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COZEN O'CONNOR

Seventh Circuit Eases ERISA Plaintiffs' Pleading Burden Against Private Company Plan Fiduciaries

On August 25, 2016, the U.S. Court of Appeals for the Seventh Circuit, in *Allen v. GreatBanc Trust Co.*, No. 15-3569, 2016 WL 4474730 (7th Cir. 2016), held that (1) the defendant in an ERISA case, rather than the plaintiff, bears the burden of proving a section 408 exemption to a transaction prohibited by ERISA as an affirmative defense; and (2) the U.S. Supreme Court's decision in *Fifth Third Bancorp v. Dudenhoeffer*, 134 S. Ct. 2459 (2014), does not apply to plan investments in stock of private companies.

Background

In *GreatBanc Trust Co.*, the Seventh Circuit was asked to reverse a decision letting GreatBanc Trust Co. (GreatBanc) off the hook for its role in a $60 million stock purchase by the "employee stock ownership plan" (ESOP) for Personal-Touch Home Care Inc. By way of background, GreatBanc was the fiduciary for an employee stock ownership plan (the plan) for employees of Personal-Touch, a private home-health-care company whose stock was not publicly traded.

As fiduciary, GreatBanc facilitated a transaction in which the plan purchased a number of shares in the company with a loan from the company itself. Unfortunately, soon after the loan closed, the shares steeply declined in value, leaving the plan with a greatly depreciated asset but heavily indebted to the company's principal shareholders. Consequently, two beneficiaries brought an action under section 502 of ERISA, raising two theories of recovery: first, that GreatBanc engaged in transactions that were prohibited by section 406 of ERISA; and secondly, that GreatBanc breached its fiduciary duty under section 404 of ERISA by failing to secure an appropriate valuation of the Personal-Touch stock.

The U.S. District Court for the Northern District of Illinois dismissed the complaint, finding that the plaintiffs had not sufficiently pled breach of fiduciary duty according to the standard outlined in *Dudenhoeffer*.[1] In that case, the Supreme Court declared that no "presumption of prudence" applied to fiduciaries of ESOPs. In rejecting the defense-friendly presumption, the high court set forth guidelines for lower courts to follow at the motion to dismiss stage that imposed challenges to plaintiffs' ability to satisfy pleading requirements in cases against ESOP fiduciaries.

One of those guidelines was 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, at least in the absence of special circumstances." 134 S.Ct. at 2471. Based on that principle, a plaintiff would arguably have to point to those "special circumstances" in the complaint, to survive a motion to dismiss. Believing that this rule applied and that no special circumstances existed, the district court dismissed the breach-of-fiduciary-duty claim. It rejected the prohibited-transaction claim for much the same reason, finding that the question whether the plan paid a fair price for the stock was not properly alleged. Plaintiffs appealed.

Prohibited Transaction

With respect to plaintiffs' argument that GreatBanc engaged in transactions that were prohibited by section 406 of ERISA, the Seventh Circuit noted that the complaint alleged a purchase of employer stock by the plan and a loan by the employer to the plan, both of which are indisputably prohibited transactions within the meaning of section 406 of ERISA. Based on that finding, the court stated that GreatBanc could only prevail if it could take advantage of one of the exemptions for such prohibited transactions listed in section 408 of ERISA.

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On this point, GreatBanc contended that plaintiffs had the burden of pleading facts that would negate the applicability of section 408's exemptions. The Seventh Circuit agreed with the district court's conclusion that GreatBanc had the ultimate burden of proving the applicability of a section 408 exemption. The circuit court, however, clarified that an ERISA plaintiff need not plead the absence of exemptions to prohibited transactions. Rather, it is the defendant who bears the burden of pleading and proving a section 408 exemption as an affirmative defense. The court reasoned that requiring plaintiffs to negate section 408 exemptions would prematurely defeat claims in which plaintiffs lacked access to such information.

As applied to the transaction at-issue, the Seventh Circuit ruled that because GreatBanc never raised any affirmative defense regarding the exemptions, the allegation of a prohibited transaction was plausible. In so holding, the court rejected GreatBanc's policy argument that there would be a flood of prohibited-transaction litigation if all that must be alleged is the occurrence of a section 406 transaction, reasoning that rational plan beneficiaries would only sue if there was a good-faith reason to do so.

Breach of Fiduciary Duty

As to the allegation that GreatBanc breached its fiduciary duty under section 404 of ERISA by failing to secure an appropriate valuation of the Personal-Touch stock, the Seventh Circuit likewise found that this claim had been plausibly alleged.

The plaintiffs' central allegation was that GreatBanc failed to conduct an adequate inquiry into the value of Personal-Touch's stock prior to the plan's purchase. To plead breach plausibly, the court noted that the plaintiffs needed to allege facts from which a factfinder could infer that the fiduciary's process was inadequate. Here, the Seventh Circuit held that the plaintiffs met this burden for pleading breach:

> they alleged that the stock value dropped dramatically after the sale (implying that the sale price was inflated), that the loan came from the employer-seller rather than from an outside entity (indicating that outside funding was not available), and that the interest rate was uncommonly high (implying that the sale was risky, or that the shareholders executed the deal in order to siphon money from the plan to themselves).

GreatBanc Trust Co., 2016 WL 4474730 at *6. In the court's view, these facts supported an inference that GreatBanc breached its fiduciary duty, either by failing to conduct an adequate inquiry into the proper valuation of the shares or by intentionally facilitating an improper transaction. Thus, the allegation of breach of fiduciary duty was plausible.

In reaching its holding, the court expressly rejected GreatBanc's reliance on *Dudenhoeffer* as unwarranted. GreatBanc had argued that *Dudenhoeffer*'s rationale should be extended to the private-stock situation because "an unbiased, independent trustee['s]" assessment of the value of stock is at least as reliable as the stock market's, and therefore the special circumstances pleading requirement should apply to private stock as well. But the Seventh Circuit disagreed, noting that GreatBanc had assumed things that may or may not be true in a particular case, i.e., was the trustee unbiased and independent and did it have solid data behind its assessment.

Because *Dudenhoeffer* focused solely on publicly traded stock, the Seventh Circuit held that there was no support for a special circumstances pleading requirement as applied to private stock transactions. In such a case, the Seventh Circuit noted that all a plaintiff must do is plead the breach of a fiduciary duty and explain how it was accomplished. In this case, plaintiffs accused GreatBanc of failing to conduct an independent assessment of the value of stock and relying instead on an interested party's number. This was enough to give notice of the claim and to allow the suit to proceed.

Accordingly, the Seventh Circuit remanded the case to the district court for further proceedings consistent with its holding.

Key Points

The Seventh Circuit's decision in *GreatBanc Trust Co.* has important ramifications. The court removed a significant impediment to prohibited transaction claims by holding that the defendant

bears the burden of pleading and proving a section 408 exemption as an affirmative defense. This placement of the pleading burden, in and of itself, will make it easier for plaintiffs to survive motions to dismiss.

In addition, the Seventh Circuit's holding that *Dudenhoeffer* does not apply to privately held stock transactions also eases plaintiffs' pleading burden. Absent the application of *Dudenhoeffer*'s guidelines, breach of fiduciary duty claims relating to private stock transactions are much easier to plead against fiduciaries and, therefore, more likely to survive a motion to dismiss.

If *GreatBanc Trust Co.* is followed by other circuits, it may usher in a new wave of litigation against ERISA plans and fiduciaries in the private company context. ERISA plan fiduciaries and their insurers should take note of this heightened risk.

To discuss any questions you may have regarding the issues discussed in this Alert, or how they may apply to your particular circumstances, please contact Angelo Savino at (212) 908-1248 or asavino@cozen.com or Alexander Selarnick at (212) 453-3740 or aselarnick@cozen.com.

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[1] *See* A. Savino and K. Abel, Supreme Court Rejects Presumption of Prudence for ESOP Fiduciaries, July 10, 2014.