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Second Circuit's *Citigroup* Decision Endorses Presumption of Prudence, Upholds Dismissal of Disclosure Claims

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In a much-anticipated decision, the U.S. Court of Appeals for the Second Circuit joined five other circuits in ruling that employer stock in a 401(k) plan is subject to a "presumption of prudence" that a plaintiff alleging fiduciary breach can overcome only upon a showing that the employer was facing a "dire situation" that was objectively unforeseeable by the plan sponsor. *In re Citigroup ERISA Litigation*, No. 09-3804, 2011 WL 4950368 (2d Cir. Oct. 19, 2011). The appellate court found the plaintiffs had not rebutted the presumption of prudence and so upheld the dismissal of their "stock drop" claims.

Background

The *Citigroup* plaintiffs were participants in two 401(k) plans that specifically required the offering of Citigroup stock as an investment option. The plaintiffs alleged that Citigroup's large subprime mortgage exposure caused the share price of Citigroup stock to decline sharply between January 2007 and January 2008, and that plan fiduciaries breached their duties of prudence and loyalty by not divesting the plans of the stock in the face of the declines. The plaintiffs further alleged that the defendants breached their duty of disclosure by not providing complete and accurate information to plan participants regarding the risks associated with investing in Citigroup stock in light of the company's exposure to the subprime market. On a motion to dismiss, the district court found no fiduciary breach because the defendants had "no discretion whatsoever" to eliminate Citigroup stock as an investment option (sometimes referred to as "hardwiring"). Alternatively, the lower court ruled that Citigroup stock was a presumptively prudent investment and the plaintiffs had not alleged sufficient facts to overcome the presumption.

Second Circuit Decision

Oral argument in the *Citigroup* case occurred nearly a year ago, and legal observers have been anxiously awaiting the court's ruling. In a 2–1 decision, with Judge Chester J. Straub issuing a lengthy dissent, the Second Circuit rejected the "hardwiring" rationale but confirmed the application of the presumption of prudence, which was first articulated by the Third Circuit in *Moench v. Robertson*, 62 F.3d 553 (3d Cir. 1995). The court also rejected claims that the defendants violated ERISA's disclosure obligations by failing to provide plan participants with information about the expected future performance of Citigroup stock.

Prudence

Joining the Third, Fifth, Sixth, Seventh, and Ninth Circuits,[1] the court adopted the presumption of prudence as the "best accommodation between the competing ERISA values of protecting retirement assets and encouraging investment in employer stock." Under the presumption of prudence, a fiduciary's decision to continue to offer participants the opportunity to invest in employer stock is reviewed under an abuse of discretion standard of review, which provides that a fiduciary's conduct will not be second-guessed so long as it is reasonable. The court also ruled that the presumption of prudence applies at the earliest stages of the litigation and is relevant to all defined contribution plans that offer employer stock (not just ESOPs, which are designed to invest primarily in employer securities).

Having announced the relevant legal standard, the court of appeals dispatched the plaintiffs' prudence claim in relatively short order. The plaintiffs alleged that Citigroup made ill-advised investments in the subprime market and hid the extent of its exposure from plan participants and the public; consequently, Citigroup's stock price was artificially inflated. These facts alone, the court held, were not enough to plead a breach of fiduciary duty: "[T]hat Citigroup made a bad business decision is insufficient to show that the company was in a 'dire situation,' much less that the Investment Committee or the Administrative Committee knew or should have known that the situation was dire." Nor could the plaintiffs carry their burden by alleging in conclusory fashion that individual fiduciaries "knew or should have known" about Citigroup's subprime exposure but failed to act. Relying on the Supreme Court's decision in *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007), the court of appeals held these bald assertions were insufficient at the pleadings stage to suggest knowledge of imprudence or to support the inference that the fiduciaries could have foreseen Citigroup's subprime losses.

Disclosure

The court's treatment of the disclosure claims was equally instructive. Plaintiffs' allegations rested on two theories of liability under ERISA: (1) failing to provide complete and accurate information to participants (the "nondisclosure" theory), and (2) conveying materially inaccurate information about Citigroup stock to participants (the "misrepresentation" theory).

As to the nondisclosure theory, the court found that Citigroup adequately disclosed in plan documents made available to participants the risks of investing in Citigroup stock, including the undiversified nature of the investment, its volatility, and the importance of diversification. The court also emphasized that ERISA does not impose an obligation on employers to disclose nonpublic information to participants regarding a specific plan investment option.

Turning to the misrepresentation theory, the court found plaintiffs' allegations that the fiduciaries "knew or should have known" about Citigroup's subprime losses, or that they failed to investigate the prudence of the stock, were too threadbare to support a claim for relief. Though plaintiffs claimed that false statements in SEC filings were incorporated by reference into summary plan descriptions (SPDs), the court found no basis to infer that the individual defendants knew the statements were false. It also concluded there were no facts which, if proved, would show (without the benefit of hindsight) that an

1. *See Howell v. Motorola, Inc.*, 633 F.3d 552, 568 (7th Cir.), *cert. denied*, 2011 WL 4530151 (2011); *Quan v. Computer Sciences Corp.*, 623 F.3d 870, 881 (9th Cir. 2010); *Kirschbaum v. Reliant Energy, Inc.*, 526 F.3d 243, 254 (5th Cir. 2008); *Kuper v. Iovenko*, 66 F.3d 1447, 1459–60 (6th Cir. 1995).

investigation of Citigroup's financial condition would have revealed the stock was no longer a prudent investment.

IMPLICATIONS

Coming from the influential Second Circuit, the *Citigroup* decision represents something of a tipping point in stock-drop jurisprudence, especially with respect to the dozens of companies (including many financial services companies) that have been sued in stock-drop cases based on events surrounding the 2007–08 global financial crisis. The Second Circuit opinion gives the presumption of prudence critical mass among appellate courts and signals a potential shift in how stock-drop claims will be evaluated, including at the motion to dismiss stage.[2]

Under the *Citigroup* analysis, fiduciaries should not override the plan terms regarding employer stock unless maintaining the stock investment would frustrate the purpose of the plan, such as when the company is facing imminent collapse or some other "dire situation" that threatens its viability. Like other circuits that have adopted the prudence presumption, the *Citigroup* court emphasized the long-term nature of retirement investing and the need to refrain from acting in response to "mere stock fluctuations, even those that trend downhill significantly." It also sided with other courts in holding that the presumption of prudence should be applied at the motion to dismiss stage (i.e., not allowing plaintiffs to gather evidence through discovery to show the imprudence of the stock). Taken together, these rulings may make it harder for plaintiffs to survive a motion to dismiss, especially where their allegations of imprudence are based on relatively short-lived declines in stock price.

Some had predicted the Second Circuit would endorse the "hardwiring" argument and allow employers to remove fiduciary discretion by designating stock as a mandatory investment in the plan document. The *Citigroup* court was unwilling to go that far, but it did adopt a "sliding scale" under which judicial scrutiny will increase with the degree of discretion a plan gives its fiduciaries to offer company stock as an investment. This is similar to the approach taken by the Ninth Circuit in *Quan* and consistent with the heightened deference that courts generally give to fiduciaries when employer stock is hardwired into the plan. Thus, through careful plan drafting, employers should be able to secure the desired standard of review. Language in the plan document and trust agreement (as well as other documents) confirming that employer stock is a required investment option should result in the most deferential standard and provide fiduciaries the greatest protection.

Also noteworthy was the court's treatment of the disclosure claims. Many stock-drop complaints piggyback on allegations of securities fraud, creating an inevitable tension between disclosure obligations under the federal securities laws and disclosure obligations under ERISA. The Second Circuit did not resolve this tension, but it construed ERISA fiduciary disclosure requirements narrowly and rejected the notion that fiduciaries have a general duty to tell participants about adverse corporate developments. The court made this ruling in the context of SPD disclosures under the 401(k) plan that identified specific risks of investing in Citigroup stock. Plan sponsors should review their SPDs and other participant communications to make sure company stock descriptions are sufficiently explicit

2. That said, plan sponsors and fiduciaries should continue to monitor future developments in *Citigroup* in light of Judge Straub's dissenting opinion and the likelihood of a petition for rehearing (or rehearing en banc), which the *Citigroup* plaintiffs have indicated they intend to seek. In his dissent, Judge Straub rejected the *Moench* presumption in favor of plenary review of fiduciary decisions regarding employer stock. He also disagreed with the majority's interpretation of ERISA disclosure duties.

about issues such as the volatility of a single-stock investment and the importance of diversification. These disclosures may go beyond what is already required under Department of Labor regulations.

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