ERISA Litigation ADVISORY

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Second Circuit Affirms Dismissal of *In re Citigroup ERISA Litigation* and *Gearren v. McGraw-Hill Cos., Inc.* and Joins the Third, Fifth, Sixth and Ninth Circuits in Adopting the *Moench* Presumption

On October 19, 2011, the Second Circuit affirmed the dismissal of two high-profile employer-stock drop cases and joined several sister circuits in officially adopting the *Moench* presumption of prudence. It also joined the Third Circuit in holding that there is no fiduciary duty to disclose information about the company's financial condition to participants. *In re Citigroup ERISA Litigation* and *Gearren v. McGraw-Hill Cos., Inc.,* were argued in tandem and decided by separately issued opinions filed on the same day.[1]

Background

Employees of both McGraw-Hill and Citigroup are eligible to participate in 401(k) retirement plans offered by their respective employers, both of which are eligible individual account plans (EIAPs) under the Employee Retirement Income Security Act of 1974, as amended, (ERISA). The 401(k) retirement plans offered by McGraw-Hill and Citigroup included the option to invest in stock funds consisting primarily of employer stock. Shortly after the market crash of 2008, and following a drop in the price of the employer stock held in their 401(k) plans, participants of the McGraw-Hill and Citigroup retirement plans filed class action complaints. During their respective class periods, McGraw-Hill stock dropped from $68.02 to $24.23 and Citigroup stock declined from $55.70 to $26.94.[2]

The plaintiffs filed suit against McGraw-Hill and Citigroup (as plan sponsors), as well as the respective plan administrators, investment and/or administrative committees and the boards of directors. In both cases, the plaintiffs alleged that the defendants (1) acted imprudently by failing to divest employer stock from the retirement plan, (2) failed to provide information about company stock and (3) made material misrepresentations on the soundness of the company stock. The plaintiffs also included additional derivative claims of failure to monitor, divided loyalty and co-fiduciary liability.

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1 *In re Citigroup ERISA Litig.,* No. 09-3804, 2011 WL 4950368 (2d Cir. Oct. 19, 2011); *Gearren v. McGraw-Hill Cos., Inc.,* Nos. 10-792, 10-934, 2011 WL 4952628 (2d Cir. Oct. 19, 2011).

2 *Gearren*, at *1; *Citigroup*, at *2.

The District Court Dismissed All Claims

On August 31, 2009, District Judge Sidney H. Stein granted in full the *Citigroup* defendants' motion to dismiss for failure to state a claim under Fed. R. Civ. P. 12(b)(6).[3] Judge Stein noted that the *Citigroup* defendants "had no discretion whatsoever to eliminate Citigroup stock as an investment option, and defendants were not acting as fiduciaries to the extent that they maintained Citigroup stock as an investment option."[4] He went on to hold that, alternatively, even if the *Citigroup* defendants did have discretion to eliminate Citigroup stock from the plan, they were entitled to a presumption that investment in the company's stock, in accordance with the terms of the plan, was prudent.[5] Judge Stein held that the plaintiffs' allegations fell short of overcoming the presumption.[6] Turning to the communications claim, Judge Stein held that the defendants had no duty to disclose information regarding Citigroup's financial condition and that any alleged misstatements were not made by the defendants acting in a fiduciary capacity or were not made by individuals who knew the statements to be false.[7] Likewise, Judge Stein dismissed the plaintiffs' claims regarding the purported failure to monitor the plan's fiduciaries, failure to disclose information to co-fiduciaries and breach of loyalty.[8]

On February 10, 2010, District Judge Richard J. Sullivan likewise granted the *McGraw-Hill* defendants' motion to dismiss.[9] He held that the *McGraw-Hill* defendants were entitled to a presumption that their decision to offer company stock was prudent.[10] He went on to find that the facts alleged by the plaintiffs were, if proven, insufficient to overcome this presumption.[11] Judge Sullivan also rejected the plaintiffs' contention that the *McGraw-Hill* defendants had an affirmative duty to disclose information regarding McGraw-Hill's financial position to plan participants.[12] He noted that the alleged representations were not made by defendants acting in an ERISA fiduciary capacity.[13] Judge Sullivan also dismissed the plaintiffs' claims regarding purported divided loyalty and a failure to monitor, stating that because the plaintiffs "failed to state a claim for imprudent investment or failure to disclose, they have likewise failed to state a claim under their theories of secondary liability."[14]

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3 *In Citigroup ERISA Litig.,* No. 07-cv-9790, 2009 WL 2762708, at *27 (S.D.N.Y. Aug. 31, 2009).

4 *Id.* at *8 (internal citation omitted).

5 *See id.* at *15-16.

6 *See id.* at *17-19.

7 *See id.* at *20-25.

8 *See id.* at *25-27.

9 *Gearren v. McGraw-Hill Cos., Inc.,* 690 F. Supp. 2d 254, 273 (S.D.N.Y. 2010).

10 *Id.* at 265-70.

11 *Id.* at 270-71.

12 *Id.* at 271-72.

13 *Id.* at 272-73.

14 *Id.* at 273.

The Second Circuit Affirmed

On appeal, the Second Circuit heard argument in tandem on both *Citigroup* and *McGraw-Hill* and affirmed the dismissal of all of the plaintiffs' claims in both cases for failure to state a claim pursuant to Fed. R. Civ. P. 12(b)(6). Most significantly, however, the Second Circuit joined the Third, Fifth, Sixth and Ninth Circuits and explicitly endorsed the *Moench* presumption of prudence as the applicable standard in reviewing such breach of fiduciary duty claims.

The Prudence Claim

The Second Circuit's discussion of the *Moench* presumption and duty of prudence takes place primarily in the *Citigroup* decision, which is incorporated by reference into *McGraw-Hill*. After looking to fellow Circuit court decisions, the Second Circuit announced:

> We now join our sister circuits in adopting the *Moench* presumption – and do so with respect to both EIAPs and ESOPs – because, as those courts have recognized, it provides the best accommodation between the competing ERISA values of protecting retirement assets and encouraging investment in employer stock.[15]

The Second Circuit also endorsed the "guiding principle" of the Ninth Circuit that "judicial scrutiny should increase with the degree of discretion a plan gives its fiduciaries to invest."[16] Thus, it will be harder for plaintiffs to overcome the *Moench* presumption where plan terms require, rather than merely permit, investment in company stock.

In addition to holding that the *Moench* presumption should not just be limited to Employer Stock Ownership Plans (ESOPs) but should extend to all EIAPs, the Second Circuit also agreed that the presumption should apply at the pleading stage. Specifically, the court opined that "[w]here plaintiffs do not allege facts sufficient to establish that a plan fiduciary has abused its discretion, there is no reason not to grant a motion to dismiss."[17]

After the court officially adopted the *Moench* presumption, it went on to analyze whether the presumption was overcome in these cases. The Second Circuit embraced the oft-quoted language from the Third Circuit in *Edgar v. Avaya* that "only circumstances placing the employer in a 'dire situation' that was objectively unforeseeable by the settlor could require fiduciaries to override plan terms."[18] It held that the "abuse of discretion" standard tests "conduct rather than results" and "ensures that a fiduciary's conduct cannot be second-guessed so long as it is reasonable."[19] While reasonableness is not to be judged from hindsight, the Second Circuit noted that Citigroup's stock

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15 *Citigroup*, at *7.

16 *Id. See Quan v. Computer Scis. Corp.*, 623 F.3d 870, 883 (9th Cir. 2010).

17 *Citigroup,* at *8.

18 *Id.* (citing *Edgar,* 503 F.3d at 348).

19 *Id.*

decline (over 50 percent) was comparable to other declines where courts held the presumption was not rebutted.[20]

In support of their breach of the duty of prudence claim, the plaintiffs in *Citigroup* alleged that the defendants were aware of company subprime activities and failed to properly investigate the situation.[21] The plaintiffs in *McGraw-Hill* alleged that the defendants were aware of inflated ratings that made the employer stock an imprudent investment.[22] In affirming dismissal of these claims, the Second Circuit found that the plaintiffs in both cases had not alleged sufficient facts to show that any of the defendants either knew or should have known that their respective company was in the sort of "dire situation" requiring divestment of company stock from the plans.[23]

The Communications Claim

In both cases, the plaintiffs also alleged that defendants breached their fiduciary duties by (1) failing to provide information about company stock and (2) making material misrepresentations about the soundness of company stock. In rejecting the plaintiffs' first communications theory, the Second Circuit held that fiduciaries have no duty to provide plan participants with non-public information about the expected performance of employer stock.[24]

With respect to their second communications theory, plaintiffs had asserted misrepresentations were made in SEC filings, which were incorporated by reference into the plans' summary plan descriptions (SPDs). In rejecting this theory, the Second Circuit noted that when the individual defendants had either signed or prepared the SEC filings, they were acting in a corporate capacity, not in their ERISA fiduciary capacity.[25] Thus, defendants could not be held liable under ERISA for any misstatements in the SEC filings. Further, the court held the plaintiffs failed to allege sufficient facts showing that any individual distributing a SPD was actually aware of any misstatements. The court also recognized there were no "warning flags" that should have triggered further investigation of the SEC filings by the fiduciaries. In this regard, it aptly noted that "requiring Plan fiduciaries to perform an independent investigation of SEC filings would increase the already-substantial burden borne by ERISA fiduciaries and would arguably contravene Congress's intent."[26]

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[20] *Id.* at *10.

[21] *Id.*

[22] *Gearren,* at *1.

[23] *Citigroup,* at *10.

[24] *Citigroup,* at *10; Gearren, at *3.

[25] *Gearren,* at *3.

[26] *Citigroup,* at *13.

Derivative Claims

The plaintiffs in both cases also alleged various secondary claims that failed upon dismissal of the primary breach of fiduciary duty claims. In addition, in *Citigroup*, the plaintiffs raised a "conflict of interest" claim because defendants' compensation was tied to the performance of Citigroup stock. In rejecting this claim, the Second Circuit "agree[d] with the many courts that have refused to hold that a conflict of interest claim can be based solely on the fact that an ERISA fiduciary's compensation was linked to the company's stock."[27]

The Dissent

Judge Straub dissented in both cases, writing a lengthy dissent in *Citigroup* that he incorporated by reference into *McGraw-Hill*. In dissent, Judge Straub rejected the *Moench* presumption as "arbitrary line-drawing [that] leaves employees wholly unprotected from fiduciaries' careless decisions to invest in employer securities."[28] In its place, Judge Straub subjected the defendants' investment decisions to plenary review, thus finding sufficient allegations for plaintiffs' breach of the duty of prudence claims to withstand the Rule 12(b)(6) motions to dismiss.

In analyzing the communications claims, Judge Straub found that ERISA fiduciaries do have an affirmative duty to disclose material information necessary to allow plan participants to adequately protect their interests. Judge Straub also found that plaintiffs had sufficiently alleged that the fiduciaries had knowingly made false statements to plan participants. Finally, Judge Straub would vacate dismissal of all secondary claims, except for the claim in *Citigroup* based on a breach of the duty to avoid conflicts of interest by receiving stock-based compensation. For this claim only, Judge Straub joined the majority opinion affirming the district court's dismissal.

Analysis

This case makes the Second Circuit the latest U.S. Court of Appeal to officially adopt the *Moench* presumption of prudence, joining the Third, Fifth, Sixth and Ninth Circuits.[29] The Second Circuit also joins those courts expanding the *Moench* presumption to all EIAPs (not just ESOPs) and holding that the presumption may be applied at all stages of litigation, including the pleading stage. While not necessarily creating any groundbreaking new law, these two opinions now offer additional authority for defendants that certain stock drop suits may be properly dismissed at the pleading stage.

Unfortunately, this tale of two cases is not necessarily over just yet. Given the length and strength of the analysis of Judge Straub's dissent, it is not only possible, but likely that plaintiffs will seek a panel rehearing or rehearing *en banc*. Furthermore, even without additional review, these decisions

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[27] *Citigroup,* at *14.

[28] *Id.* at *15.

[29] *See, e.g., Moench v. Robertson,* 62 F.3d 553 (3rd Cir. 1995); *Kirschbaum v. Reliant Energy, Inc.,* 526 F.3d 243 (5th Cir. 2008); *Kuper v. Iovenko,* 66 F.3d 1447 (6th Cir. 1995); *Quan v. Computer Scis. Corp.,* 623 F.3d 870 (9th Cir. 2010).

leave the door open for further debate on at least two significant areas as district courts endeavor to apply the *Moench* presumption. First, how dire is “dire”? In his dissent, Judge Straub noted that the majority failed to provide an adequate, workable definition of how “dire” the sponsor’s financial health should be before the presumption dissolves. Second, the guiding principle that “judicial scrutiny should increase with the degree of discretion a plan gives its fiduciaries to invest” leaves open debate as to what magic words in the plan language will heighten or lessen judicial scrutiny. Thus, despite the Second Circuit’s blessing of the *Moench* presumption, the plaintiffs’ bar will undoubtedly continue to pursue such prudence claims and further refine these gray areas still open for debate.

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