ALERTS

The Second Circuit's Adoption of the *Moench* Presumption of Prudence Provides "Accommodation" for Employers Facing Stock Drop Suits

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A recent opinion from the United States Court of Appeals for the Second Circuit should reassure employers worried about employee lawsuits alleging the imprudence of investing in company stock through company retirement plans during unstable economic times. In recent years, the federal courts have heard an increasing number of these so-called "stock drop" cases (including many that have arisen as a result of the crash of the subprime mortgage market). Until now, the Second Circuit remained silent as to the decisive standard of review applicable to such claims.

Adoption of the *Moench* Presumption of Prudence

On Oct. 19, 2011, the Second Circuit joined its sister circuits in adopting the presumption of prudence — first articulated by the Third Circuit in *Moench v. Robertson*, 62 F.3d 553 (3rd Cir. 1995) — as the standard of review applicable to stock drop claims. *See In re: Citigroup ERISA Litig.*, No. 09-3804; *Gearren v. McGraw-Hill Cos., Inc.*, Nos. 10-792, 10-934.[1] Under the presumption, an employer's decision to retain company stock as an investment option in an employee benefit plan covered by ERISA can be reviewed only for an "abuse of discretion." Absent circumstances placing a company in a "dire situation" that was "objectively unforeseeable," the employer is not required to override plan terms requiring that employees have the option of investing in company stock. In

a divided opinion (with Judge Chester J. Straub dissenting), the court explained that the presumption provides "the best accommodation between the competing ERISA values of protecting retirement assets and encouraging investment in employer stock."[2]

Employees' Claims Against Citigroup

Following a 50 percent decline in Citigroup's stock price, employee participants in Citigroup's 401(k) plans filed a class action suit in 2008, alleging that the company and named defendants breached their fiduciary duty of prudence by failing to divest the plans of Citigroup stock despite its unsteady value. The employees also claimed that certain corporate defendants breached their fiduciary duty of communication by neglecting to provide complete and accurate information to employee participants in the plans regarding company stock and its exposure to risks associated with the subprime mortgage market. The plaintiffs alleged other breaches of fiduciary duties, including the duty of loyalty.

The Court's Dismissal of Employees' Claims

The Second Circuit affirmed the district court's dismissal of all of the plaintiffs' claims against the company. Applying the *Moench* presumption to the Citigroup employees' prudence claims, the court found that the plaintiffs' allegation that Citigroup had made bad business decisions was insufficient to show that the company was in a "dire situation" or that named defendants knew or should have known that the situation was dire. Moreover, the court found that the plaintiffs had pleaded no facts that, if proved, would show that an investigation of Citigroup stock would have led the defendants to conclude that Citigroup was no longer a prudent investment. Rather than relying on the steepness of the stock decline, the court considered "the extent to which plan fiduciaries at a given point in time reasonably could have predicted the outcome that followed." Under this standard, given the unexpectedness of Citigroup's losses, the court dismissed the plaintiffs' claims that their employer acted imprudently. The court also rejected the plaintiffs' argument that Citigroup's stock price was "inflated" during the class period "because the price did not reflect the company's true underlying value." The panel asserted that these facts alone cannot sufficiently plead a fiduciary breach.

The court dismissed the plaintiffs' communications claim. Because ERISA does not require fiduciaries to provide plan participants with non-public

information pertaining to the expected performance of plan investment options, the court found that the defendants had "no duty to communicate a forecast as to when this volatility would manifest itself in a sharp decline in stock price." In addition, the court dismissed the plaintiffs' misrepresentation claim because the company and its CEO did not act as fiduciaries while discussing Citigroup's financial health and because the Administrative Committee did not knowingly make any false statements.

The court also dismissed the plaintiffs' duty of loyalty claim. The court held that such a claim cannot be based solely on the fact that an ERISA fiduciary's compensation is linked to company stock. Under the plaintiffs' reasoning, the court explained, "almost no corporate manager could ever serve as a fiduciary of his company's [p]lan."

Finally, the court dismissed the plaintiffs' remaining claims as derivative of the prudence and communication claims.

Lingering Concerns for Employers

In its articulation of the *Moench* standard, the court noted that judicial scrutiny should increase with the degree of discretion a plan gives its fiduciaries to invest in company stock. Here, under the plain language of the relevant plans, the plan fiduciaries were not provided any discretion to divest the plan of Citigroup stock. Although the court was willing to decrease the level of judicial scrutiny in the absence of fiduciary discretion, the court refused to completely insulate such employers from liability: "[S]uch a rule would leave employees' retirement savings that are invested in [company stock] without any protection at all." Employers with benefit plans granting discretion to plan fiduciaries with respect to company stock should be aware that courts in the Second Circuit may be less deferential to the decisions of those fiduciaries.

Circuit Judge Straub wrote a lengthy and strongly-worded dissent, rejecting, among other things, the court's adoption of the *Moench* standard. Under Judge Straub's preferred "plenary" standard — as opposed to the deferential abuse of discretion standard — employers would have a much more difficult time defending against employees' stock drop claims. Dismissal on the pleadings would also be unlikely under this plenary standard.

For Now, Employers Can Relax About Stock Drop Claims

Courts within the Second Circuit are now tasked with fleshing out how the presumption of prudence should be applied in practice, including determining how plan language impacts that analysis. In the meantime, employers and plan fiduciaries can take some comfort in the Second Circuit joining the Third, Fifth, Sixth and Ninth Circuits in adopting the deferential *Moench* presumption.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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[1] This *Alert* discusses the *Citigroup* opinion as the lead decision. The panel adopted the same reasoning in the "companion" *Gearren* decision.

[2] In its decision, the Second Circuit adopted the *Moench* presumption with respect to both employee stock ownership plans ("ESOPs") and eligible individual account plans ("EIAPs"). The court also noted that the presumption would apply at the pleading stage: "Where plaintiffs do not allege facts sufficient to establish that a plan fiduciary has abused his discretion, there is no reason not to grant a motion to dismiss."

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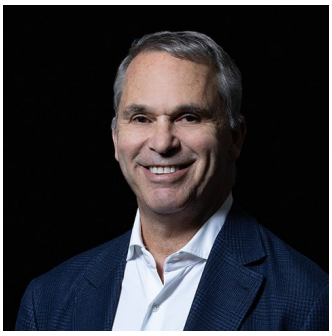

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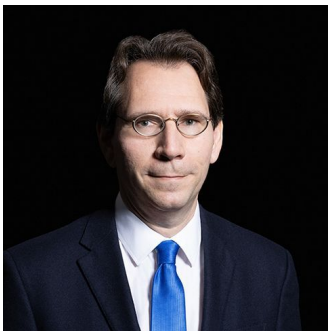

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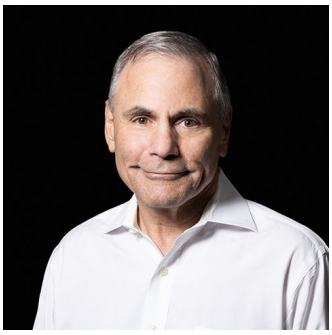

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