2nd Circuit: Court Adopts 'Presumption of Prudence' Standard in 'Stock Drop' Cases

11/4/2011 By Ilana S. Pearlman

Courts should presume that administrators of employee stock ownership plans do not violate their fiduciary duties by investing in their employer's stock, the 2nd U.S. Circuit Court of Appeals held.

The appeals court addressed this issue in a pair of class-action cases, *McGraw-Hill* and *Citigroup*, in which employees sued the retirement plan administrators after a significant decline in the value of their employers' stock prices. Among other allegations, the employees alleged that defendants had violated their fiduciary duties under the Employee Retirement Income Security Act (ERISA) by including employer stock as an investment option in their retirement plans.

In its rulings, the court attempted to reconcile two competing goals of ERISA. The first goal is to protect employee retirement security by imposing fiduciary duties on plan administrators. The second goal is to encourage employee stock ownership through employee stock ownership plans (ESOPs) and eligible individual account plans (EIAPs). These goals may sometimes conflict because investments in employer securities are generally riskier than more diversified plans.

To resolve this conflict, the court determined that review of administrators' decisions to permit investment in employer stock should be done under an abuse of discretion standard. Specifically, the court adopted the "Moench presumption," a rebuttable presumption that administrators, by offering employer stock though an ESOP or EIAP, have complied with their fiduciary obligations under ERISA. This presumption can be overcome only by establishing that the administrator knew or should have known that the employer was in a "dire situation" that was unforeseeable by the individual employee.

The court noted that the presumption provides room for reasonable people to disagree about whether to invest or divest from a particular company's stock. Stock fluctuations that trend downward significantly are not enough to establish the requisite imprudence to rebut the presumption of compliance with ERISA. Furthermore, the amount of judicial scrutiny depends on the degree of discretion that the plan allows in making investments; a failure to divest is less likely to constitute an abuse of discretion when the plan requires investment in company stock.

The appeals court applied the Moench presumption in both *Citigroup* and *McGraw Hill*. In *Citigroup*, the employees claimed that Citigroup made ill-advised investments in the subprime-mortgage market while hiding the extent of its investments. However, the court held that the facts were insufficient to show that the situation was "dire." Even if the administrators knew or should have known that a $30 billion loss would eventually occur, that would not have compelled them to find that Citigroup was in a dire situation as it had a market capitalization at the time of nearly $200 billion.

Similarly, in *McGraw Hill*, the employees claimed that the employer's stock became an imprudent investment option because the employer's financial services division, S&P, had knowingly provided inflated ratings on financial products linked to the subprime-mortgage market. The court held that defendants could not reasonably have foreseen, based on the information available to them at the time, the sharp decline in the price of the company's stock that occurred once S&P's rating practices became public.

In both of these cases, before the defendants won on appeal, they had also prevailed on summary judgment motions at the trial court level.

In re Citigroup ERISA Litig. (Gray v. Citigroup Inc.), 2nd Cir., No. 09-3804-cv (Oct. 19, 2011) and *Gearren v. McGraw-Hill Cos.*, 2nd Cir., No. 10-792-cv (L) (Oct. 19, 2011).

Professional Pointer: These cases point out that ERISA retirement plan administrators can face different liability exposure depending on what types of investments the investment plans permit. And the greater the discretion a plan provides with respect to whether to provide employer stock as an investment option, the greater the potential liability exposure.

Ilana S. Pearlman is an attorney with Foster Employment Law, the Worklaw® Network member firm in Oakland, Calif.

Editor's Note: This article should not be construed as legal advice.

Society for Human Resource Management

1800 Duke Street
Alexandria, Virginia 22314 USA

Phone US Only: (800) 283-SHRM
Phone International: +1 (703) 548-3440

TTY/TDD (703) 548-6999
Fax (703) 535-6490

Questions? ContactSHRM
Careers Careers@SHRM