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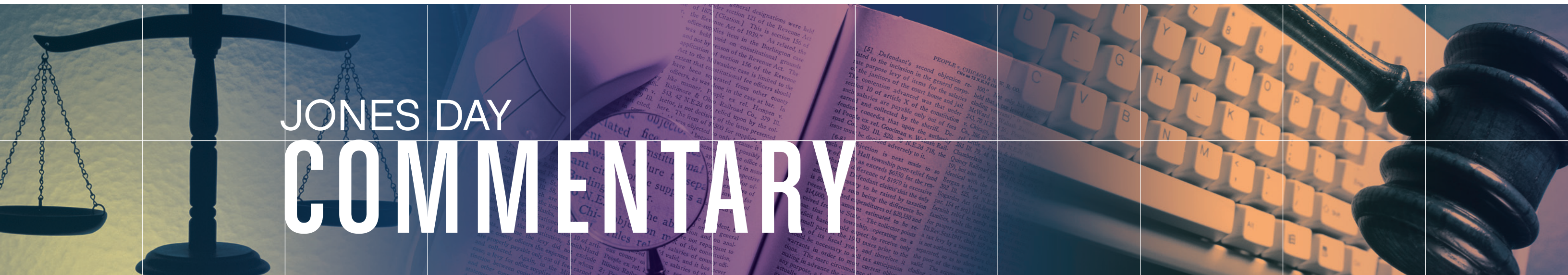

IN RE: CITIGROUP ERISA LITIGATION: HAS THE DEATH KNELL SOUNDED FOR STOCK DROP CASES?

Following the spectacular collapse of Enron in 2001, a cottage litigation industry was created, in which a handful of plaintiffs' firms now routinely rush to bring ERISA class actions whenever a pension plan invests in the stock of the corporate sponsor and the stock price declines significantly. Known in the trade as "stock drop cases," these actions allege that the affected company, and its officers and directors, breached their ERISA fiduciary duties of care and loyalty by permitting employees who were 401(k) and ESOP plan participants to continue to hold and invest plan assets in company stock during the period of decline. In the vast majority of these cases, the litigation pattern is the same. Defendants respond to the complaint with a motion to dismiss for failure to state a claim. If the motion is denied in whole or in substantial part, most defendants promptly settle. Class counsel are only too happy to oblige, and they frequently litigate with an eye solely on muscling a settlement. Thus, successfully defending such suits at the 12(b)(6) stage has become crucial. In recent years, district courts have been more willing to grant such dismissals, but there have been few appellate decisions examining the propriety of a grant of 12(b)(6) relief.[1]

This is perhaps why the Second Circuit's decision in *In Re: Citigroup ERISA Litigation*, —F.3d—, 2011 WL 4950368 (2d Cir. Oct. 19, 2011) (as well as in *Gearren v. McGraw-Hill Co., Inc.* (Case No. 10-792))[2] was so highly anticipated. This respected appeals court was not simply being asked to articulate the standard of review applicable to ERISA fiduciary conduct in the context of stock drop claims, but also to determine the pleading requirements sufficient to allow such complaints to proceed. And it would do so in connection with a stock drop case involving a significant

1 Of the Courts of Appeals to review stock drop cases, only one did so on a motion to dismiss. *See Edgar v. Avaya*, 503 F.3d 340 (3d Cir. 2007).

2 *McGraw-Hill* was a *per curiam* decision in which the majority and the dissent in *Citigroup* adopted the same positions. This *Commentary* will therefore focus exclusively on the *Citigroup* decision.

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player in the subprime mortgage crisis, and where it had received the views of the U.S. Department of Labor, which had filed an amicus brief setting forth its position on the governing legal standards.

On October 19, 2011, in a 2–1 opinion, the Second Circuit affirmed the lower court's dismissal of the complaint. The decision is very favorable to the employer-fiduciary community. First, the Second Circuit officially adopted the *Moench* presumption, becoming the fifth appellate court to do so. The so-called *Moench* presumption was established by the Third Circuit in *Moench v. Robertson*, 62 F.3d 553 (3d Cir. 1995), and it provides that there is a presumption of compliance with ERISA when a fiduciary invests ESOP assets in the employer's stock. Second, the court held that the *Moench* presumption applies not just to ESOPs but to defined contribution individual account retirement plans. Third, the court held that the *Moench* presumption is a standard of review and not an evidentiary presumption, and therefore applies at the pleading stage. Fourth, the court held that the presumption is a "substantial shield" against ERISA fiduciary attack, and that a stock drop complaint must allege facts sufficient to show that the employer was in a "dire situation" in order to overcome the presumption. Finally, the court held that there is no ERISA fiduciary requirement to provide plan participants with nonpublic information pertaining to an employer stock investment option, or any other investment option, and it affirmed dismissal of fiduciary claims relating to failure to provide adequate investment information to participants.

The *Citigroup* decision is unquestionably significant. Plaintiffs' counsel in stock drop litigation invariably take these cases on a contingent fee basis, and it is crucial they be confident they'll overcome a motion to dismiss. Indeed, it is the threat of long and expensive discovery, and the prospect of burdening senior corporate executives with depositions, that often provides such counsel with settlement leverage. The Second Circuit's adoption and application of *Moench* at the pleadings stage reduces the risk that the remaining appellate courts will adopt a rule less favorable to employers. And although the "dire situation" pleading requirement that the *Citigroup* court adopted to overcome *Moench* is somewhat ill-defined, at the least it will require a stock drop complaint to demonstrate extreme corporate distress. The decision may not amount to a tolling of the funeral bells for stock drop litigation, but it surely moves such litigation down a moribund path.[3]

DISCUSSION

The claims in *Citigroup* followed the standard formulation in stock drop cases. The plaintiffs claimed that the defendants breached their fiduciary duty to act prudently by allowing continued investment in employer stock when they should have known that the company would be negatively impacted by its involvement in the subprime mortgage market. The plaintiffs also claimed the defendants breached their duty of loyalty by failing to disclose to participants nonpublic information regarding the expected performance of Citigroup stock. The plaintiffs also included claims for failure to monitor, co-fiduciary liability, and conflict of interest, all of which were derivative of the primary claims, and none of which received much attention from the court.

The Second Circuit's Adoption of *Moench*. The Second Circuit chose to join its sister circuits in adopting *Moench* on the ground that it "provides the best accommodation between the competing ERISA values of protecting retirement assets and encouraging investment in employer stock." 2011 WL 4950368 at *7.[4] Borrowing from the Ninth Circuit decision in *Quan v. Computer Sciences Corp.*, 623 F.3d 870, 883 (9th Cir. 2010), the most recent decision to adopt *Moench* prior to *Citigroup*, the court adopted the "guiding principle" that "judicial scrutiny should increase with the degree of discretion a plan gives its fiduciaries to invest." *Citigroup*, 2011 WL 4950368 at *7. In other words, the court held that attacks on fiduciary decisions to continue to allow participants to hold and invest in company stock will be presumed to be prudent, and will only be overturned if the

3 The plaintiff has already requested and received an extension of time to file a petition for rehearing en banc. If the petition for rehearing is denied, it is likely that the plaintiffs would petition for certiorari, especially in light of the unusually long dissenting opinion.

4 The Second Circuit joined the Sixth, Fifth, and Ninth Circuits in adopting the Third Circuit's *Moench* presumption. *See Kuper v. Iovenko*, 66 F.3d 1447 (6th Cir. 1995); *Kirschbaum v. Reliant Energy Inc.*, 526 F.3d 243 (5th Cir. 2008); and *Quan v. Computer Sciences Corp.*, 623 F.3d 870 (9th Cir. 2010).

fiduciary "abused its discretion." The court also provided a partial victory to those who argued that a "hard-wired" plan was safe from review because the fiduciaries had no discretion to remove the stock option from the plan. The court refused to affirm the district court's holding that the defendants had no liability "because they had no discretion to divest the Plans of employer stock." *Id.* at *8. While the court found that Congressional intent of allowing investment in employer stock must be respected, it could not be so unregulated as to leave retirement savings in employer stock completely unprotected, which it believed would foil Congressional intent of enacting ERISA in the first place. *Id.* at *7–9. It also recognized that plan fiduciaries are obligated to follow the terms of the plan document, but only to the extent consistent with ERISA. *Id.* at *8. The court therefore concluded that to best meet the competing obligations, if the formal pension plan documents "hard wire" the requirement of company stock, the presumption will be harder to overcome than if the plan did not require employer stock, thus providing those with hard-wired plans a greater degree of deference than those without.

The court also summarily rejected a recurring plaintiff-side argument that the *Moench* presumption cannot be appropriately applied at the pleading stage. Albeit without much analysis, the court explained that the "'presumption' is not an evidentiary presumption; it is a standard of review…" and that if a plaintiff does not allege facts to support a finding that the fiduciary abused its discretion, the presumption should lead to the granting of a motion to dismiss. *Id.* at *8.

The Second Circuit's Application of *Moench*. In applying the *Moench* presumption, the court confirmed that the *Moench* presumption is a "substantial shield" for fiduciaries, citing *Kirschbaum v. Reliant Energy, Inc.*, 526 F.3d a243, 256 (5th Cir. 2008), and it determined that it could be overcome only if the complaint pleaded facts to show that there were "dire circumstances" affecting the company. *Citigroup* at *8 ("only circumstances placing the employer in a 'dire situation' that was objectively unforeseeable by the settlor could require fiduciaries to override plan terms"). Unfortunately, the Second Circuit offered little concrete guidance on what constitutes a "dire situation." It implied that one can have a dire situation without an impending collapse, *Id.* at *9, but that mere stock fluctuations, even if significant, and bad business decisions do not qualify as creating a dire situation. For the majority, losses amounting to scores of billions were insufficient to cause a dire situation for a company "with a market capitalization of almost $200 billion," and this was the case even if the relevant fiduciaries had undertaken an investigation that would have revealed that Citigroup's foray into the subprime mortgage market would result in large losses and a significant stock price decline. *Id.* at *9–10. Because the plaintiffs failed to allege facts that would support a conclusion that the defendants could have predicted that Citigroup would lose significant amounts of money, the court affirmed dismissal of their claim.

While the court discussed in some detail the type of investigation a fiduciary might have to undertake in order to avoid a breach of fiduciary duty, and explained that bad business decisions do not suffice to qualify as "dire circumstances," it effectively ignored the plaintiffs' claim that the price of Citigroup stock was "inflated" during the class period. *Id.* at *9. In light of the court's analysis with respect to disclosure obligations and the role of the SEC (discussed below), it's quite possible that the court's subtext is that all securities-sounding claims should be left to the securities laws for resolution.

The Second Circuit's Refusal to Create Fiduciary Duty to Provide All Relevant Investment Information. The plaintiffs also alleged that certain defendants breached their fiduciary duties by failing to provide complete and accurate information regarding Citigroup stock. The court held that fiduciaries do not have a duty "to provide Plan participants with non-public information that could pertain to the expected performance of Plan investment options." *Id.* at *10. The court explained that ERISA contains specific reporting and disclosure requirements that were not violated and that the plaintiffs were unable to provide any case law supporting a general fiduciary duty to disclose information regarding employer stock. *Id.* at *11. The court agreed with the District Court that an imposition of that type of obligation would turn fiduciaries into investment advisors. *Id.*

The court also based its affirmance on the fact that the plaintiffs failed to allege that any defendant made a statement while acting as a fiduciary that the fiduciary knew was false. The court distinguished the cases the plaintiffs cited in support of a duty to inform because in those cases, there was a duty to inform to correct a previous misstatement and because they involved plan administration issues, not investment issues. The court therefore "decline[d] to create a duty to provide participants with nonpublic information pertaining to specific investment options." *Id.* at *11.

The court also undertook an analysis of the plaintiffs' claim that the defendants engaged in misrepresentations. The plaintiffs claimed that even if there were not an affirmative duty to disclose information, there was a fiduciary duty not to misrepresent the expected performance of Citigroup stock. *Id.* at *12. The court explained that in order to have a potential claim, a plaintiff would have to demonstrate that the defendant was acting as a fiduciary when making the misrepresentation. The plaintiffs brought this misrepresentation claim against the company, the CEO, and the Administration Committee that served as plan administrator. The court concluded that neither the company nor the CEO was the plan administrator and that they were therefore not fiduciaries. As they were not fiduciaries, they were not responsible for communications with plan participants. They thus spoke to participants in their employer capacity, rather than as fiduciaries, and could not be liable for a breach of fiduciary duty.

The court also found that the plaintiffs could not maintain a claim against the Administration Committee because there were no allegations that the Administration Committee knew that the information about Citigroup stock included in the SPDs was false. *Id.* at *13. In rejecting the plaintiffs' claim that the Administration Committee should have known the information about Citigroup stock in the SPDs was false, the court found that it would be unreasonable to require plan fiduciaries to investigate the veracity of all SEC filings. The court explained that while it had some leeway to create a federal common law of ERISA, that leeway narrows when there is another federal actor involved, implying that any violations related to the accuracy of SEC filings will be left to the securities laws.

The Dissenting Opinion. Judge Straub dissented from all material parts of the majority opinion. His dissent is notable for its length, which was nearly as long as the majority opinion, and for the unprecedentedly broad legal duties it would impose on fiduciary insiders respecting company stock in 401(k) plans. The dissent disagreed with the majority on both the prudence and communications claims. The dissent rejected the *Moench* presumption as unreasonable, *id.* at *16, and refused to acknowledge any of the policy considerations that the majority believed counseled for a narrower fiduciary rule. Judge Straub concluded instead that *Moench*-type deference "results in an emasculation of ERISA's 'prudent man' standard of conduct," *id.* at *17, and that there should not be special treatment for ESOPs, regardless of the policy reasons supporting the establishment of ESOPs on which *Moench* relied.

With respect to the communication claims, the dissent asserted that there is an obligation to communicate with participants, contrary to what the majority held. The dissent stated that there is a "duty to disclose material, adverse information regarding an employer's financial condition or its stock, where such information could materially and negatively affect the expected performance of plan investment options." *Id.* at *27. Such an assertion, however, conflicts with all the other courts of appeals that have addressed this issue in the stock drop context. The dissent went on to broadly claim that even if an individual is not a fiduciary for any other purpose, based on *Varity v. Howe*, 516 U.S. 489, 502 (1996), anyone who provides information that is linked in any way to plan benefits becomes a fiduciary. *Citigroup*, at *29. Relying on this reasoning, the dissent found that the plaintiffs' allegations that Citigroup communicated about the performance of its stock through writings and town hall meetings, thereby encouraging employees to invest through the plans, sufficed to maintain a claim for misrepresentation.

Open Questions in Second Circuit after *Citigroup*. While the court is firm in its holding that *Moench* provides a strong

presumption of prudence, particularly when the plan documents require that the plan offer employer stock as an investment option, it is less clear with respect to the standard applied when the stock option is not "hard-wired" into the plan. There are several instances in the opinion where the court implies that the standard of review might not be quite as deferential in some circumstances as it is when the stock option is hard-wired into the plan. For instance, the court states that "judicial scrutiny should increase with the degree of discretion a plan gives its fiduciaries to invest" and that therefore "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." *Citigroup*, at *7. At the same time, the court stated that as long as a fiduciary's decision with respect to employer stock is reasonable, it cannot be second-guessed, implying a low level of judicial scrutiny regardless of how much discretion the fiduciaries have in offering employer stock as an investment option. *Id.* at * 8. It's not clear what circumstances would be reasonable where the stock was hard-wired but unreasonable where it wasn't. While *Citigroup* is a very favorable decision for defendants in stock drop cases, the boundaries of reasonableness, particularly when the stock option is not hard-wired, as well as the parameters of "dire circumstances," remain undefined. Although there is no question that *Citigroup* should serve as a nail in the coffin for many stock drop suits, it has not foreclosed them entirely.

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