A Means of Meeting the *Dudenhoeffer* Standard

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Much has been written lately about the recent U.S. Supreme Court decision titled *Third Fifth Bancorp v. Dudenhoeffer.* In its decision, the U.S. Supreme Court held that a "presumption of prudence" does not apply to company stock held in an employee stock ownership plan (ESOP). Rather, the ordinary ERISA fiduciary duties apply, except there is no need to diversify assets. (Courts of Appeals had issued conflicting rulings on the subject.)

Presumably, the *Dudenhoeffer* decision relates to all eligible individual accounts plans, including stock bonus plans and 401(k) components of profit sharing plans. The Court ruled that plan terms cannot override the duty of prudence.

The Court determined that markets relating to publicly-traded stocks are efficient, meaning it is next to impossible to claim breach of fiduciary duty with respect to a stock drop based on public knowledge. Concerning the very important issue of the conflict between the federal securities laws and ERISA, the Court held that a fiduciary has no duty to break a securities law to comply with ERISA. So, a fiduciary cannot sell company stock if doing so would violate the federal securities laws (i.e., due to use of inside information that led the fiduciary to believe the stock would lose value).

Concerning the issues of whether a duty to stop purchasing exists when inside information shows a loss in value is likely and whether a fiduciary has a duty to make public inside information that would likely cause the stock to drop, the Court punted (i.e., it left them to the lower courts to decide). Many people fail to realize that the prudence issue relates to *all* ESOPs, not just those of publicly-traded companies. Failure to regularly monitor prudence very likely is a breach of fiduciary duty. The likely practical end result of *Dudenhoeffer* is that company stock drop cases that allege a breach of fiduciary duty based on facts known that are not publicly-known should overcome a motion to dismiss, while all other cases will be dismissed. Query how many non-insiders know non-publicly known facts? It would seem the answer is none. Thus, it is hard to imagine how a claim could be brought that would overcome a motion to dismiss. Does this imply a sovereign immunity equivalent exists for company stock (i.e. an undiversified investment), while diversified portfolios remain subject to ERISA's prudent man standard? ERISA has no specific such "out," and thus there must be a potential avenue for recovery.

It would seem there is one situation where participants could sue and win: The 1970s typewriter business situation. In other words, if a company is in a dying industry, and professional investment analysts without inside information determine such is the case, continuing to hold company stock would be imprudent. Of course,

as noted in *Dudenhoeffer*, markets are efficient. This should mean that the gloom is already reflected in the stock's value. This begs the question of whether something will change, such as the typewriter coming back into style, gold being found under the company's office building or a secret new invention in the making, etc. that is going to rocket the stock back to the good old days. Only insiders would know about the latter two possibilities, and they would violate securities laws by profiting from the knowledge (or providing for others to profit from the knowledge).

So, what's a fiduciary to do? For a publicly-traded company, the stock of which is tracked by numerous reputable professional analysts, it would seem that making the analysts' aggregate determination the determining factor of prudence could not be questioned, unless the act of moving the decision-making process from an insider or group of insiders (if that is where it resides) to non-insiders is, in itself, an imprudent action under ERISA. For reasons noted below, such an action should not be imprudent.

Dudenhoeffer essentially said that a fiduciary cannot sell company stock to a third party when the insider has inside information showing the stock will drop (otherwise, securities laws would be broken). Regarding whether a duty exists to stop purchasing, how would cessation of purchasing, in itself, not inform the market that something bad was coming for the stock? Unless the (presumably efficient) public market failed to pick up the news, the stock would presumably drop to some degree. How much it would drop is anyone's guess. Disclosing bad information before any purchases or sales would, assuming public markets are efficient, adjust the stock downward to market value. There is no specific definition of a prudent process under ERISA, and there is no requirement that company insiders be fiduciaries.

Having lived through two publicly-traded company stock lawsuits in the late 1990s (one a direct case in which I had advised the fiduciaries and was the first person deposed and the other a sub-issue in an ESOP interpleader action), I experienced firsthand the issues presented in *Dudenhoeffer*. I summarized my thoughts in an autumn 2001 *Journal of Pension Benefits* article titled "Eligible Individual Account Plans and ERISA's Fiduciary Duties." In the late '90s, *Kuper v. Iovenko* and *Moench v. Robertson* were virtually "it" in terms of the 'presumption of prudence' cases. Over the years, I have watched the law develop. I don't think it has developed much. I though the securities laws issues would have been resolved by now. Only one of those issues has been resolved, and it was resolved in *Dudenhoeffer*.

The autumn 2001 *Journal of Pension Benefits* article noted the issue of whether transferring the prudence issue to outsiders from insiders could violate ERISA. On page 35, the article provides: "Although nothing in ERISA technically prohibits a third party from acting as the sole fiduciary with respect to investment oversight, the independent fiduciary approach may raise the issue of a potential ERISA violation simply because of the transfer of the decision-making process from someone with superior knowledge to someone with inferior knowledge." The article then discussed

the potentially large costs of paying a third party to deal with the matter. On further reflection in light of *Dudenhoeffer*, the matter should potentially be subject to handling in-house by a non-insider for little costs. And, there should be no fiduciary breach for making such a transfer. In this regard, superior knowledge is of no value if it cannot be lawfully used to benefit participants.

Returning to the means of satisfying the prudence standard, with respect to a company the stock of which is publicly-held, it should be lawful and prudent to choose reputable analysts that track the stock and use a majority opinion with respect to them to make the prudence determination. For example, Charles Schwab's website lists the analysts that track companies' stocks. The named fiduciary or a hired professional could determine an odd number of analysts (preferably five, if available, but at least three), and go with the majority rule. If a majority rated the stock as a "hold" or better, it would be deemed a prudent investment. If most rate the stock as less than a hold (i.e., "sell" or "underperform"), the stock would not be deemed a prudent investment. A non-insider employee (e.g., someone from Human Resources) could be required to track the results as of a date in each quarter, and report the results to the investment fiduciary or fiduciaries. An interim analysis could be performed if an unusual event occurred that caused a sudden stock value drop.

The plan in issue could be drafted to provide for the system of analysis described in the preceding paragraph. If an imprudence determination was made, the stock could be gradually sold pursuant to plan terms over a period of months to eliminate the common stock, subject to a reversal of the sales and reinvestment in company stock if the majority rule transitioned back to a prudent investment determination.

ESOPs must, by law under Internal Revenue Code section 4975(e)(7), be designed to invest primarily in employer securities. However, ESOPs are subject to ERISA's prudence requirements. Presumably, a plan drafted in a manner described in the preceding paragraph would pass must under Code section 4975(e)(7). In this regard, just as ERISA does not require the securities laws relating to insider trading to be violated, Code section 4975(e)(7) should not permit ERISA's prudence rule to violated. The plan would be designed to investment primarily in employer securities, subject to override by ERISA's prudence requirement.

The foregoing means of dealing with the prudence issue does not work for companies the stock of which is not publicly traded. For them, it would seem that constantly being open to purchase offers and prudently entertaining offers that are close to the most recent annual valuation (whether below or above) would meet the standard. It would seem that such companies would not need to constantly be on the sales block, as being so suggests desperation (likely producing a lower offer price).

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