CASE COMMENT

DIVERSE MANDATES REGARDING THE ESOP DIVERSIFICATION REQUIREMENT FOLLOWING *FIFTH THIRD BANCORP V. DUDENHOEFFER*

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Employee participation in Employee Stock Ownership Plans (ESOPs) has increased dramatically since they were statutorily sanctioned in 1974 through various provisions of the Employee Retirement Income Security Act of 1974 (ERISA) and revisions to the Internal Revenue Code (IRC). The National Center for Employee Ownership estimates that 28 million Americans own employer securities through a variety of means, including profit sharing plans, stock options, and their 401(k) retirement plans.[1] Of these, 13.5 million hold employer securities through participation in a qualified ESOP, with assets held in these accounts totaling in excess of $942 billion.[2] Although these plans have significant assets under management, the legal and functional understanding of these vehicles remains a delicate balance of public policy and private utility. Within the realm of public policy, the dual mandates imposed on plan fiduciaries often conflict. Plan fiduciaries are tasked with safeguarding the employee-participants' retirement assets as well as complying with the dictates of the plan documents mandating investment principally in employer securities. Basic portfolio theory implies these requirements are prima facie incompatible in that the optimal Sharpe Ratio[3] would be achieved through diversification of plan assets. The defining feature of the ESOP however is that it holds contributed assets chiefly in one asset (employer securities). This single holding

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1 *A Statistical Profile for Employment Ownership*, NAT'L CENTER FOR EMP. OWNERSHIP, http://www.nceo.org/articles/statistical-profile-employee-ownership (last updated June 2015).

2 *Id.*

3 The risk-adjusted return of the portfolio.

dramatically increases the risk of the fund as compared to a prudently diversified portfolio.

In *Donovan v. Cunningham*,[4] the Fifth Circuit summarized the plight of the ESOP fiduciary:

> On the one hand, Congress has repeatedly expressed its intent to encourage the formation of ESOPs by passing legislation granting such plans favorable treatment, and has warned against judicial and administrative action that would thwart that goal. Competing with Congress' expressed policy to foster the formation of ESOPs is the policy expressed in equally forceful terms in ERISA: that of safeguarding the interests of participants in employee benefit plans by vigorously enforcing standards of fiduciary responsibility. Our task in interpreting the statute is to balance these concerns so that competent fiduciaries will not be afraid to serve, but without giving unscrupulous ones a license to steal.[5]

When contemplating the role of ESOP fiduciaries, the Fifth Circuit expressed its concern that it must seek to "satisfy the demands of [c]ongressional policies that seem destined to collide."[6] This conflict between traditional ERISA jurisprudence and the congressional favor granted to ESOPs came to a head in the recent Supreme Court decision in *Fifth Third Bancorp v. Dudenhoeffer*,[7] where a unanimous Court held that ESOP fiduciaries are not entitled to a presumption of prudence in regard to asset allocation at the pleading stage.

In *Dudenhoeffer*, the Court focused on the ESOP as a retirement benefit plan.[8] However, this is only one function of ESOPs. Viewed in terms of both the original intent of Congress and contemporary corporate finance, the ESOPs are designed to meet several goals, including the alignment of employee and employer interests to facilitate a wider base of capital ownership including the average employee. As the Court has lost sight of these fundamental goals, it has drifted into the fallacy of interpreting ESOPs principally as employee retirement accounts. This has led the Court to apply ERISA fiduciary obligations to the ESOP fiduciaries without regard for the special statutory status of ESOPs. This creates difficulties for plan fiduciaries in seeking to fulfill the underlying purposes of the fund while at the same time complying with the heightened duties imposed upon them by ERISA. Courts have consistently maintained that they are to enforce ERISA fiduciary standards with "uncompromising rigidity"[9] which, when coupled with the recent ruling in *Dudenhoeffer*, results in significant con-

4 Donovan v. Cunningham, 716 F.2d 1455 (5th Cir. 1983).

5 *Donovan*, 716 F.2d at 1466 (footnotes omitted) (citation omitted).

6 *Id.*

7 Fifth Third Bancorp v. Dudenhoeffer, 134 S. Ct. 2459 (2014).

8 *Id.* at 2463–64.

9 Donovan v. Estate of Fitzsimmons, 778 F.2d 298, 302 (7th Cir. 1985) (quoting NLRB v. Amax Coal Co., 453 U.S. 322, 329–30 (1981)).

cern for ESOP settlors and plan fiduciaries who desire to continue to use these investment vehicles for any of the myriad other purposes for which they have heretofore been employed (with apparent congressional blessing).

I. *DUDENHOEFFER* AND THE FUTURE OF ESOP FIDUCIARY STANDARDS

This past term, the Supreme Court addressed whether ESOP fiduciaries are entitled to a presumption of prudence at the pleading stage when the fiduciary decides to buy or hold employer stock.[10] While the lower courts have generally accepted such a presumption, the circuits split on whether the presumption attached at the pleading stage.

Here, Fifth Third maintained a defined contribution plan for its employees, which included a matching contribution from Fifth Third of up to four percent of an employee's compensation.[11] Participating employees were provided twenty different funds amongst which they would be permitted to allocate their salary withholdings.[12] One of those twenty allowed funds was the Fifth Third ESOP.[13] While the employees were not required to invest in the ESOP, the matching contribution made by Fifth Third would by default be contributed to the ESOP, although the employee could later chose to reallocate the investment.[14] The respondent-plaintiffs in this action were former Fifth Third employees who had participated in the ESOP, and who alleged that the ESOP fiduciaries had violated their duties of loyalty and prudence.[15] The Court focused principally on the duty of prudence claims.[16]

A. The Moench *Standard*

Dudenhoeffer arrived at the Supreme Court after the Sixth Circuit broke from courts in its sister circuits with regard to the proper standard to hold ESOP fiduciaries to when examining their investment decisions. Prior to the Sixth Circuit's decision, courts in most circuits followed the *Moench* standard.[17] This standard permitted a presumption that an ESOP fiduci-

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10 *Dudenhoeffer*, 134 S. Ct. at 2463.
11 *Id.*
12 *Id.* at 2463–64.
13 *Id.* at 2464.
14 *Id.*
15 *Id.*
16 *Id.*
17 *See* Kirschbaum v. Reliant Energy, Inc., 526 F.3d 243 (5th Cir. 2008); Lingis v. Motorola, Inc., 649 F. Supp. 2d 861 (N.D. Ill. 2009); Morrison v. Moneygram Int'l, Inc., 607 F. Supp. 2d 1033 (D. Minn. 2009); *In re* Ford Motor Co. ERISA Litig., 590 F. Supp. 2d 883 (E.D. Mich. 2008); *In re* McKesson HBOC, Inc. ERISA Litig., No. C00-20030 RMW, 2002 U.S. Dist. LEXIS 19473 (N.D. Cal. Sept. 30, 2002).

ary's decision to remain invested in, or continue investing in pursuant to an investment plan, employer securities.[18] The plaintiff can then rebut the presumption by "showing that a prudent fiduciary acting under similar circumstances would have made a different investment decision."[19]

This standard is derived from the Third Circuit's decision in *Moench v. Robertson*,[20] which was the first case to expressly state a presumption of prudence for ESOP fiduciaries.[21] *Moench* also recognized an exception to the presumption for actions taken when the employer was in dire financial straits.[22] *Moench* arose out of the voluntary bankruptcy of Statewide Bancorp (Statewide).[23] The plaintiff, Charles Moench, was an employee of Statewide and a participant in Statewide's ESOP.[24] The suit focused on the period running from July 1989 to May 1991, a period which saw dramatic decreases in share valuation, rendering the ESOP holdings virtually worthless.[25] In addition to the adverse market movement, federal banking regulators repeatedly expressed concern to Statewide's board about the state of Statewide's portfolio and financial condition.[26]

In *Moench*, the Third Circuit began their examination by recognizing the general requirement that pension benefit plan fiduciaries are required to "diversify investments of the plan assets 'so as to minimize the risk of large losses'"[27] as well as recognizing the express ESOP exemption from this general rule found at 29 U.S.C. § 1104(a)(2).[28] In effect, the ESOP exemption permits a qualifying plan fiduciary to hold a level of plan assets in employer securities (or other qualifying property) which, under other circumstances, would be deemed imprudent under traditional portfolio theory. The Third Circuit therefore recognizes that "under normal circumstances,

18 Dudenhoefer v. Fifth Third Bancorp, 692 F.3d 410, 418 (6th Cir. 2012), *vacated*, 134 S. Ct. 2459 (2014).

19 *Id.* (quoting Kuper v. Iovenko, 66 F.3d 1447, 1459 (6th Cir. 1995) (internal quotation marks omitted)).

20 Moench v. Robertson, 62 F.3d 553 (3d Cir. 1995), *abrogated by* Fifth Third Bancorp v. Dudenhoeffer, 134 S. Ct. 2459 (2014).

21 *Id.* at 571.

22 *Id.* at 568.

23 *Id.* at 557.

24 *Id.* at 559.

25 *Id.* at 557 (stating that statewide common stock fell from $18.25 per share in July 1989 to less than 25 cents in May 1991).

26 *Id.*

27 *Id.* at 568 (quoting 29 U.S.C. § 1104(a)(1)(C) (2012)).

28 29 U.S.C. § 1104(a)(2) (""In the case of an eligible individual account plan (as defined in section 1107(d)(3) of this title), the diversification requirement of paragraph (1)(C) and the prudence requirement (only to the extent that it requires diversification) of paragraph (1)(B) is not violated by acquisition or holding of qualifying employer real property or qualifying employer securities (as defined in section 1107(d)(4) and (5) of this title).").

ESOP fiduciaries cannot be taken to task for failing to diversify investments, regardless of how prudent diversification would be under the terms of an ordinary non-ESOP pension plan."[29] This exemption is perfectly reasonable given that by their very terms ESOPs are required to invest primarily in qualified employer securities. The Third Circuit went on to explain, however, that "while the fiduciary presumptively is required to invest in employer securities, there may come a time when such investments no longer serve the purpose of the trust, or the settlor's intent."[30]

The settlor's intent, and the purpose of the trust generally, is more than merely safeguarding the employees' assets for retirement. A normal 401(k), or other retirement planning vehicle, would be more efficient at doing that, and would better align employee and employer interests by giving the employee a stake in corporate performance, among other goals. Certain considerations, such as the firm nearing insolvency, would make the continued investment in employer securities run counter to the congressional and settlor goals. It would not be logical to completely exempt ESOP fiduciaries from judicial oversight over their decision to invest in employer securities. Yet because plan fiduciaries are required to invest for a multiplicity of goals, it would not be proper to expose ESOP fiduciaries to de novo review with regard to investment decisions generally. The trust imposed in plan fiduciaries is akin to that placed in corporate fiduciaries who enjoy the protection of the business judgment rule with respect to corporate actions. In both cases, the courts are admittedly less skilled than the appointed managers at determining the proper investment plan and risk thresholds for plan assets.

This deference led the *Moench* court to determine that the proper standard of review for the ESOP fiduciary's investment decisions was abuse of discretion.[31] To defeat the presumption of prudence, the plaintiff must show that there were circumstances that were not known or anticipated by the settlor, and that would defeat or substantially impair the accomplishment of the objective of the fund should the ESOP fiduciary continue to invest in accordance with the plan.[32] The Third Circuit noted that "as the financial state of the company deteriorates, ESOP fiduciaries who double as directors of the corporation often begin to serve two masters."[33] Just as is the case with corporate law generally, when the fiduciary becomes conflicted he no longer is entitled to judicial deference, as even though the

29 *Moench*, 62 F.3d at 568.

30 *Id.* at 571.

31 *Id.* ("[A]n ESOP fiduciary who invests the assets in employer stock is entitled to a presumption that it acted consistently with ERISA by virtue of that decision. However, the plaintiff may overcome that presumption by establishing that the fiduciary abused its discretion by investing in employer securities.").

32 *Id.* at 571 (citing RESTATEMENT (SECOND) OF TRUSTS § 227 cmt. q (1959)).

33 *Moench*, 62 F.3d at 572.

court may be a poor judge of investment policy, the conflicted fiduciary is even worse. The Third Circuit vacated the district court's grant of summary judgment to the ESOP fiduciaries, only permitting the matter to proceed given the possible duty of loyalty concerns arising from the extraordinary financial state of Statewide.[34]

The Third Circuit is not the only court to impose a presumption of prudence at the pleading stage conditioned on the exception for extreme financial duress. In *White v. Marshall & Ilsley Corp.*,[35] the Seventh Circuit required that for the presumption of prudence to be overcome, the plaintiff was required to plead and ultimately prove that "the company faced impending collapse or dire circumstances that could not have been foreseen by the founder of the plan."[36] This case arose out of significant declines in employer stock value during the global financial crisis of 2008–2009. The employee-participants alleged that the continued offering of an ESOP along with several other investment options for employee investment violated the ESOP fiduciaries' duty of prudence.[37] Here, the Seventh Circuit reaffirmed that the defendant ESOP fiduciaries are entitled to a presumption of prudence, even though the court is required to accept all of the plaintiff's allegations as true under the motion to dismiss standard.[38] The court confronted the plaintiff's argument that the dramatic decline in stock valuation would require the fiduciaries to remove the ESOP as an option for employee investment because it would result in large losses.[39] It noted however that there was a possibility of a recovery—at which point the plaintiffs could sue the fiduciaries for the foregone gains that would have been realized had the fiduciaries stayed the course with the ESOP's investment plan.[40] The court determined that:

> If the fiduciaries had chosen to violate the terms of the Plan and had forced a sale of employees' M&I [Marshall & Ilsley] stock at the lowest point, the employees would have lost out on the later increase in value and would seem to have had viable claims under ERISA for the fiduciaries' failure to comply with the terms of the Plan document.[41]

It would be illogical to hold ESOP fiduciaries liable for market movements given the "random walk" of equity prices. Therefore, the protection afforded to ESOP fiduciaries by the presumption of prudence would

34 *Id.*

35 White v. Marshall & Ilsley Corp., 714 F.3d 980 (7th Cir. 2013), *abrogated by* Fifth Third Bancorp v. Dudenhoeffer, 134 S. Ct. 2459 (2014).

36 *Id.* at 989 (internal quotation marks omitted).

37 *Id.* at 982.

38 *Id.*

39 *Id.* at 987.

40 *Id.*

41 *Id.*

effectively shelter fiduciary decisions while still allowing for liability if they disregard firm specific information that rises to a critical level.

The Ninth Circuit similarly looks to the presumption of prudence tempered by an exception for instances in which the viability of the employer as a going concern are at issue. In *Quan v. Computer Sciences Corp.*,[42] the court expressly embraced *Moench*. The *Quan* court accepted the *Moench* presumption, explicitly adding that "if there is room for reasonable fiduciaries to disagree as to whether they are bound to divest from company stock, the abuse of discretion standard protects a fiduciary's choice not to divest."[43] The Ninth Circuit here clarified that the presumption of prudence did not only apply to purchases of company shares in accordance with the ESOP plan documents, but also to the refusal of plan fiduciaries to divest from those assets if there were some question as to whether or not they would be safe investments for the ESOP to continue holding. Most other federal circuits which have addressed this issue have joined in following the *Moench* standard, and in those which have yet to address ESOP fiduciary duties with regard to fund diversification, the district courts in those circuits have followed the lead of the other circuits in applying *Moench*.[44]

B. The Supreme Court Rejects Moench *at the Pleading Stage*

Justice Breyer, writing for a unanimous court, rejected the application of a presumption of prudence in favor of ESOP fiduciary actions, as embodied in the *Moench* standard, at the pleading stage.[45] In reaching this determination, the Court placed great emphasis on the role of an ESOP fund as a retirement income and wealth preservation device in line with other ERISA-governed plans.[46] In so doing, the Court determined that ERISA's primary purpose of safeguarding the expectancy interests of plan participants in their retirement incomes should be given special weight in the ESOP context. Justice Breyer turned to the prudent man standard of care that is applicable to ERISA plan fiduciaries and quoted directly from 29 U.S.C. § 1104 to reiterate that the ERISA fiduciary is bound to exercise his discretion solely for the benefit of the plan participants and beneficiaries.[47] In so doing, the ESOP fiduciary is held to the standard of care of a prudent man under similar circumstances, must prudently diversify the ac-

42 Quan v. Computer Scis. Corp., 623 F.3d 870 (9th Cir. 2010), *abrogated by* Fifth Third Bancorp v. Dudenhoeffer, 134 S. Ct. 2459 (2014).

43 *Id.* at 882.

44 *See* DiFelice v. U.S. Airways, Inc., 497 F.3d 410 (4th Cir. 2007); Morrison v. Moneygram Int'l, Inc., 607 F. Supp. 2d 1033 (D. Minn. 2009); Harris v. Koenig, 602 F. Supp. 2d 39 (D.D.C. 2009); *In re* Ford Motor Co. ERISA Litig., 590 F. Supp 2d 883 (E.D. Mich. 2008).

45 *Dudenhoeffer*, 134 S. Ct. at 2463.

46 *Id.* at 2467–68.

47 *Id.* at 2465.

count, and must administer the plan in accordance with the plan documents in so far as such documents do not conflict with the provisions of ERISA.[48] He followed this with the recognition that ESOPs are "designed to invest primarily in the stock of the participants' employer"[49] and are therefore given statutory exemptions from the requirement of prudent diversification.[50] By looking at the exception in this way, Justice Breyer and the Court implicitly limited the latitude given to the plan fiduciary to pursue other aims of the plan which might be adverse to the ultimate safety of the employees' deferred income.

When examining the standard by which to assess ESOP fiduciary conduct, the Court determined that "the same standard of prudence applies to all ERISA fiduciaries, including ESOP fiduciaries, except that an ESOP fiduciary is under no duty to diversify the ESOP's holdings."[51] Special emphasis was placed on the qualifier in the statutory exemption to the prudent man standard permitted for ESOP fiduciaries, which limits deviations from prudent behavior "only to the extent that it requires diversification."[52] The Court pointed to the language of § 1104(a)(1)(B) and delved into the meaning of "an enterprise of a like character and with like aims."[53] This qualifier to the prudent man standard is taken to mean a fiduciary engaged in pursuing the goals enumerated immediately above in § 1104(a)(1)(A), namely to provide benefits to plan participants and their beneficiaries and defray reasonable expenses of plan administration.[54] The Court determined that "benefits" as used in §1104(a)(1)(A)(i) refers only to financial benefits that are intended to accrue to plan participants and their beneficiaries, not to "nonpecuniary benefits like those supposed to arise from employee ownership of employer stock."[55] Section 1104(a)(1)(D), which mandates plan fiduciaries act in accordance with plan documents, does not afford ESOP fiduciaries added protections when engaging in the purchase and holding of qualified employer securities, because the duty of prudence established at § 1104(a)(1)(B) "trumps the instructions of a plan document, such as an instruction to invest exclusively in employer stock even if financial goals demand the contrary."[56]

48 *Id.*

49 *Id.* (citing 29 U.S.C. § 1107(d)(6)(A) (2012) (internal quotation marks omitted)).

50 *Id.* at 2465 (citing 29 U.S.C. § 1104(a)(1)(C) (an ESOP fiduciary is not obligated to "diversif[y] the investments of the plan so as to minimize the risk of large losses") and 29 U.S.C. § 1104(a)(1)(B) (exempting the fiduciary from the prudent man standard relating to diversification of plan assets)).

51 *Id.* at 2467.

52 *Id.* (quoting 29 U.S.C. § 1104(a)(2) (emphasis removed)).

53 *Id.* at 2467 (quoting 29 U.S.C. § 1104(a)(1)(B)).

54 *Id.* at 2468.

55 *Id.*

56 *Id.*

The Court made a token gesture to their prior recognition that "ERISA represents a 'careful balancing' between ensuring fair and prompt enforcement of rights under a plan and the encouragement of the creation of such plans."[57] Even in this acknowledgement, however, the Supreme Court implicitly equated an ESOP with a traditional ERISA-governed retirement benefit plan. Through focusing on the retirement plan features of ESOPs, the Court held that the presumption of prudence in favor of ESOP fiduciaries at the pleading stage "makes it impossible for a plaintiff to state a duty-of-prudence claim, no matter how meritorious, unless the employer is in very bad economic circumstances."[58] The desire to see meritorious cases move forward through the adjudicative process requires a more detailed examination of the facts on a case-by-case basis to determine whether or not the plaintiffs state a plausible claim which would survive the pleading standard of *Bell Atlantic Corp. v. Twombly*[59] and *Ashcroft v. Iqbal*.[60] This more detailed examination comes at a real cost, however, in terms of both time and money that plans and plan fiduciaries must expend to address the alleged improprieties, even if they ultimately prove meritless. These costs are borne not solely by the fiduciaries, but also by all of the plan participants. The Court determined that this increased cost incurred from the increased number of, and effort expended on, ESOP fiduciary duty claims, as well as the increase in instances of nonmeritorious claims moving forward at the pleading level is worth the reduction in false negatives at the same level.

The Court went on to affirm its acceptance of the efficient market hypothesis in its treatment of the duty of loyalty issues; however, this also has applications to the duty of care issues addressed here. Justice Breyer directly confronted the plaintiff's claim that the ESOP fiduciaries should have known from publicly available information that Fifth Third stock was overvalued, and rejected that claim by relying on the efficient market hypothesis.[61] This usage of the efficient market hypothesis would imply that "where a stock is publicly traded, allegations that a fiduciary should have recognized from publicly available information alone that the market was over- or undervaluing the stock are implausible as a general rule."[62] Because we can assume that all publicly available information is incorporated into the market valuation of publically traded securities, ERISA plan fiduciaries cannot hope to beat the market relying solely on such public information.

57 *Id.* at 2470 (quoting Conkright v. Frommert, 559 U.S. 506, 517 (2010)).

58 *Id.*

59 Bell Atlantic Corp. v. Twombly, 550 U.S. 544 (2007).

60 Ashcroft v. Iqbal, 556 U.S. 662 (2009).

61 *Dudenhoeffer*, 134 S. Ct. at 2471.

62 *Id.*

This led the Court to the second allegation that the plaintiffs raised in the complaint: that the ESOP fiduciaries, by virtue of their position as Fifth Third insiders should have known that the stock was overvalued. Because of insider duties under the federal securities laws, in order for the plaintiff to validly put forth a claim against the fiduciaries for a violation of their duty of prudence to the plan, he must "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."[63] The duty of prudence under ERISA does not require that a fiduciary take illegal action, even if such action could feasibly be for the benefit of the fund.

The Court ended its analysis by remanding the case for a determination whether the plaintiff had stated a claim sufficient to overcome the *Twombly* pleading standard without recourse to a presumption that the ESOP fiduciaries acted prudently in following the terms of the plan by acquiring and holding qualified Fifth Third equity securities.[64] While the Court gave some protection to plan fiduciaries in their affirmation of the efficient market hypothesis and repudiation of a requirement for plan fiduciaries to improperly use information gained as an insider for the benefit of plan participants and beneficiaries, it has opened up ESOP fiduciaries to increased litigation risk. This may deter qualified fiduciaries from serving in such capacities and may deplete ESOP funds by increasing the likelihood that plan fiduciaries will need to spend time and resources defending their actions after adverse movements in the value of the underlying employer securities. More fundamentally, this decision may have been arrived at through a fundamental misunderstanding of the multifaceted role of the ESOP as a vehicle for capital formation and incentive alignment as well as a retirement planning device.

II. EFFECTS AND ADVISABILITY OF IMPOSING TRADITIONAL ERISA FIDUCIARY REQUIREMENTS ON ESOP FIDUCIARIES

When attempting to effectively regulate ESOPs, it is important to first recognize the primary purpose for these plans. When enacting legislation to effectuate the incentive scheme needed to entice employers to sponsor ESOPs, "Congress expressly intended that the ESOP would be both an employee retirement benefit plan and a 'technique of corporate finance' that would encourage employee ownership."[65] The intent of the employer should also be given weight as ESOP sponsorship is completely voluntary. If the Court or Congress were to alter the legal environment in which

63 *Id.* at 2472.

64 *Id.* at 2473.

65 Martin v. Feilen, 965 F.2d 660, 664 (8th Cir. 1992) (quoting 129 CONG. REC. S16636 (daily ed. Nov. 17, 1983) (statement of Sen. Long)).

ESOPs exist in a way which frustrates the aims of the employers in sponsoring the plan, employers may decide not to sponsor new ESOPs or terminate their plans. It is this possibility that employers may begin to shy away from ESOPs that Congress identified in the Tax Reform Act of 1976:

> INTENT OF CONGRESS CONCERNING EMPLOYEE STOCK OWNERSHIP PLANS.—The Congress, in a series of laws [including ERISA] has made clear its interest in encouraging [ESOPs] as a bold and innovative method of strengthening the free private enterprise system which will solve the dual problems of securing capital funds for necessary capital growth and of bringing about stock ownership by all corporate employees. The Congress is deeply concerned that the objectives sought by this series of laws will be made unattainable by regulations and rulings which treat [ESOPs] as conventional retirement plans, which reduce the freedom of the employee trusts and employers to take the necessary steps to implement the plans, and which otherwise block the establishment and success of these plans.[66]

Due to the unique multipurpose mandate of these investment plans, the practical functionality of the plans, and their position and purpose within the broader corporate capital structure scheme, any changes to ESOP regulation affects a broad array of legal areas including corporate financing, and individual retirement, estate, and tax planning. Because of the many different areas ESOP regulation can impact, treating ESOPs as merely a retirement plan or as a capital formation vehicle would risk doing significant damage to the other structures which rely on ESOPs as integral parts of their overall corporate or personal planning.

When investing in an ESOP, the employees are aware that they are investing in an undiversified asset pool and are thus exposed to the unique risks associated with the underlying securities. If the employer suffers financial difficulties, the employees who are invested in the ESOP will suffer a double blow: on the one hand to the probability of their future employment, and on the other to the money that they have invested in the company through the deferred compensation plan. However, the flip side of this dire situation is important to consider as well. If the firm is to do well, the employee is likely to gain twice over, firstly through the increased health of their employer and arguably safer employment prospects, and secondarily through the appreciation of their interests held by the ESOP.

This alignment of interest between employees and the employer which is achieved through the ESOP's investing primarily in employer securities cannot be matched by a traditional ERISA-governed pension plan which must be managed so as to preserve the participant's retirement income security. While the traditional defined contribution plan's focus on wealth preservation does not actively decouple the interests of the employee from

66 *Dudenhoeffer*, 134 S. Ct. at 2465–66 (citing Tax Reform Act of 1976, §803(h), Pub L. No. 94-455, 90 Stat. 1590).

that of the employer, it does nothing to better align their interests. Basic agency theory shows that the greater the alignment of interests between principal and agent, the lower the transaction costs are which arise from the agent favoring his own interest over the interest of the principal. The decrease in interest alignment between employer and employee caused by the heightened requirements placed on ESOP fiduciaries to deviate from the plan documents in certain critical instances likewise reduces the effectiveness of the ESOP as a means of reducing agency costs in sponsoring corporations.

This decoupling of interest can also impact management's incentive to implement an ESOP from a more self-interested perspective. An ESOP can be viewed as an effective anti-takeover device as the interests of employees and management are better aligned in the case of a hostile tender offer than those of management and the shareholders generally. In a takeover, the shareholders are confronted with the possibility of a current premium. Management alleges that the value of the shares if retained would be worth more than the takeover premium. Management, for better or worse, may be concerned with preserving themselves in office. Even when management is supposedly acting in the interest of the shareholders because they in good faith believe that the securities are substantially undervalued and that, given time, the corporation would generate a return in excess of what the would-be acquirer is offering in the tender bid, they may be suffering from several psychological biases that would overinflate their valuation. In this way, the incumbent directors could at the same time attempt to block a beneficial transaction and yet not be in violation of their fiduciary duties of loyalty and care. The employees would likewise generally be opposed to an attempted takeover of the company. In addition, the ESOP fiduciary is also often a member of management or another high-ranking corporate insider. As such, he would likely fall victim to many of the same heuristics as management generally, which would be reflected in the fiduciary's actions with respect to the assets held in trust.[67]

Employers also consider implementing an ESOP as a tax efficient means of raising capital. The IRC allows a qualified plan to incur debt, secured by the employer, to purchase company stock. The ESOP may collateralize its debt obligations with employer stock acquired with the proceeds from the loan.[68] Beyond access to capital, by using an ESOP the employer can further reduce its tax liability by deducting both payments on principal and interest payments on the debt.[69] When the abandonment of

67 While the use of an ESOP in this situation may not objectively be in the best interest of the shareholders, this does not detract from the attractiveness of an ESOP as an anti-takeover device generally.

68 *See* I.R.C. § 4975(d)(3) (2012); *see also* Treas. Reg. § 54.4975-7(b)(5) (1977).

69 *See* I.R.C. § 404(a)(9)(A) (permitting a deduction for contributions to an ESOP applied to the repayment of the principal of a loan used to acquire qualified securities up to

the *Moench* presumption at the pleading stage does not impact these ESOP mechanics, it does alter the overall risk of these strategies. At the margin, this shift may cause employers to choose to raise capital in other ways which entail their own particular risks and effects on the firm's capital and governance structure.

CONCLUSION

While ESOPs may not be right for every company or every situation, they fill a key role in many firms' capital structures and in the investment portfolios of many employees. ESOP policy walks the narrow edge between seeking to incentivize employee ownership of their employer's security interests (and thus realize gains from incentive alignments) and capital formation on the one hand, and an interest in safeguarding employees' deferred compensation and retirement interests on the other. Because of the precarious balance that must be struck to ensure that the ESOPs meet the various objectives that Congress has set for them, even small changes, such as shifting away from a liability regime that favored the defendant at the pleading stage with a presumption of prudence as the Court recently did in *Dudenhoeffer*, could have significant consequences in the overall employer sponsorship of ESOPs. Important also is the fact that Congress has shown itself to be more than willing to adjust the balance between incentives for employer-sponsors and protections for employee-participants when it determines that the balance is suboptimal. This can be seen in the strong statements made by Congress in the Tax Reform Act of 1967, which effectively halted efforts by the Departments of the Treasury and Labor to tighten regulations on ESOPs and bring them more in line with traditional defined contribution plans. When Congress determined that it needed to increase protections to employee-participants, it did so through the Pension Protection Act of 2006 by mandating that employer-sponsors provide an option for employee-participants to reallocate assets held in an ESOP to one of several alternative investment funds.[70] The proven ability of Congress to act to adjust this policy balance when needed would seem to cut clearly against the wisdom of the Court unilaterally shifting established litigation presumptions. This is particularly true in an area where significant long-term planning is required to adequately achieve the goals of both the plan sponsors and society as a whole.

25% of ESOP participants compensation); I.R.C. § 404(a)(9)(B) (permitting a deduction for amounts paid to an ESOP that are used to pay interest on a loan used to acquire qualified securities). *But see* I.R.C. § 404(a)(9)(C) (stating that the deductions for contributions applied to the payment of interest and principal are not permitted for subchapter S corporations).

70 Pension Protection Act of 2006, Pub. L. No. 109-208, 120 Stat. 780 (codified in scattered sections of the U.S. Code).

Given the careful balance that must be maintained to ensure that the congressionally desired level of ESOP participation is maintained, it would be prudent for Congress to examine the possible significant adverse impact that the shift in presumption of prudence that ESOP fiduciaries had previously enjoyed may have on the overall public policies that ESOPs were authorized to support. If Congress finds that there is a net negative impact on these policies by *Dudenhoeffer*, then it may find it advisable to legislatively reinstate the *Moench* presumption that the industry had heretofore relied upon. While it is up to Congress to determine whether or not it is comfortable with the change handed down by the Court, employer-sponsors too should reexamine their risk exposure in light of the increased possibility of litigation proceeding past the pleading stages.