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Employer Stock Litigation Update: Second Circuit Adopts "Moench" Presumption

Companies that sponsor 401(k), ESOPs and other forms of eligible individual account plans ("EIAPs") that hold company stock often are subjected to class action lawsuits under ERISA when there is a substantial decline in the stock price. One of the key bases for dismissal of these cases at the pre-trial stage is the so-called "*Moench*" presumption of prudence. Under the *Moench* presumption, a plan fiduciary's decision to continue offering company stock as an investment option is considered consistent with ERISA, unless the plaintiff can show that the fiduciary knew or should have known during the relevant time period of an imminent corporate collapse or other dire circumstances. Where pleading and proof of that kind of knowledge is absent from the plaintiffs' complaint — which often is the case for non-bankrupt plan sponsors that remain economically viable — the court may use *Moench* presumption to dismiss the lawsuit.

In *In Re: Citigroup ERISA Litigation (Gray v. Citigroup, Inc.)*, No. 09-3804 (2nd Cir. Oct. 19, 2011), the United States Court of Appeals for the Second Circuit joined the Third, Fifth, Sixth, and Ninth Circuits in expressly adopting the *Moench* presumption of prudence.

Second Circuit Decision

The *Citigroup* action was brought by a group of participants in the company's 401(k) plan. According to the plaintiffs, when the subprime mortgage market collapsed in 2008, Citigroup lost tens of billions of dollars in its subprime mortgage-related investments, and its stock lost more than half its value. The plaintiffs alleged that plan fiduciaries acted imprudently by continuing to offer Citigroup stock as an investment option when they knew of the company's exposure to the subprime mortgage market. The plaintiffs also claimed that the plan fiduciaries failed to provide adequate and truthful information to participants regarding the company stock fund and its exposure to the risks associated with the subprime mortgage market.

In a 2-1 decision, the Second Circuit affirmed the district court's ruling that dismissed the lawsuit. The majority began its analysis by recognizing the tension between what it saw to be core competing goals of ERISA: "(1) the protection of employee retirement savings through the imposition of fiduciary duties and (2) the encouragement of employee ownership through the special status provided to [ESOPS and EIAPS]." Following the reasoning of several other circuits, the Court adopted the *Moench* presumption of prudence as a means of accommodating these competing goals.

In adopting the presumption, the Court determined that applying the general prudence analysis in the employer stock context would leave fiduciaries in the untenable position of being vulnerable to suit, on the one hand, for adhering to the plan's terms if the stock price dropped, and, on the other hand, for deviating from the plan terms if they were to sell the stock and the stock value later increased. The Court considered this double-edged sword particularly troubling for the long-term establishment and success of EIAPs, which Congress

sought to encourage. The Court also noted that the presumption allows courts to judge fiduciary actions based on the information available to the fiduciary at that time, and not "from the vantage point of hindsight."

While fiduciaries are not granted absolute immunity with regard to employer stock, the presumption is a substantial shield against liability for stock drop claims. The presumption may be overcome by showing a "dire situation" that was "objectively unforeseeable by the settlor," and should protect fiduciaries from liability where "there is room for reasonable fiduciaries to disagree as to whether they are bound to divest from company stock." The Court did not specifically define "dire circumstance," but echoed rulings by other circuits in finding that "mere stock fluctuations, even those that trend downhill significantly, are insufficient to establish the requisite imprudence to rebut the *Moench* presumption."

In applying the presumption, the Court held that the plaintiffs' allegations in *Citigroup* were insufficient to overcome the presumption. The Court found the plaintiffs' claim that the fiduciaries "knew or should have known about Citigroup's massive subprime exposure as a result of their responsibilities as fiduciaries" to be conclusory. Even if the fiduciaries had investigated the continued prudence of the company stock investment, as the plaintiffs claimed they should have, the plaintiffs failed to allege facts to show that an investigation would have persuaded fiduciaries that continued investment in Citigroup stock was imprudent. In so finding, the Court identified that Citigroup retained a market capitalization of almost $200 billion.

It should be noted that, in adopting the *Moench* presumption, the Court explicitly disagreed with the district court's ruling that mandatory plan language "hardwiring" the employer stock investment into a plan provided an absolute bar to plaintiffs' prudence claim. The Court instead endorsed a sliding scale that "a fiduciary's failure to divest from company stock is less likely to constitute an abuse of discretion if the plan's terms require – rather than merely permit – investment in company stock."

The Court also rejected the plaintiffs' disclosure claims, finding that (1) fiduciaries have no duty to provide participants with nonpublic information regarding the expected performance of plan investment options, and (2) the fiduciaries gave participants "adequate warning that the stock fund was undiversified and subject to volatility." On the misrepresentation claim, the Court held that plaintiffs did not adequately allege that the committee made statements it knew to be false and that the fiduciaries were not required to perform an independent review of SEC filings before incorporating them into the summary plan description.

Judge Straub wrote a lengthy dissent in which he criticized the majority's adoption of the *Moench* presumption, arguing that the presumption ensures that enormous losses in stock drop cases "will go remediless." In addressing the Court's recognition of the "dire situation" standard, Judge Straub maintained that "arbitrary line-drawing leaves employees wholly unprotected from fiduciaries' careless decisions to invest in employer securities so long as the employer's 'situation' is just shy of 'dire'" and that "the duty of prudence does not wax and wane depending on circumstance." Judge Straub also disagreed with the majority that ERISA fiduciaries need not provide participants with material information about the expected performance of plan investment options. He would have found that the plaintiffs met their burden on their misrepresentation claim by alleging that the fiduciaries intentionally connected their statements about the financial health of the company and performance of its stock to Plan benefits.

Observations

The Second Circuit's adoption of the *Moench* presumption represents an important victory for financial institutions and other plan sponsors located in the Second Circuit (New York, Connecticut and Vermont). In adopting the presumption, the Second Circuit overruled the Department of Labor, which had filed an amicus brief and also presented oral argument. However, given the lengthy and strongly-worded dissenting opinion, we anticipate plaintiffs will seek rehearing en banc in the coming weeks.