ESOP Law Blog

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Ninth Circuit Adopts *Moench* Presumption in Favor of Fiduciaries

In *Quan v. Computer Sciences Corporation*, No. 09-56190, D.C. No. 2:08-cv-02398-SJO-JWJ, September 30, 2010, the Ninth Circuit has made clear it will apply the so-called *Moench* presumption in favor of fiduciaries who manage employer stock investments for 401(k) plans and ESOPs.

Quan involved a fact pattern fairly common among employer-stock drop cases. Computer Sciences Corporation ("CSC") made substantial errors in running its stock option program and in the related tax accounting for the stock option plans. When these problems came to light, the price of CSC's publicly traded stock suffered a 12% drop in one day. It appears that the stock price recovered fairly quickly after these events.

Plaintiffs charged that it was imprudent of the plan's fiduciaries to offer CSC stock as an investment alternative under the plan, and also charged that the plan committee members made misrepresentations to plan participants through inaccurate securities law filings. The lower court ruled in favor of the fiduciaries, dismissing the case at the summary judgment level. The district court concluded that the plaintiffs failed to establish a breach of ERISA fiduciary duty regardless of whether the district court applied the *Moench* presumption or used a more general prudent fiduciary test.

Prior to *Quan*, the Ninth Circuit had two opportunities to make clear its adoption of *Moench* but did not do so. These cases were *Wright v. Oregon Metalurgical Corp*, 360 F. 3rd 1090 (9th Cir. 2004) and *In re Syncor ERISA Litig.*, 516 F.3rd 1095 (9th Cir. 2008). In adopting the *Moench* presumption, the Ninth Circuit explained its additional thinking on the concerns it had expressed in *Wright*. First, the Court explained that the Moench presumption does not apply in a case asserting a failure to diversify out of employer stock. Both 401(k) plans and ESOPs are exempt from the diversification requirements of ERISA Section 404(a). The Ninth Circuit stated in Quan that there is no need for a presumption of prudence in a diversification case because " . . .fiduciaries are not subject to a prudence requirement to begin with [in a diversification case]". Second, the Ninth Circuit had expressed prior concerns that the *Moench* presumption would encourage corporate officers who are also plan fiduciaries to utilize insider information for the benefit of participants in violation of federal securities laws. In *Quan*, the Ninth Circuit concluded that a properly administered presumption in favor of fiduciaries would actually lessen the risk, since officers who are plan fiduciaries would not feel an obligation to impermissibly use inside information for the benefit of the plan.

Consider the practical effect of the *Moench* preemption. The presumption states that when a fiduciary of a 401(k) plan or ESOP is charged with imprudently investing in employer stock, the court will presume the fiduciary was acting appropriately and the plaintiffs must show the fiduciaries "abused their discretion" in investing in employer stock. A question that has run through the circuit court opinions and that is raised literally in *Quan*, is, "How bad do things have to be before no reasonable fiduciary in similar circumstances would have continued investing in company stock?"

The answer to that question cannot be expressed in black and white. *Quan* looked to some of the standards articulated by the Circuits: (1) would the continued investment in employer stock by the trust "defeat or substantially impair the . . . purposes of the trust"; and (2) was there a "precipitous decline" in stock value coupled with an insider fiduciary's knowledge of the stock's "impending collapse" and the fiduciary's own "conflicted status."

Importantly, *Quan* states that a guiding principle " . . . is that the burden to rebut the presumption varies directly with the strength of a plan's requirement that fiduciaries invest in employer stock>'

After the court concluded that *Moench* applied, it assessed the plaintiffs' claim that the CSC stock was an imprudent investment. First, the Ninth Circuit stated that a fiduciary who becomes aware of circumstances that may impair stock value does not have an immediate duty to sell employer stock. Second, a fiduciary must consider whether a sale will cause the plan to miss future increases in share value. Third, a sudden one-day drop in stock price was not an indicator of imprudence where the share value rebounded in a short period of time. Fourth, the "red flag" issues relating to the stock option plan problems were adequately investigated by CSC and therefore plaintiffs failed to establish that the fiduciaries did not act appropriately in light of the knowledge they possessed. Fifth, the Ninth Circuit confirmed that plaintiffs must show a causal link between the failure to investigate or divest and the harm suffered by the plan.

In adopting the *Moench* presumption, the Ninth Circuit also confirmed that plan fiduciaries are under no ERISA obligation to violate securities laws to benefit the plan's participants over public shareholders.

Finally, we note that the Department of Labor filed amicus briefs in the cases of *Patrick L. Gearren et al. v. The McGraw-Hill Companies, Inc., et al.* and *In re Citigroup Litig.* in the Second Circuit, arguing that the Moench presumption is inconsistent with ERISA fiduciary duties. At this time, the Third, Fifth, Sixth and Ninth Circuits have affirmatively adopted the Moench presumption, with the First Circuit being the only circuit to have rejected the presumption.