February 11, 2010

Employer Stock Litigation Update: United States Department of Labor Urges Second Circuit Court of Appeals to Reject "*Moench*" Presumption of Prudence in the *Citigroup ERISA Litigation*

Companies that sponsor ESOPs, 401(k) and other forms of eligible individual account plans ("EIAPs") often are subjected to class action lawsuits under ERISA when the company stock held by the plan drops in value. Since the 2001 collapse of Enron Corporation, more than 200 such "stock drop" lawsuits have been filed under ERISA on behalf of alleged classes of plan participants. Historically, many defendants decided to settle these lawsuits – often for tens of millions of dollars – rather than run the risk of a trial.

In recent years, however, the federal courts have shown an increased willingness to dismiss ERISA stock drop lawsuits at an early pre-trial stage. One of the key bases for dismissal is the so-called "*Moench*" presumption of prudence. That presumption (named after a 1995 decision issued by the Third Circuit Court of Appeals) treats a fiduciary's decision to continue offering the company stock investment as being consistent with ERISA, unless the plaintiff can show that the fiduciary knew at a pertinent time of an imminent corporate collapse or other dire situation. Where pleading and proof of that kind of knowledge is absent from the plaintiffs' complaint – which typically is the case for non-bankrupt plan sponsors that remain economically viable – the lawsuit may be thrown out well before trial.

Concerned that the recent court rulings tip too much in favor of fiduciary defendants, the United States Department of Labor ("DOL") has launched a frontal assault on the *Moench* presumption. In a recent amicus curiae brief filed in the *Citigroup ERISA Litigation*, DOL has urged the Second Circuit Court of Appeals to reject the *Moench* presumption as a tool for deciding ERISA stock drop cases. DOL maintains that the stock drop cases should proceed without applying any presumption in favor of fiduciary defendants. In doing so, DOL argues that stock drop cases are not meaningfully different from any ERISA investment case that alleges a fiduciary knowingly caused or permitted the plan to overpay for an otherwise lawful investment.

DOL's arguments, if adopted by the Second Circuit, could substantially change the legal landscape in connection with employer stock investments, including the way that ERISA stock drop cases are litigated. As explained below, however, some of those changes may not necessarily tip the scales in the direction intended by DOL.

Background

By definition, ESOPs and other EIAPs are designed to give participating employees an opportunity to invest in the stock of the sponsoring employer. Even so, hundreds of class action lawsuits have been filed on the theory that ERISA's fiduciary standard of prudent care required plan fiduciaries to remove the employer stock as a plan investment option based on an allegedly foreseen or foreseeable drop in the stock's price.

Without exception, these ERISA lawsuits have been designed to assert claims different from traditional securities fraud claims. Instead of claiming that the plan overpaid for the stock because of an alleged fraud on the market, the plaintiffs in the ERISA stock drop lawsuits allege a broader and conceptually different injury. Specifically, the ERISA plaintiffs typically frame their injury in terms of a lost investment opportunity: had employer stock been discontinued as a plan investment option, money directed to that option would have been invested instead in another plan investment option (or options) where it purportedly would have produced a materially better investment result for the plan and its participants.

The prudence theory advocated in these stock drop cases has forced federal courts to grapple with a number of practical questions under ERISA. A threshold question is whether there can ever be a duty to override plan language that expressly provides for employer stock investments. If such a duty exists, a second question is when and under what circumstance such a duty to override plan language might be triggered.

As to the first question, a few federal courts have suggested that, if a plan mandates that employer stock be included as an investment option, a fiduciary may not have a duty to override the plan terms in any circumstances. Assuming there could be such a fiduciary duty, to answer the latter question, a number of federal courts have borrowed a principle developed under the common law of trusts. That principle can require a fiduciary to disobey trust language providing for a specified investment if, owing to circumstances not anticipated by the trust's settlor, continuation of the investment would defeat or substantially impair the accomplishment of the purposes of the trust. Applying this trust law principle to ERISA, a number of federal courts have adopted a presumption of prudence for ESOP and EIAP fiduciaries. That presumption treats a fiduciary's decision to continue offering company stock investments under such a plan as being consistent with ERISA's standard of prudent care, unless circumstances unforeseen by the plan's settlor somehow create the type of dire economic situation that would make continued company stock investments defeat the plan's purpose.

The United States Courts of Appeals for the Third, Fifth and Sixth Circuits have expressly adopted this presumption as part of federal common law under ERISA. The United States Courts of Appeals for the Seventh and Ninth have affirmed summary dismissals of ERISA stock drop claims without specifically adopting such a presumption.

In re Citigroup ERISA Litigation

The United States Court of Appeals for the Second Circuit (which encompasses New York, Connecticut and Vermont) now is being asked to consider the presumption in a case that involves a pair of EIAPs sponsored by Citigroup. Following the pattern allegations in prior ERISA stock lawsuits, the plaintiffs in the *Citigroup* case alleged that plan fiduciaries should have jettisoned the plans' Citigroup stock investments sometime in 2007 or 2008 because those fiduciaries allegedly knew ahead of time that the market value of Citigroup's stock was about to collapse.

The district court in New York in which the case was filed dismissed the lawsuit after concluding that, under the plan documents, the plan fiduciaries had no choice but to offer

Citigroup stock as an investment option. As an alternative ground for dismissal, the court also held that, even if the plan fiduciaries had discretion to remove Citigroup stock from the plans, they did not breach their duties by failing to do so because the fiduciaries were entitled to a presumption that offering Citigroup stock as an investment option was prudent. On this point, the court further held that plaintiffs failed to overcome this presumption because the facts alleged did not suggest "the type of dire situation" that would have caused defendants to believe that continued adherence to the Plans' mandate regarding Citigroup stock was no longer "in keeping with the settlors' expectations of how a prudent trustee would operate." The Citigroup plaintiffs have asked the Second Circuit to reverse the district court's decision

Department of Labor's Amicus Brief

In its amicus brief in support of the plaintiffs, DOL attacks all aspects of the district court's decision. Most importantly, DOL urges the Second Circuit not to adopt any presumption of prudence with regard to plan investments in employer stock.

DOL does not dispute that such a presumption is well rooted in the law of trusts. Nor does DOL take issue with trust law's rationale for using such a presumption to resolve claims that a trust-mandated investment had become an unlawful investment. DOL argues instead that ERISA's "text and policies" do not expressly require federal courts to adopt such a presumption for ERISA cases. Indeed, DOL suggests that employer stock cases are not materially different from any other ERISA lawsuits alleging that a fiduciary knowingly caused or permitted a plan to overpay for an otherwise lawful investment. According to DOL,

> . . . the *Moench* presumption should not apply to a case, like this one, that challenges the prudence and loyalty of purchasing company stock in light of information that the stock's price was "unlawfully and artificially inflated." . . . In this context, presuming that the fiduciaries acted prudently is unwarranted, and the company's viability is irrelevant. Knowingly overpaying for an asset is neither prudent nor in the interest of plan participants and beneficiaries. . . . This follows from the well-established rule that a fiduciary breaches his duties by knowingly paying too much for an asset for the plan. *See Feilen*, 965 F.2d at 671; Restatement (Third) of Trusts § 205 cmt. e, illus. 9.

Brief of Amicus Curiae Hilda L. Solis, Secretary for the United States Department of Labor, *In re Citigroup ERISA Litig*., No. 09-3804-cv (2d Cir.), at pp. 20-21.

Observations

Given the large and growing number of stock drop cases that have been filed, federal trial courts understandably are skeptical of claims positing that EIAP fiduciaries can foresee future stock prices. The *Moench* presumption provides a useful tool for culling claims that are implausible and untenable from the start. It would be unfortunate for EIAP sponsors if the Second Circuit were to discard that presumption as a means to decide stock drop cases at the pre-trial stage.

DOL's arguments for discarding the presumption under ERISA are curious. The Supreme Court has repeatedly instructed federal courts to look to trust law as a source for developing federal common law under ERISA. DOL's brief does not meaningfully grapple with the obvious question why this trust law principle for deciding disputes over trust-mandated investments should not be incorporated into the federal common law under ERISA.

More troubling is DOL's suggestion that ERISA stock drop cases should be handled like traditional cases alleging a knowing overpayment for an otherwise lawful investment asset, rather than as cases alleging that employer stock had become an imprudent (*i.e.*, unlawful, in the plaintiffs' view) investment. Such treatment would reinstate many of the pleading and proof hurdles that private ERISA plaintiffs have sought to avoid since the inception of this form of action.

For example, to maintain a traditional overpayment case, a plaintiff must plead and prove that the plan, in fact, overpaid for the asset in question. Where, as in the *Citigroup* case, that asset is publicly-traded stock, this would seem to require pleading and proof that the market price of that stock was artificially inflated as a result of fraud on the market. Federal law imposes a heightened standard for pleading any such fraud, and it is highly questionable whether many of the pattern-cut ERISA employer stock complaints would meet that standard.

And, like many other cases that have been filed, the ERISA based claims in *Citigroup* are being pursued at the same time that other plaintiffs are pursuing parallel securities fraud litigation against the plan sponsor. DOL's overpayment theory begs the additional question of why the ERISA case would not be entirely or substantially redundant of the parallel securities fraud case. Indeed, the traditional monetary remedy for an ERISA overpayment case is restoration of the actual overpayment with interest (in contrast to the lost-opportunity measure sought in cases alleging an unlawful investment). Yet that overpayment remedy would be indistinguishable from the remedy typically sought in any such parallel securities fraud case.

Finally, DOL's brief does not offer any meaningful suggestions on how EIAP fiduciaries might identify whether and when the market price of employer stock has been artificially inflated by fraud. Instead, and quoting a 2004 Field Assistance Bulletin, DOL merely restates its view that "if" a fiduciary learns of such fraud through non-public information, the fiduciary should not buy employer stock at artificially inflated prices. *Id.*

* * *

Groom Law Group is representing defendants in several stock drop lawsuits and we continue to track developments in this area. If you would like further information or have question regarding the fee cases, please contact one of the following Groom attorneys:

Jon Breyfogle	jwb@groom.com	(202) 861-6641
Lars Golumbic	lcg@groom.com	(202) 861-6615
Tom Gigot	tsg@groom.com	(202) 861-6624
Mike Prame	mjp@groom.com	(202) 861-6633
Ted Scallet	eas@groom.com	(202) 861-5422
Julia Zuckerman	jez@groom.com	(202) 861-6605