to periodically review and update investment offerings and possible consideration of inside information in accordance with the securities laws.

Jackson Lewis attorneys are available to answer inquiries regarding this case and other workplace developments.