Second Circuit Holds That The *Moench* Presumption of Prudence Applies To ERISA Stock Drop Suits

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The Second Circuit, on October 19, 2011, held that "the decision not to divest [401(k)] plans of [company] stock or impose restrictions on participants' investment in that stock are entitled to a presumption of prudence and should be reviewed for an abuse of discretion." By doing so, the court affirmed the dismissal of two ERISA stock drop cases, *In re Citigroup ERISA Litig*., No. 07 Civ. 9790, 2009 WL 2762708 (S.D.N.Y. Aug. 31, 2009) and *Gearren v. McGraw-Hill Cos., Inc*., 690 F. Supp. 2d 254 (S.D.N.Y. 2010), and joined the Third, Fifth, Sixth, and Ninth Circuits in adopting a presumption of prudence, first articulated by the Third Circuit in *Moench v. Robertson*, 62 F.3d 553 (3d Cir. 1995). In addition to adopting the *Moench* presumption, the Second Circuit held that there is no affirmative duty under ERISA to disclose nonpublic information to Plan participants and that purported misstatements made by non-fiduciaries in SEC filings are corporate, not fiduciary, communications and thus not subject to liability under ERISA.

BACKGROUND

In order to protect "the interests of participants in employee benefit plans," ERISA sets forth fiduciary standards of conduct for Plan administrators. A fiduciary under ERISA is required to "discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries" and this should be done, "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man" would use. *See* 29 U.S.C. § 1104(a)(1)(A) and (B). Specifically, ERISA requires fiduciaries to diversify Plan assets and act with prudence in selecting investments. 29 U.S.C. § 1104(a)(1)(c). If a fiduciary breaches his or her obligations under ERISA, he "shall be personally liable to make good to such plan any losses to the plan resulting from each such breach . . . and shall be subject to such other equitable or remedial relief as the court may deem appropriate." 29 U.S.C. § 1109(a).

In recent years, there has been a surge in putative class actions brought on behalf of Plan participants alleging breaches of fiduciary duty under ERISA in connection with a decrease in a company's stock price. These actions, commonly referred to as ERISA stock drop cases, often are brought in tandem with related securities suits and frequently contain similar underlying allegations – *i.e.*, misconduct on behalf of a company which, when disclosed, led to a decline in the company's stock price. Often, plaintiffs in an ERISA stock drop suit allege that Plan fiduciaries breach their duties by

(i) allowing employees to invest in company stock when it was imprudent to do so ("prudence claim"); and (ii) failing to disclose financial information about the company to Plan participants and/or making misrepresentations (usually in SEC filings) about the financial status of the company ("communications claims"). In addition, plaintiffs may also allege a breach of a duty to monitor by company directors and/or a conflict of interest claim.

Both the *Citigroup* case, which was commenced on September 15, 2008, and the *McGraw-Hill* case, which was commenced on June 12, 2009, arose out of the recent financial crisis. Plaintiffs in each action were participants in their company's 401(K) Plans, where the Plans offered the company stock fund as an investment option. Like other ERISA stock drop cases, following a decline in their company's stock price, plaintiffs filed complaints alleging breaches of fiduciary duty under ERISA.

In decisions issued by the Southern District of New York, Judge Stein dismissed the *Citigroup* case on August 31, 2009, and Judge Sullivan dismissed the *McGraw-Hill* case on February 10, 2010. Plaintiffs in both *Citigroup* and *McGraw-Hill* appealed and the cases were heard together on September 28, 2010 by the Second Circuit panel of Judges Walker, Cabranes, and Straub. Although a number of other stock drop cases are before the Second Circuit, *Citigroup* and *McGraw-Hill* were the first to be heard and now the first to be decided by the Second Circuit.

SUMMARY OF THE DECISIONS

In two 2-1 opinions, with Judge Walker writing the majority in the *Citigroup* case (the *McGraw-Hill* decision was per curiam) and Judge Straub dissenting and concurring in part in *Citigroup* and dissenting in *McGraw-Hill*, the Second Circuit affirmed the decisions of the district courts in *Citigroup* and *McGraw-Hill* granting defendants' motions to dismiss. In affirming, the Second Circuit held that plaintiffs in both cases failed to allege sufficient facts (i) "to establish that defendants had abused their discretion by continuing to offer Plan participants the opportunity to invest in [company] stock," and (ii) to show that "defendants made any statement, while acting in a fiduciary capacity, that they knew to be false." The court also held, in both cases, that defendants do not have a duty to disclose nonpublic information to Plan participants.

I. THE CITIGROUP DECISION

Following an alleged 52 percent drop in the price of Citigroup stock from late 2007 into 2008, plaintiffs, a putative class of participants in two Eligible Individual Account Plans ("EIAPs"), the Citigroup 401(k) Plan and the Citibuilder 401(k) Plan for Puerto Rico (together, the "Citigroup's 401(k) Plans"), filed a complaint alleging that Citigroup's involvement in the "ill-fated subprime mortgage market caused the stock price drop." They further alleged that defendants, including the Administration and Investment Committees (together, "Plan Committees"), Citigroup, and Citibank, "breached their fiduciary duties of prudence and loyalty" by "refusing to divest the Plans of Citigroup stock" even though "'Citigroup's perilous operations tied to the subprime securities market' made it an imprudent investment. Plaintiffs further alleged that defendants breached their fiduciary duties by "failing to provide complete and accurate information to Plan participants regarding the [Stock] Fund and its exposure" to the subprime market. In addition, plaintiffs alleged that Citigroup and individual members of its board of directors failed to monitor the Plan Committees, failed to disclose information about Citigroup's financial condition to Committee members, put the interests of Citigroup and themselves above the interest of Plan participants, and are liable as co-fiduciaries.

A. <u>Prudence Claim</u>

In affirming the dismissal of plaintiffs' prudence claim, the Second Circuit held that plaintiffs failed to allege that defendants abused their discretion by deciding not to divest the 401(k) Plans of the Citigroup Group Common Stock Fund (the "Stock Fund"). In so holding, the court noted that "[p]laintiffs' claims placed in tension two of ERISA's core goals: (1) the protection of employee retirement savings through the imposition of fiduciary duties and (2) the encouragement of employee ownership through the special status accorded employee stock ownership plans and eligible individual account plans." The Second Circuit looked to the Third Circuit's decision in *Moench*. The *Moench* court explained that, in such situations, fiduciaries are entitled to a presumption of prudence and should divest the "investment in employer stock only when . . . maintaining the investment in company stock 'would defeat or substantially impair the accomplishment of the purposes of the [Plan].'" The Second Circuit stated that "[w]e agree with this formulation" and "that only circumstances placing the employer in a 'dire situation' that was objectively unforeseeable by the settlor could require fiduciaries to override the plan's terms."

In adopting the *Moench* presumption, the court rejected the district court's holding that "defendants were insulated from liability because they had no discretion to divest the Plans of employer stock." Instead, the court endorsed as a "guiding principle" that "judicial scrutiny should increase with the degree of discretion a plan gives its fiduciaries to invest." Further, rather than relying on hindsight in evaluating the presumption to which the fiduciaries are entitled, courts should instead consider "the extent to which plan fiduciaries at a given point in time reasonably could have predicted the outcome that followed."

The court then applied the *Moench* presumption to plaintiffs' allegations regarding the fiduciaries' failure to divest the Citigroup 401(k) Plans of the Stock Fund. As an initial matter, the court held that only the Plan Committees were fiduciaries with respect to the Plans, and that plaintiffs failed to allege facts showing that Citigroup and Citibank were "de facto fiduciaries." The court further held that even if "we assume that each of the defendants was a fiduciary," allegations that "Citigroup became aware of the impending collapse of the subprime market and that, ultimately, Citigroup reported losses of about $30 billion due to its subprime exposure" were insufficient to show that the company was in a "'dire situation,' much less that the [Plan Committees] knew or should have known that the situation was dire."

Moreover, the court held that plaintiffs failed to support their "bald assertion" that the Plan Committees "knew about Citigroup's subprime activities." The court similarly rejected plaintiffs' contention that Plan Committee members should have investigated the prudence of investing, observing that plaintiffs had not shown that "an adequate investigation would have revealed to a reasonable fiduciary that the investment at issue was improvident." The court concluded by noting that even if an investigation had revealed all of the facts plaintiffs alleged, the Plan Committees "would not have been compelled to conclude that Citigroup was in a dire situation" based on losses of tens of billions of dollars and a 52 percent drop in stock price, in light of Citigroup's "market capitalization of almost $200 billion."

B. <u>Communications Claims</u>

The Second Circuit also rejected plaintiffs' claims that Citigroup, the Administration Committee, and Citigroup executive at the time, Charles Prince, breached their fiduciary duties under ERISA by failing to disclose non-public information to Plan participants and by conveying inaccurate material information through statements and omissions in Plan documents. The court held that (i) "fiduciaries have no duty to provide Plan participants with non-public information" and (ii) no facts had been alleged, if proved, to "support a conclusion that defendants made statements, while acting in a fiduciary capacity, that they knew to be false."

Plaintiffs claimed that defendants violated ERISA's general duty of loyalty, 29 U.S.C. § 1104(a)(1), "by failing to provide participants with information regarding the expected future performance of Citigroup stock." The court rejected this theory of liability, stating that the cases plaintiffs relied upon were inapposite. Therefore, the court "decline[d] to broaden the application of these cases to create a duty to provide participants with nonpublic information" because "such a requirement would improperly 'transform fiduciaries into investment advisors.'"

In addition, the court dismissed plaintiffs' claim that Citigroup, the Administration Committee and Prince were liable under ERISA for alleged misstatements in SEC filings referred to in Plan documents. As an initial matter, the court held that Citigroup and Prince were acting as employers and not Plan fiduciaries when making the alleged statements and are therefore not liable under ERISA. In so holding, the court rejected plaintiffs' contention that statements made by an employer that are "intentionally connected" to Plan benefits are actionable under ERISA. The court made clear that "only the Plan administrator is responsible for meeting ERISA's disclosure requirements and therefore for communicating with Plan participants." The court stated that, here, "Citigroup and Prince were not Plan administrators" and "cannot be held liable, at least under ERISA, for any alleged misstatements made to Citigroup employees." The court further held that, as to the Administration Committee, plaintiffs had failed to adequately allege, beyond a "naked assertion," that the Committee members "knew or should have known" that the statements at issue were false.

C. <u>Derivative Claims</u>

The Second Circuit similarly dismissed plaintiffs' claims regarding the duty to monitor, share information with co-fiduciaries, and co-fiduciary liability as derivative of plaintiffs' prudence and communications claims. In addition, the court rejected plaintiffs' conflict of interest claim based on defendants' investments in Citigroup stock, stating that disallowing such an investment would mean that "almost no corporate manager could ever serve as a fiduciary of his company's plan" and that there is "no evidence that Congress intended such a severe interpretation of the duty of loyalty."

<u>Judge Straub's Opinion, Dissenting and Concurring in part</u>

Judge Straub's opinion, dissenting and concurring in part, argued for a plenary review of ERISA fiduciary investment decisions, rather than a *Moench* presumption of prudence. He referred to the *Moench* presumption's requirement of a "dire situation" in order for plaintiffs to state a claim under ERISA with respect to employer stock funds as 'arbitrary line drawing" that "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'—a standard that the majority neglects to define in any meaningful way." Judge Straub found no justification "for cloaking fiduciaries' investment decisions in a mantle of presumptive prudence," stating that the presumption renders ERISA's prudent man standard moot. He would "preserve the statutorily mandated standard of prudence by calling for plenary, rather than deferential, review of an ESOP fiduciary's investment decision."

Judge Straub also concluded that "ERISA fiduciaries have an affirmative duty to disclose material information that Plan participants need to know to adequately protect their interests" and that such a requirement is rooted in the common law of trusts. He disagreed with the majority that such a requirement would "transform fiduciaries into investment advisors" because the duty to disclose "would merely ensure that, where retirement plan assets are severely threatened, employees receive complete, factual information such that they can make their own investment decisions on an informed basis."

In addition, Judge Straub concluded that Citigroup and Prince were fiduciaries when making alleged misstatements because plaintiffs have, in his view, sufficiently alleged facts showing that Citigroup and Prince exercised authority and responsibility over the Plans. He rejected the majority's "formalistic" rule that an employer "may qualify under the circumstances alleged here only if it is also the designated Plan administrator." He also concluded that plaintiffs have adequately alleged facts showing that the Administration Committee knowingly made false statements to Plan participants because at least one member of the Administration Committee—Mr. Tazik—also served on the Investment Committee and so "would have at least some awareness of both Citigroup's massive subprime exposure, and the growing potential for market-wide crisis." Finally, he would vacate the dismissal of plaintiffs' derivative claims but would concur with the majority's dismissal of plaintiffs' claim regarding conflict of interest with respect to stock-based compensation.

II. THE MCGRAW-HILL DECISION

Like the plaintiffs in *Citigroup*, the plaintiffs in *McGraw-Hill* are participants in the 401(k) Savings and Profit Sharing Plan of the McGraw-Hill Companies, Inc. and its Subsidiaries, and the Standard and Poor's 401(k) Savings and Profit Sharing Plan for Represented Employees (together, the "McGraw-Hill's 401(k) Plans"). Both Plans are EIAPs that allow participants to invest in a number of different options, including the McGraw-Hill Stock Fund (the "Stock Fund"), which invests primarily in the Common Stock of McGraw-Hill.

On June 12, 2009, after McGraw-Hill stock dropped in price from $68.02 to $24.23, plaintiffs filed a complaint against McGraw-Hill, Marty Martin (the Plan administrator), the Pension Investment Committee (the "Committee"), and McGraw-Hill's Board of Directors (the "Directors") alleging claims similar to the ones in *Citigroup*. The plaintiffs specifically alleged that McGraw-Hill stock became an imprudent investment because its financial services decision, Standard & Poor's (S & P), "knowingly provided inflated ratings to financial products linked to the subprime-mortgage market" and that defendants failed to divest the Plans of the Stock Fund. Plaintiffs further alleged that defendants violated their duty of loyalty by making misrepresentations regarding McGraw-Hill's financial condition in SEC filings incorporated into Plan documents. In addition, they alleged that defendants violated the duty of loyalty because of a conflict of interest, and that the Directors failed to monitor the members of the Pension Investment Committee.

Applying the *Moench* presumption, the court held that, with respect to plaintiffs' claim regarding the Stock Fund being an imprudent investment, even if the allegations in plaintiffs' case were proved—that S&P's Credit Markets Group provided inflated ratings to financial products—they do not establish that "defendants knew or should have known that McGraw-Hill was in a dire situation." The court further stated that "[d]efendants could not reasonably have foreseen, based on the information alleged to have been available to them at the time, the sharp decline in the price of McGraw-Hill stock." McGraw-Hill stock dropped 64% during the class period. The court stated that "[m]ere stock fluctuations, even those that trend downward significantly, are insufficient to establish the requisite imprudence to rebut the presumption." Therefore, the court held that plaintiffs' allegations do not overcome the presumption of prudence afforded to the Plan fiduciary in this case.

With respect to plaintiffs' communications claims, the court held that defendants had no duty to disclose nonpublic information and that the alleged misstatements in the SEC filings (incorporated into Plan documents) were made by defendants acting in a corporate, rather than ERISA, capacity. To the extent that Plan fiduciaries communicated these SEC filings through Plan documents, the court held that plaintiffs have failed to allege that the Plan fiduciary here—Plan administrator Marty Martin—"knew or should have known" that the alleged misstatements were false. Finally, the court held that plaintiffs' remaining claims are derivative and must also fail.

Judge Straub dissented "for substantially the same reasons expressed in his dissent and partial concurrence" in *Citigroup*.

IMPLICATIONS

The Second Circuit's decisions in *Citigroup* and *McGraw-Hill* will have far-reaching effect on numerous stock drop cases pending before the district courts in the circuit as well as any cases currently on appeal. With respect to the managing of employer stock funds, the decisions provide Plan fiduciaries with a strong defense in the *Moench* presumption against allegations of imprudent investment, shield Plan fiduciaries from any liability regarding the failure to disclose nonpublic information to Plan participants, and limit liability regarding alleged misstatements in Plan documents to Plan administrators who knew or should have known that the alleged misstatements were false.

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