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Legal Update
October 20, 2011

Second Circuit Holds that "Presumption of Prudence" Applies in ERISA Stock Drop Litigation

On October 19, 2011, a divided panel of the US Court of Appeals for the Second Circuit issued two long-awaited opinions addressing the legal standard governing breach of fiduciary duty claims brought against administrators of defined-contribution retirement plans in so-called "stock drop" cases. *See In re: Citigroup ERISA Litigation*, No. 09-3804, and *Gearren v. McGraw-Hill Cos., Inc.*, Nos. 10-792, 10-934. We focus on the *In re: Citigroup* decision, which was the lead decision and therefore contained the substance of the Second Circuit's reasoning.

When a company's stock tumbles in value after bad news is revealed, employee stockholders often file complaints charging plan fiduciaries with breaches of duty under the Employee Retirement Income Securities Act (ERISA). Continuing economic difficulties have led to a surge of such "stock drop" actions against large financial institutions and other companies, and a large share of these cases have been filed in district courts within the Second Circuit.

Compared to its sister circuits, the Second Circuit's ERISA stock drop precedent has been relatively undeveloped. With *In re: Citigroup*, the Second Circuit provides guidance on key legal issues—e.g., affirming the applicability of a presumption of prudence to a fiduciary's decision to permit investment in company stock and significantly limiting the extent of fiduciary disclosure obligations—that will make it considerably easier for defendants to obtain early dismissals of stock drop claims in district courts within the Second Circuit.

In the archetypal ERISA stock drop case, the plaintiff contends that the plan's fiduciaries breached their "duty of prudence" to plan participants by allowing them to invest in company stock when the stock was inflated in value or otherwise too risky. The plaintiff usually also alleges that the plan's fiduciaries failed to disclose, or otherwise misrepresented, material information pertaining to the expected performance of company stock. Another common claim is that the fiduciaries acted disloyally or under a conflict of interest.

By these standards, *In re: Citigroup* was an unexceptional case. The plaintiffs were participants in the Citigroup 401(k) plan or a related plan, which were ERISA-governed eligible individual account plans that permitted individuals to choose from a menu of investment alternatives. One of these alternatives was the Citigroup Common Stock Fund, which was specifically required under the terms of the plans to be maintained as an available investment option. As its name indicates, the Citigroup Common Stock Fund was invested in shares of Citigroup stock.

The *In re: Citigroup* plaintiffs alleged that Citigroup stock was an imprudent investment option on account of Citigroup's participation in the subprime mortgage market. According to the plaintiffs, when the subprime market faltered

in 2007, Citigroup's stock took a sharp dive because of the company's allegedly excessive exposure to the risky line of business. The plaintiffs brought suit against the plans' fiduciaries, asserting, *inter alia*, that the fiduciaries acted imprudently by not eliminating Citigroup stock as an investment option, and that they failed to provide complete and accurate information about the magnitude of Citigroup's subprime exposure. The plaintiffs also asserted claims for breaches of the duty of loyalty and a host of derivative claims. The Second Circuit affirmed the district court's dismissal of the complaint in its entirety.

Prudence claim. In accord with decisions of the Third, Fifth, Sixth, and Ninth Circuits, the Second Circuit held that the defendants' decision "not to divest the Plans of Citigroup stock or impose restrictions on participants' investment in that stock" was entitled to a "presumption of prudence" and therefore should be subject only to a deferential abuse of discretion standard of review, as opposed to a stricter one. This "presumption of prudence"—often called the *Moench* presumption after the seminal Third Circuit decision in *Moench v. Robertson*, 62 F.3d 553 (3d Cir. 1995), that first articulated it—entitles fiduciaries to a presumption that they act consistently with ERISA when they maintain company stock as an investment option for participants.

The Second Circuit explained that this presumption "provides the best accommodation between the competing ERISA values of protecting retirement assets and encouraging investment in employer stock." Thus, fiduciaries are not required to divest the plan of "employer stock at the sign of any impending price decline," and mere fluctuations in stock price—even significant ones—are insufficient to rebut the presumption of fiduciary prudence. Rather, the potential for liability attaches only when there are "circumstances placing the employer in a 'dire situation,'" such that any reasonable fiduciary would have been "compelled to find" the plan's express provision for company stock as an investment option should be overridden.[1]

Disclosure and misrepresentation claim. Again aligning the Second Circuit with other Courts of Appeals, the *In re: Citigroup* majority held that fiduciaries have no affirmative "duty to provide Plan participants with non-public information that could pertain to the expected performance" of Citigroup stock. The court held that it was sufficient for fiduciaries to disclose that a company stock fund is, by its nature, "an undiversified investment subject to volatility and that Plan participants would be well advised to diversify their retirement savings." The court also rejected the plaintiffs' misrepresentation claim, concluding that the statements they identified were made by Citigroup and its officers in their *corporate* capacities, and not in their *fiduciary* ones, and thus could not give rise to ERISA liability.

Breach of the duty of loyalty claim. The plaintiffs contended that the "defendants breached their duty to avoid conflicts of interest" because "compensation of some of the fiduciaries was tied to the performance of Citigroup stock." Without difficulty, the Second Circuit rejected this unprecedented, expansive theory of liability, observing that "[u]nder plaintiffs' reasoning, almost no corporate manager could ever serve as a fiduciary of his company's Plan," and holding that there "simply is no evidence that Congress intended such a severe interpretation of the duty of loyalty."

Derivative claims. Having concluded that the complaint did not state a viable claim for relief as to any primary breach of fiduciary duty, the Second Circuit affirmed the dismissal of the various derivative claims asserted by the plaintiffs—e.g., claims that certain defendants had failed to properly monitor their co-fiduciaries or failed to share information with them.

In sum, the *In re: Citigroup* decision addresses a number of important questions of first

impression in the Second Circuit and will have wide-ranging implications for the defendants in stock drop cases. It now is settled that boilerplate allegations that a company's "stock price was 'inflated,'" ostensibly because "the price did not reflect the company's true underlying value," "cannot sufficiently plead a fiduciary breach" claim in the Second Circuit. That said, as district courts wrestle with the implications of the *In re: Citigroup* decision, litigants should expect continuing developments in this evolving area of the law.

Endnotes

[1] Because the Citigroup plan expressly mandated that Citigroup stock be maintained as an investment option under all circumstances, the Second Circuit was not squarely confronted with the issue of what standard of review applies when the plan *authorizes* an employer stock fund, but does not *require* it. The decision suggests that a deferential standard of review still would apply, although "judicial scrutiny should increase with the degree of discretion a plan gives its fiduciaries to invest." Thus, "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."

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