

Stock Drop Cases and the Presumption of Prudence: When It Applies, How It Is Overcome

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The authors examine the “presumption of prudence” investment standard and fiduciary responsibility.

I. Quotable Quotes

“[W]e hold that in the first instance, *an ESOP fiduciary who invests the assets in employer stock is entitled to a presumption that it acted consistently with ERISA* by virtue of that decision. However, the plaintiff may overcome that presumption by establishing that the fiduciary abused its discretion by investing in employer securities.” *Moench v. Robertson*, 62 F.3d 553, 571 (3d Cir. 1995) (emphasis supplied).

“We do not hold that the Moench presumption applies only in the case of investments in stock of a company that is about to collapse. The presumption, however, is a substantial shield. As Moench states, it may only be rebutted if unforeseen circumstances would defeat or substantially impair the accomplishment of the trust’s purposes. Moench, 62 F.3d at 571. One cannot say that whenever plan fiduciaries are aware of circumstances that may impair the value of company stock, they have a fiduciary duty to depart from ESOP or EIAP plan provisions. Instead, there ought to be persuasive and analytically rigorous facts demonstrating that reasonable fiduciaries would have considered themselves bound to divest. Less than rigorous application of the Moench presumption threatens its essential purpose. A fiduciary cannot

be placed in the untenable position of having to predict the future of the company stock’s performance. In such a case, he could be sued for not selling if he adhered to the plan, but also sued for deviating from the plan if the stock rebounded.” *Kirschbaum v. Reliant Energy, Inc.*, 526 F.3d 243, 256 (5th Cir. 2008) (emphasis supplied).

II. Plans to Which the Presumption Applies

A. **EIAPs.** Courts developed the presumption of prudence to reconcile the conflict between a plan fiduciary’s ERISA obligation to prudently invest plan funds to provide retirement income and ERISA provisions serving the frequently inconsistent policy of promoting employee stock ownership (or at least recognizing that employers may offer better plans if the plan can serve that purpose). ERISA allows individual account plans to promote stock ownership by qualifying as “eligible individual account plans” or EIAPs, comprising the category of “profit-sharing” or “stock bonus” plans (using Code section 401(a) terminology) which expressly provide for the contemplated investment in employer stock. ERISA grants EIAPs exemption from (i) ERISA’s general limitation of plan investments in employer securities to no more than 10 percent of plan assets, (ii) the requirement to diversify investments in order to minimize the risk of large losses, (iii) the duty of prudence to the extent it requires diversification, and (iv) prohibitions

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against self-dealing and transacting with parties in interest, prohibitions that would otherwise impair the plan's ability to acquire employer stock from the company or its significant stockholders.

- B. **ESOPs.** If the EIAP contains additional provisions needed to qualify as an employee stock ownership plan or ESOP (including a requirement that it be designed to invest "primarily in qualifying employer securities"), the plan is also exempt from prohibited transaction provisions barring extensions of credit to such parties, and thus may leverage the acquisition of employer securities. ESOPs also have enjoyed varying income tax incentives thought desirable in the interest of promoting employee stock ownership.

III. Presumption of Prudence— Seminal ESOP Cases

- A. In *Moench v. Robertson*, 62 F.3d 553 (3d Cir. 1995), the Third Circuit, in addressing an appeal from the granting of summary judgment for the defendants, sought to provide a standard for determining when an ESOP fiduciary should be held liable for investing solely in employer common stock when the plan document contains language, required by ERISA, that the primary purpose of the plan is to invest in employer securities.

ESOP participants alleged that the members of the committee that administered the ESOP (who were also members of the Company's Board of Directors) imprudently caused the ESOP to invest solely in Company stock at a time when the stock price was continually and precipitously declining, and despite knowledge of the Company's precarious condition. The Court observed that:

"[U]nlike the traditional pension plan governed by ERISA, ESOP assets generally are invested 'in securities issued by [the plan's] sponsoring company.'" *Id.* at 568 (quoting *Donovan v. Cunningham*, 716 F.2d 1455, 1458 (5th Cir. 1983)).

"ESOPs, unlike pension plans, are not intended to guarantee retirement benefits and, indeed, by its very nature, 'an ESOP places employee retirement assets at much greater risk than does the typical diversified ERISA

plan.'" *Id.* (quoting *Martin v. Feilen*, 965 F.2d 660, 664 (8th Cir. 1992)).

"Congress expressly intended that the ESOP would be both an employee retirement benefit plan and a 'technique of corporate finance' that would encourage employee ownership." *Id.* at 569 (quoting *Martin*, 965 F.2d at 664).

After analyzing the standards imposed on fiduciaries by the common law of trusts, the Third Circuit adopted the presumption set forth in the paragraph at the beginning of this outline. The court stated that in order to rebut this presumption, "the plaintiff may introduce evidence that 'owing to circumstances not known to the settlor and not anticipated by him [the making of such investment] would defeat or substantially impair the accomplishment of the purposes of the trust.'" *Id.* at 571 (quoting Restatement (Second) of Trusts § 227 cmt. g). "[T]he plaintiff must show that the ERISA fiduciary could not have believed reasonably that continued adherence to the ESOP's direction was in keeping with the settlor's expectations of how a prudent trustee would operate." *Id.* However, "courts must recognize that if the fiduciary, in what it regards as an exercise of caution, does not maintain the investment in the employer's securities, it may face liability for that caution, particularly if the employer's securities thrive." *Id.* at 571-72.

The court further observed that "as the financial state of the company deteriorates, ESOP fiduciaries who double as directors of the corporation often begin to serve two masters," and "the more uncertain the loyalties of the fiduciary, the less discretion it has to act." *Id.* at 572. Under such circumstances, "if the fiduciary cannot show that he or she impartially investigated the options, courts should be willing to find an abuse of discretion." *Id.*

Applying these principles, the Court noted that plaintiffs contended "that the precipitous decline in the price of [the Company's] stock [from \$18.25 per share to less than 25 cents per share], as well as the Committee's knowledge of its impending collapse and its members' own conflicted status, changed circumstances to such an extent that the Committee properly could effectuate the purposes of the trust only by devi-

ating from the trust's direction or by contracting out investment decisions to an impartial outsider." *Id.* Because the record was incomplete, the Third Circuit reversed the grant of summary judgment to the defendants and remanded for further factual development. *Id.*

After remand, the parties agreed to a settlement in which defendants paid \$700,000 to the ESOP to be distributed to eligible members of the plaintiff class. *Moench v. Robertson*, Civ. Action No. 92-4829 (MLP), 1996 U.S. Dist. LEXIS 21898, at *14 (D.N.J. Nov. 1, 1996).

- B. In *Kuper v. Iovenko*, 66 F.3d 1447 (6th Cir. 1995), the Sixth Circuit applied the presumption of prudence in affirming the district court's grant of summary judgment dismissing a claim that plan committee members breached their fiduciary obligations by failing to diversify or liquidate an ESOP's holdings during an 18-month period in which the company's stock declined from approximately \$50 per share to approximately \$10 per share. Citing *Moench*, the Sixth Circuit stated: "We agree with and adopt the Third Circuit's holding that a proper balance between the purpose of ERISA and the nature of ESOPs requires that we review an ESOP fiduciary's decision to invest in employer securities under an abuse of discretion. In this regard, we will presume that a fiduciary's decision to remain invested in employer securities was reasonable. A plaintiff may then rebut this presumption of reasonableness by showing that a prudent fiduciary acting under similar circumstances would have made a different investment decision." *Id.* at 1459.

The court concluded that plaintiffs failed to overcome the presumption, despite evidence that defendants did not investigate the appropriateness of diversifying or liquidating the ESOP in the face of the substantial decline in the price of the company's stock, plaintiffs' assertion that defendants' decision to continue to hold employer stock was unreasonable because they were aware of events that would cause the stock to continue to decline in value, and the company CEO's sale of his stock. The court held that a failure to investigate alone does not establish that the decision to hold company stock was imprudent. "Instead, to show that an investment decision breached a fiduciary's duty to act reasonably in an effort to hold the fiduciary liable for a loss attributable to this investment decision, a plaintiff

must show a causal link between the failure to investigate and the harm suffered by the plan." *Id.* The court held that plaintiffs' showing was insufficient to establish a causal link in light of defendants' evidence that the stock price fluctuated significantly during the period in question and several investment advisors recommended holding the stock. *Id.* at 1460.

- C. The presumption of prudence adopted in *Moench* and *Kuper* has generally been followed by courts considering whether ESOP fiduciaries acted imprudently when they purchased or held employer stock. (Notably, the Ninth Circuit has expressly declined either to adopt or reject the *Moench* presumption, see IX below.) However, *Moench* and *Kuper* did not address whether the presumption should also be applied to eligible individual account plans ("EIAPs") other than ESOPs.

IV. Application of the Presumption of Prudence to EIAPs other than ESOPs

- A. ERISA defines an EIAP, in pertinent part, as "an individual account plan which is (i) a profit-sharing, stock bonus, thrift, or savings plan; [or] (ii) an employee stock ownership plan" which "explicitly provides for the acquisition and holding of" employer stock. 29 U.S.C. § 1107(d)(3). ERISA exempts EIAPs from ERISA's diversification requirement (including the prudence requirement insofar as it requires diversification), as well as the 10% limit on holding employer securities.
- B. In *Wright v. Oregon Metallurgical Corp.*, 360 F.3d 1090, 1098 n.3 (9th Cir. 2004), the Ninth Circuit, while declining to adopt the *Moench* presumption, held that "stock bonus plans, as present in this case, and ESOPs are both EIAPs and are treated the same for the purpose of fiduciary duty analysis."
- C. In *Edgar v. Avaya, Inc.*, 503 F.3d 340 (3d Cir. 2007), the Third Circuit expressly held that the *Moench* presumption applies to claims involving EIAPs other than ESOPs:

Because one of the purposes of EIAPs is to promote investment in employer securities, they are subject to many of the same exceptions that apply to ESOPs For example, § 1104(a)(2) provides that all EIAPs, not just ESOPs, are exempt from

ERISA's duty to diversify: 'In the case of an *eligible individual account plan* . . . the diversification requirement . . . and the prudence requirement (only to the extent that it requires diversification) . . . is not violated by acquisition or holding of . . . qualifying employer securities.' 29 U.S.C. § 1104(a) (2) (emphasis added). And § 1108(e)(3)(A) states that ERISA's prohibitions against dealing with a party in interest or self-dealing 'shall not apply to the acquisition or sale by a plan of qualifying employer securities . . . if the plan is an *eligible individual account plan*.' 29 U.S.C. § 1108(e)(3)(A) (emphasis added). Consequently, EIAPs, like ESOPs, 'place employee retirement assets at much greater risk' than traditional ERISA plans. *Wright*, 360 F.3d at 1097 n. 2. Given these similarities, we conclude that the underlying rationale of *Moench* applies equally here. 503 F.3d at 347 (alterations in original).

D. Avaya's holding that the *Moench* presumption of prudence applies to all EIAPs and not only to ESOPs has generally been followed in subsequent cases. See, e.g., *Kirschbaum v. Reliant Energy, Inc.*, 526 F.3d 243, 254 (5th Cir. 2008) ("The *Moench* presumption logically applies to any allegations of fiduciary duty breach for failure to divest an EIAP or ESOP of company stock."); *In re Merck & Co. Vytorin ERISA Litig.*, No. 08-CV-1974 (DMC), 2009 WL 2834792, at *2 (D.N.J. Sept. 1, 2009); *Morrison v. MoneyGram Intl., Inc.*, 607 F. Supp. 2d 1033, 1051 (D. Minn. 2009); *Urban v. Comcast Corp.*, Civ. Action No. 08-773, 2008 WL 4739519, at *12 (E.D. Pa. Oct. 28, 2008); *In re Dell, Inc. ERISA Litig.*, 563 F. Supp. 2d 681, 692 (W.D. Tex. 2008); *In re RadioShack Corp. "ERISA" Litig.*, 547 F. Supp. 2d 606, 613 (N.D. Tex. 2008).

V. Presumption of Prudence Not Overcome: Complaint Dismissed

A. **Bare allegations of fraud and wrongdoing do not overcome the presumption.** In *Avaya*, the Third Circuit relied on *Moench* to affirm a dismissal of plaintiff's claim that the defendants—officers of the employer who administered its EIAP—acted

imprudently when they continued including the employer's common stock as an investment option during a period in which the defendants knew the employer was experiencing difficulties from a recent acquisition and a dramatic reduction in demand for its products, and the stock price declined from \$10.69 to \$8.01 per share. The court held that plaintiff's allegations did not present "the type of dire situation which would require defendants to disobey the terms of the Plans by not offering the Avaya Stock Fund as an investment option, or by divesting the Plans of Avaya securities." 503 F.3d at 348. The court stated that "[w]e do not interpret *Moench* as requiring a company to be on the brink of bankruptcy before a fiduciary is required to divest a plan of employer securities," but "the bare allegations of fraud and other wrongdoing set forth" in the complaint were insufficient to establish an abuse of discretion, particularly in light of a quick rebound in the price of the employer's stock. *Id.* at 349 n.13.

B. **The presumption was not overcome where the Company's viability was not threatened.** Similarly, in *Kirschbaum v. Reliant Energy, Inc.*, 526 F.3d 243 (5th Cir. 2008), the Fifth Circuit held that plaintiffs did not state a claim for breach of fiduciary duty with allegations that the Company and the EIAP committee acted imprudently by continuing to purchase and hold the Company's stock when they had inside knowledge that the Company was engaging in "round-trip" trading, which artificially inflated its stock price. The court held that even though the value of the Company's stock dropped by forty percent when the round-trip trading became known, there was no indication that the Company's viability as a going concern was threatened nor that its stock was in danger of becoming essentially worthless, and therefore the *Moench* presumption of prudence was not overcome. *Id.* at 256.

C. **Allegations of imprudent business practices that did not create a "dire situation" do not state a claim that overcomes the presumption.** In *In re Citigroup ERISA Litig.*, No. 07 Civ. 9790, 2009 WL 2762708, at *15-19 (S.D.N.Y. Aug. 31, 2009), plaintiffs claimed that the committee members for Citigroup's 401(k) plans breached their duty of prudence by failing to eliminate Citigroup stock as an investment option. Plaintiffs alleged that Citigroup engaged in a pattern of risky loan

practices and mortgage-related investments, and assumed liabilities that were not reflected on Citigroup's balance sheet but instead were contained in off-balance-sheet entities; and that as a result, Citigroup suffered losses totaling tens of billions of dollars when the subprime mortgage market crashed, and the price of Citigroup stock declined by 52 percent. *Id.* at *18. The court held that plaintiffs' allegations that Citigroup engaged in imprudent and risky business strategies that resulted in substantial losses did not present the type of "dire situation" that would cause a reasonably prudent fiduciary to conclude that continued adherence to the plans' mandate regarding Citigroup stock was no longer in accord with the settlor's expectations of how a prudent trustee would operate. *Id.* The court noted that other courts have held that stock price declines of similar or greater magnitude were not enough to overcome the *Moench* presumption, and that the allegations did not provide any indication that Citigroup's viability as a going concern was threatened, particularly given Citigroup's enormous size. *Id.* at 18-19.

D. **The presumption was not overcome by allegations that amount to normal business vicissitudes.** In *In re Avon Products, Inc. Sec. Litig.*, No. 05 Civ. 6803 (LAK) (MHD), 2009 WL 848083 (S.D.N.Y. Mar. 3, 2009) (Report and Recommendation of Magistrate Judge), *adopted by District Court*, 2009 WL 884687 (S.D.N.Y. Mar. 30, 2009), plaintiffs claimed that members of Avon's Retirement Board and five of its senior officers breached their duty of prudence as ESOP fiduciaries by continuing to offer Avon stock as an investment option during a period in which Avon stock suffered losses because of company recruitment and sales practices that increased short-term sales and earnings but were likely to adversely affect corporate performance. The price of Avon common stock went from \$34.36 at the start of the class period to more than \$45.00, before descending to \$26.00 at the end of the class period. 2009 WL 848083, at *11. The court concluded that these allegations failed to state a claim that overcame the *Moench* presumption: "Indeed, the courts have regularly rejected claims based on allegations or proof that the company was suffering from far more substantial slides in its stock price, whether as a result of short-term or longer-term circumstances, together with other

corporate woes far more serious than plaintiffs' criticisms of Avon's business practices." *Id.* "The complaint is devoid of any suggestion that during the class period Avon was in the grip of such a long-term and serious slide as to justify compelling the fiduciaries to deprive the Plan participants of the Avon-investment option that the Plan was designed to give them. Moreover, apart from the share-price fluctuations, even assuming *arguendo* that their critique of the recruitment and selling practices that they identify has some merit, plaintiffs identify no long-term systemic crises in the company's operations." *Id.*

E. **Allegations that do not establish that the overall viability of the Company was in jeopardy do not overcome the presumption.** In *In re Bausch & Lomb Inc. ERISA Litig.*, No. 06-CV-6297, 2008 WL 5234281 (W.D.N.Y. Dec. 12, 2008), plaintiffs claimed that members of B & L's board of directors and 401(k) plan committee breached their duty of prudence as plan fiduciaries by failing to remove company stock from the plan when the stock price allegedly became artificially inflated due to accounting fraud by B & L's foreign subsidiaries and a risk of infection posed by one of B & L's products. The district court held that the *Moench* presumption of prudence "is rebutted only when a company's overall viability appear[s] to be in jeopardy" and that plaintiffs' allegations failed to overcome the *Moench* presumption. *Id.* at *6. "Even if the plaintiffs' allegations were true and even if the alleged fraud were known to the Plan's fiduciaries, the allegations would not have led a reasonable Plan fiduciary to conclude that B & L's financial condition was in the type of jeopardy that would have caused the Plan drafters to discontinue participant discretion to invest in and out of the B & L Stock Fund and instead discontinue that Fund altogether." *Id.* The allegations in the complaint did not present a situation where the company's financial situation was seriously deteriorating and there was a genuine risk of insider self-dealing, nor were the supposed misrepresentations alleged to have inflated B & L's stock price by a magnitude that would have caused a reasonable fiduciary to conclude that B & L's financial condition required the divestiture of B & L stock. *Id.*

F. **The presumption was not overcome by allegations of misleading statements and a stock drop.** In *In re RadioShack Corp. "ERISA" Litig.*, 547 F.

Supp. 2d 606 (N.D. Tex. 2008), plaintiffs claimed that RadioShack executives who administered its 401(k) plan breached their duty of prudence by permitting investments in RadioShack stock despite knowing information about RadioShack's business that made those investments undesirable. Plaintiffs alleged that RadioShack issued a series of false statements in press releases, quarterly reports, and presentations to investors and analysts that overstated earnings, inflated earnings projections, and overvalued inventory; that these statements touted RadioShack's culture of integrity and inventory controls, and included assurances that the inventory would not have to be marked down; and that in 2006 RadioShack announced that it did write down \$62 million in inventory in 2005, and its stock then dropped 8 percent. The district court held that plaintiffs' allegations failed to state a claim for breach of the duty of prudence because they did not present the type of dire situation that would require a reasonable fiduciary to divest the plans of company stock, and mere stock fluctuations, even those trending significantly downward are insufficient to overcome the *Moench* presumption of prudence. *Id.* at 615-16.

G. **Allegations of business difficulties and stock underperformance were insufficient to overcome the presumption.** In *In re Dell, Inc. ERISA Litig.*, 563 F. Supp. 2d 681 (W.D. Tex. 2008), plaintiffs claimed that the members of the 401(k) plan committee plan breached their duty of prudence by including Dell stock as an investment option when they knew or should have known the stock price was artificially inflated by Dell's undisclosed use of improper accounting and financial reporting techniques. Plaintiffs alleged that defendants "(1) knew Dell was experiencing a significant decline in profit margins, sales, and market share but failed to accurately reveal the true nature of its declining business, instead reporting industry-leading results and growth; (2) knew improper accounting practices were inflating Dell's profit and revenue growth reports; (3) knew of, but failed to disclose, unfavorable inventory accumulation trends; (4) knew of, but failed to timely disclose, a massive battery recall; and (5) knew Dell was failing in its efforts to expand into other business areas." *Id.* at 694. Plaintiffs cited the underperformance of Dell stock in relation to various stock indexes as evidence that con-

tinued investment in Dell stock was imprudent. However, the district court held that plaintiffs' allegations were insufficient to overcome the *Moench* presumption of prudence as adopted by the Fifth Circuit in *Kirschbaum*. "[T]here is no indication Dell's survival was ever threatened nor that Dell's stock was in danger of becoming worthless." *Id.* Mere stock fluctuations, even when trending significantly downward, were insufficient to overcome the presumption.

VI. Complaint Not Dismissed: Plaintiffs Were Found Not to be Required to Plead Facts Sufficient to Overcome The Presumption of Prudence At The Motion to Dismiss Stage, Or Allegations of Undisclosed Business Difficulties That Had a Substantial Adverse Impact, High Risk or a Stock Collapse Were Found Sufficient To Do So

A. **The Presumption Was Found Inapplicable At The Motion To Dismiss Stage and in any event overcome by allegations that did not amount to a "dire situation."** In *In re Pfizer Inc. ERISA Litig.*, No. 04 Civ. 10071 (LTS) (JFE), 2009 WL 749545 (S.D.N.Y. Mar. 20, 2009), plaintiffs claimed that Pfizer, Pharmacia (which had been acquired by Pfizer) and members of their boards of directors and plan committees breached their duty of prudence by continuing to offer Pfizer and Pharmacia stock as investment options when they knew or should have known that the failure to disclose problems concerning Celebrex and Bextra artificially inflated the stock price, and that defendants concealed or presented misleading information about studies that revealed health risks posed by the products. Plaintiffs further alleged that because the vast majority of the EIAPs' assets were invested in company stock, their investments lost 24 percent of their value when negative information regarding the two drugs became public. *Id.* at *3. The district court denied defendants' motion to dismiss this claim, holding that (i) the presumption of prudence does

not apply at the pleading stage, and alternatively (ii) even if the presumption did apply plaintiffs' allegations regarding the substantial losses the plans experienced and that defendants knew or should have known of risky business and marketing practices concerning Celebrex and Bextra, were sufficient to state a plausible claim for breach of the duty of prudence. *Id.* at *12. Notably, the court did not address the "dire situation" requirement that *Avaya* and other courts have required plaintiffs to plead to overcome the *Moench* presumption.

B. Allegations of facts establishing that the Company's stock was high risk were found sufficient to state a claim that overcame the presumption even in the absence of fraud or an investment collapse. In *In re Ford Motor Co. ERISA Litig.*, 590 F. Supp. 2d 883 (E.D. Mich. 2008), plaintiffs claimed that Ford, as sponsor of its 401(k) plans (which were found to be ESOPs), and various Ford employees and related organizations involved in administering the plans, violated their duty of prudence by continuing to invest plan assets in Ford stock when that stock had allegedly become an imprudent investment as a result of Ford's poor financial and operating performance. The court denied defendants' Rule 12(b)(6) motion, rejecting defendants' argument that the presumption of prudence permits liability only where the employer's stock price is artificially inflated due to fraud on the market or where the fiduciary knows the company faces imminent collapse: **"In the Court's view, a stock can be imprudently risky for an employee savings plan even in the absence of fraud or imminent collapse.** It is entirely possible that a company built on high speculation – for instance, one with no clear path to profitability, but with possibly tremendous potential – could, without fraud, attract a huge amount of capital from highly risk-tolerant investors, and thus be in no danger of imminent collapse despite being extraordinarily risky. This Court is unable to say as a matter of law that such a company's stock could never be an 'imprudent' investment for an EIAP, especially one whose participants were mostly near retirement and particularly risk-averse." *Id.* at 892 (emphasis supplied). Instead, the district court held the "presumption of prudence means that 29 U.S.C. § 1104(a)(1)-(2) requires fiduciaries to divest their plans of company stock when holding it becomes so risky – that is, so

imprudent – that the problem could not be fixed by diversifying into other assets. In other words, with respect to EIAPs, an abuse of discretion . . . begins (and the presumption of prudence ends) at the point at which company stock becomes so risky that no prudent fiduciary, reasonably aware of the needs and risk tolerance of the plan's beneficiaries, would invest any plan assets in it, regardless of what other stocks were also in that plan's portfolio." *Id.* at 892-93.

C. Allegations of nondisclosure of a "dire situation" which caused a 38 percent stock drop were found sufficient to rebut the presumption on a motion to dismiss. In *In re Merck & Co. Vytorin ERISA Litig.*, No. 08-CV-1974 (DMC), 2009 WL 2834792 (D.N.J. Sept. 1, 2009), plaintiffs alleged that Merck plan fiduciaries breached the duty of prudence by continuing to offer Merck stock as an investment option when they knew of adverse clinical studies regarding Vytorin, Merck's top-selling drug, and the disclosure of the studies eventually caused the price of Merck stock to drop by 38 percent. The district court denied defendants' Rule 12(b)(6) motion, holding that "plaintiffs must plead evidence demonstrating a 'dire situation' at the subject company, . . . [but] they need not plead that the company is 'on the brink of bankruptcy.'" *Id.* at *2; see also *In re Merck & Co., Inc. Sec., Derivative & "ERISA" Litig.*, MDL No. 1658 (SRC), 2009 WL 790452, at *4 (D.N.J. Mar. 23, 2009) (denying defendants' motion for judgment on the pleadings in connection with similar claim based on defendants' alleged knowledge of undisclosed problems regarding the safety of Vioxx).

D. Motion to dismiss granted but with leave to replead facts that would establish defendants' knowledge of nondisclosure that would rebut the presumption. In *In re Schering-Plough ERISA Litig.*, No. Civ. A 08CV1432 (DMC), 2009 WL 2762685 (D.N.J. Sept. 1, 2009), plaintiffs claimed that Schering-Plough and its plan fiduciaries breached their duty of prudence by making company stock available during a period in which they allegedly knew of the adverse clinical study results regarding Vytorin, and therefore knew or should have known that the stock was an imprudent investment alternative for the plans. The court granted defendants' Rule 12(b)(6) motion, holding that plaintiffs failed to plead sufficient factual allegations to support a finding that defen-

dants knew of the clinical study results at the time in question. *Id.* at *2. The court noted, however, that in the related *Merck* cases involving Vytarin it found that knowledge of the clinical study results had been adequately pled and granted plaintiffs leave to amend their complaint. *Id.*

- E. **Plaintiffs were found not to be required to plead specific facts to rebut the presumption at the motion to dismiss stage but only to plead a plausible claim of a breach of the duty of prudence.** In *Shanehchian v. Macy's Inc.*, No. 1:07-CV-00828, 2009 WL 2524562 (S.D. Ohio Aug. 14, 2009), a participant in Macy's 401(k) plan alleged Macy's, a number of its directors and officers and the plan's committee breached their duty of prudence by continuing to permit investment of plan assets in Macy's stock during a period after a corporate acquisition when Macy's stock price was allegedly artificially inflated because of supposed misrepresentations and omissions regarding declining sales growth and its failure to convert stores of the acquired company into Macy's stores. The Court denied defendants' Rule 12(b)(6) motion, relying on *In re Ford Motor Co. ERISA Litig.*, 590 F. Supp. 2d 883 (E.D. Mich 2008), to hold that at the motion to dismiss stage plaintiffs do not have an affirmative burden to plead the specific facts necessary to overcome the presumption of prudence, but only to plead sufficient facts to demonstrate they have a plausible ERISA claim in light of the presumption. 2009 WL 2524562, at *6. The court held that plaintiff's allegations that (i) in spite of problems in the integration process, "Defendants continued to reassure the market and the Plans' Participants regarding the success of the merger"; (ii) "as a result of undisclosed facts concerning the difficulties of the integration process the stock price was artificially inflated," and "Defendants knew or should have known that the stock was an imprudent investment" but continued to invest plan assets in company stock; and (iii) when defendants publicly "conceded the problems with the merger and company sales, the stock plummeted," sufficed for Rule 12(b)(6) purposes. *Id.* at *7.
- F. **Allegations of a high risk company strategy leading to a 92% stock drop were found sufficient to overcome the presumption at the pleading stage.** In *Morrison v. MoneyGram Int'l, Inc.*, 607 F. Supp. 2d 1033, 1052-54 (D. Minn. 2009), a 401(k) plan participant claimed the company, the plan com-

mittee, and various corporate directors and officers breached their duty of prudence by permitting investments in company stock during a period in which the company suffered enormous investment losses and pursued a highly risky strategy involving borrowing money to invest in mortgage-backed securities, and as a result the stock lost 92 percent of its value. *Id.* at 1053. The court held that these allegations sufficed to establish that at some point the company stock became so risky that no prudent fiduciary aware of the needs and risk tolerance of the plan's beneficiaries would have invested any plan assets in it, and were therefore sufficient to overcome the *Moench* presumption of prudence. *Id.* at 1053-54.

- G. **Allegations of serious mismanagement resulting in a 99% stock drop were found to state a claim to rebut any presumption.** In *Jones v. NovaStar Fin., Inc.*, No. 08-00490-CV-W-NKL, 2009 WL 331553 (W.D. Mo. Feb. 11, 2009), a 401(k) plan participant claimed that the company as plan sponsor and administrator, its chairman and CEO, and members of the plan committee breached their duty of prudence by permitting investment of plan assets in company stock when they knew of the company's serious mismanagement and improper business practices in connection with subprime mortgages. *Id.* at *1. Plaintiff alleged that following the revelation of the mismanagement and improper business practices, the stock price dropped by 99 percent. *Id.* at *2. The district court held that plaintiff "has pleaded facts indicating a precipitous decline in Novastar stock and that Defendants knew, or should have known, of NovaStar's impending collapse," and "has adequately pleaded facts overcoming any presumption of prudence applicable to the NovaStar stock investments." *Id.* at *6.
- H. **Elimination of stock fund mandate renders presumption unavailable.** In *Graden v. Conexant Systems, Inc.*, 574 F. Supp. 2d 456 (D.N.J. 2008), the EIAP mandated inclusion of 401(k) plan with an option to invest in Company stock during a portion of the relevant period and eliminated the mandate during the balance of the period. Plaintiff claimed that Company officers and directors, including members of its 401(k) plan committee, breached their duty of prudence by permitting plan assets to be invested in Company stock throughout the period. Plaintiff alleged these investments were imprudent because the defendants

were aware that the Company was experiencing problems integrating corporate acquisitions and was trying to conceal the problems.

The court held the allegations were insufficient to overcome the presumption of prudence and state a claim during the period when the plan mandated that the company stock fund be offered because “the Complaint does not allege any quantifiable financial detriment to [the Company], let alone the dire circumstances that Avaya held might warrant deviating” from the plan’s instructions to permit Company stock as an investment option. *Id.* at 463-64. “Moreover, even if a stock price drop for this time period had been alleged, *Edgar* teaches that this alone, without a corresponding allegation that the fiduciaries knew that [the Company] was about to collapse, would be insufficient to rebut the presumption of prudence and state a viable imprudent investment claim.” *Id.* at 464. However, the court held that plaintiff’s allegations did state a claim for breach of the duty of prudence during the period after the plan was amended to eliminate the language mandating that a company common stock fund be offered as an investment option, and gave the plan committee the authority to determine which investment funds to make available to participants. The court held that at that point defendants were not entitled to the presumption of prudence, under *Moench* and *Avaya* their decisions were subject to de novo review, and plaintiff’s allegations sufficed to state a claim. *Id.*

VII. Summary Judgment for Defendants

A. **Dismissal based on presumption.** In *Shirk v. Fifth Third Bancorp*, No. 05- cv-049, 2009 WL 692124, at *13-14 (S.D. Ohio Jan. 29, 2009), the district court granted summary judgment in favor of the Company and its directors and plan committee members on plaintiffs’ claim that defendants breached their duty of prudence by permitting company stock to be offered as an investment option in the Company’s profit sharing plan, which was determined to be an ESOP, when they knew or should have known that the stock was an imprudent investment. Plaintiffs claimed that defendants knew or should have known that a merger had severely strained the Company’s infrastructure and exposed a widespread

breakdown in its internal controls, undermining the integrity of its financial reporting and leading to an \$81 million charge for an erroneous accounting reconciliation. *Id.* at *1. Plaintiffs also contended that the Company’s misconduct and breakdown in its internal controls led to investigations by the Federal Reserve and the SEC, and that the Federal Reserve took formal action requiring the Company to enter into an agreement admitting that it lacked appropriate internal financial controls and processes and promising to remedy these failings. *Id.* Nevertheless, the district court held that plaintiffs’ evidence failed to overcome the presumption of reasonableness adopted by the Sixth Circuit in *Kuper*. After reviewing the evidence offered by both sides, including defendants’ evidence that the Company’s stock price increased from the beginning to the end of the class period, shareholders had a positive return during the class period, the Company’s financial results compared favorably to those of its peers, and institutional investors increased their Company stock holdings during the class period, the court concluded: “Plaintiffs do not present any testimony, expert or otherwise, that any of the documents evidence that [Company] stock was an imprudent investment option at any time during the Class Period, *i.e.*, that a reasonable fiduciary in the same or similar circumstances would have made different investment decisions. The fact that Defendants may have engaged in some non-optimal business practices is insufficient to rebut the presumption of reasonableness.” *Id.* at *14.

VIII. Victory at Trial for Defendants

A. **Dismissal without regard to presumption.** In *Brieger v. Tellabs, Inc.*, 629 F. Supp. 2d 848, 860-64 (N.D. Ill. 2009), after a bench trial, the district court found that plaintiffs failed to demonstrate that the Company and several of its directors and officers and plan committee members violated their duty of prudence by allowing the plan to continue to hold and invest in Tellabs stock during a period beginning in 2001 when Tellabs and the telecommunications industry generally experienced serious problems. Observing that the Seventh Circuit has neither adopted nor rejected the *Moench* presumption of prudence, the court

held that defendants were entitled to judgment regardless of whether the presumption were to be applied. The court held that the fact that the plan's investment and administrative committees did not discuss whether Tellabs stock should remain part of the plan and did not retain the services of an independent fiduciary did not establish that defendants were procedurally imprudent because the members of those committees were high level executives and employees who discussed Tellabs' business, stock price, and future prospects with each other outside the context of the committees, and "implicitly concluded . . . in light of their intimate knowledge of Tellabs' business, that there was no reason to discuss removing the Tellabs stock fund from the Plan." *Id.* at 862. The court further held that even if plaintiffs had established that defendants failed to properly examine whether to retain Tellabs stock as an investment option, defendants would still be entitled to judgment because the evidence showed that a reasonably prudent fiduciary who undertook such an examination would not have sold the plan's Tellabs stock or removed it as an investment option: "Regardless of whether the standard is impending collapse or something short of that, plaintiffs have not proven that it was imprudent for the Plan to continue investing in Tellabs stock during the class period." *Id.* at 863.

IX. The Ninth Circuit's Independent Thinking

A. **Moench presumption rejected by the Court of Appeals.** In *In re Syncor ERISA Litig.*, 516 F.3d 1095 (9th Cir. 2008); the Ninth Circuit explicitly declined to adopt the *Moench* presumption, reversed the district court's grant of summary judgment in favor of defendants and held that "[w]hile financial viability is a factor to be considered, it is not determinative of whether the fiduciaries failed to act with . . . prudence." *Id.* at 1102. Plaintiffs contended that defendants, while allowing the plan to hold and acquire Syncor stock, knew of and/or participated in an illegal scheme involving the payment of bribes to doctors in foreign countries in order to increase sales and grow Syncor's health care services business, and that after the disclosure of the scheme, Syncor's stock lost almost half its value. After expressly declining to adopt the *Moench* presumption, the court

stated: "In any event, the district court's determination that the Class did not rebut the *Moench* presumption based solely upon Syncor's financial viability (as shown by evidence that Syncor stock outperformed both the NASDAQ and S & P 500) is not an appropriate application of the prudent man standard set forth in either *Moench* or 29 U.S.C. § 1104." *Id.* According to the Ninth Circuit, "A prudent man standard based only upon a company's alleged financial viability does not take into account the myriad of circumstances that could violate the standard. A violation may occur where a company's stock did not trend downward over time, but was artificially inflated during that time by an illegal scheme about which the fiduciaries knew or should have known, and then suddenly declined when the scheme was exposed." The court held that plaintiffs' evidence that defendants continued to purchase and hold company stock when they knew the company had engaged in an illegal scheme raised a genuine issue of material fact as to whether defendants breached their duty of prudence. *Id.* at 1102-03.

- B. **District courts' rejection of the presumption, and denial of motions to dismiss.** Subsequently, district courts within the Ninth Circuit have relied on *Syncor*, and its refusal to adopt the *Moench* presumption, in denying motions to dismiss claims for breach of the duty of prudence. See *In re Fremont Gen. Corp. Litig.*, 564 F. Supp. 2d 1156, 1158 (C.D. Cal. 2008); *In re First American Corp. ERISA Litig.*, No. SACV 07-01357-JVS (RNBx), 2008 WL 5666637, at *4-5 (C.D. Cal. July 14, 2008), *mot. for certification of interlocutory appeal denied*, 2008 WL 5666635, at *1-2 (C.D. Cal. Sept. 12, 2008).
- C. **Moench may not go far enough.** While currently viewed as rejecting *Moench* as overly protective of fiduciaries, other opinions in the Ninth Circuit suggest that *Moench* may provide excessive leeway to hold fiduciaries liable for not following plan document requirements. See the discussion of the *McKesson* and *Wright* cases under X below.

X. Effect of EIAP Mandatory Requirement for Investment in Employer Stock

- A. **Moench explicitly left this issue open.** "In view of our result, we are not concerned with a situation

in which an ESOP plan in absolutely unmistakable terms requires that the fiduciary invest the assets in the employer's securities regardless of the surrounding circumstances. Consequently, we should not be understood as suggesting that there never could be a breach of fiduciary duty in such a case. We similarly do not reach Moench's argument that if the plan directed the Committee to invest the funds solely in Statewide stock, ERISA nevertheless required the Committee to ignore the plan terms when those terms conflicted with its fiduciary obligations under ERISA." *Moench v. Robertson*, 62 F.3d 553, 567 n.4 (3d Cir. 1995); see also *Edgar v. Avaya, Inc.*, 503 F.3d 340, 346 n.10 (3d Cir. 2007) (noting that *Moench* left this issue open).

- B. Several courts have held that an EIAP requirement to invest in company stock is not an absolute defense.** ERISA requires fiduciaries to follow the plan document, but only where not inconsistent with ERISA. See ERISA § 404(a)(1)(D). Accordingly, several courts have held a fiduciary may be held liable for complying with a requirement for investment in employer stock if the requirement becomes inconsistent with ERISA under the particular circumstances. See *Kuper v. Iovenko*, 66 F.3d 1447, 1457 (6th Cir. 1995) ("We conclude that the purpose and nature of ERISA and ESOPs precludes a plan's per se prohibition against diversification or liquidation. . . . ERISA provides that a fiduciary may only follow plan terms to the extent that the terms are consistent with ERISA."); *Shanehchian v. Macy's Inc.*, No. 1:07-CV-00828, 2009 WL 2524562, at *5 (S.D. Ohio Aug. 14, 2009) (following *Kuper*); *In re Ford Motor Co. ERISA Litig.*, 590 F. Supp. 2d 883, 889-90 (E.D. Mich. 2008) (same); *In re Polaroid ERISA Litig.*, 362 F. Supp. 2d 461, 474 (S.D.N.Y. 2005) (same). Even if it is not a complete defense, a mandatory requirement for investment in the employer's stock may (a) narrow the class of persons with fiduciary responsibility to those expressly or impliedly responsible for determining whether the requirement must be disregarded as violative of ERISA, and (b) increase the force of the presumption of prudence which those fiduciaries enjoy.
- C. Other courts have held an EIAP requirement to permit an option to invest in company stock is a complete defense or at a minimum narrows exposure to liability.**
- Administrators of EIAP were not fiduciaries to the extent they maintained an EIAP-mandated option to invest in company stock.** In *In re Citigroup ERISA Litig.*, No. 07 Civ. 9790, 2009 WL 2762708, at *7-14 (S.D.N.Y. Aug. 31, 2009), the court held that under the relevant retirement plans defendants had no discretion to eliminate Citigroup stock as an investment option, so they were not fiduciaries to the extent they maintained Citigroup stock as an investment option. The court concluded that requiring those who administered EIAPs to adhere to the plan's terms regarding employer stock, even when the price of that stock falls, accords with ERISA's text, structure, and purpose. Otherwise, such persons would be placed in the untenable position of having to predict the company stock's future performance and exposed to the risk of liability whether or not they decided to override the plan's terms. *Id.* at *13. The court further held that even if defendants were fiduciaries, plaintiffs failed to state a claim for breach of the duty of prudence. *Id.* at *15-19.
 - When an EIAP requires an option to invest in company stock, EIAP fiduciaries are exempt from a challenge on prudence grounds to offering the option.** In *In re Coca-Cola Enterprises Inc. ERISA Litig.*, No. 1:06-CV-0953 (TWT), 2007 WL 1810211 (N.D. Ga. June 20, 2007), the court granted defendants' motion to dismiss for failure to state a claim, holding that where an EIAP expressly established company stock as an investment option, applying *Moench* to require divestment where company stock is no longer a prudent investment "runs counter to the plain language of ERISA" exempting EIAP fiduciaries from the diversification requirement and the prudence requirement to the extent it requires diversification. *Id.* at *10. Moreover, even if *Moench* were applied, a claim "would still be appropriate only where a company is on the verge of financial collapse." *Id.*; see also *Pedraza v. Coca-Cola Co.*, 456 F. Supp. 2d 1262, 1275-76 (N.D. Ga. 2006) (same).
 - EIAP fiduciaries could not be liable for failing to sell company stock contrary to the plan's terms.** In *In re McKesson HBOC, Inc. ERISA Litig.*, 391 F. Supp. 2d 812, 825-29 (N.D. Cal. 2005), the court granted defendants' motion

to dismiss, holding that imposing liability on ESOP fiduciaries for failing to sell company stock contrary to the plan's terms was inconsistent with ERISA section 404's exemption of ESOP fiduciaries from the diversification requirement and the duty of prudence insofar as it requires diversification. The court held in the alternative that plaintiffs failed to state a claim for breach of the duty of prudence even if *Moench* were applied. *Id.* at 829-33.

4. **Questioning the compatibility of *Moench* with ERISA's exemption of EIAP fiduciaries from the duty to diversify.** In *Wright v. Oregon Metallurgical Corp.*, 360 F.3d 1090 (9th Cir. 2004), the Ninth Circuit, while affirming the district court's dismissal of plaintiffs' claim for breach of the duty of prudence, suggested that *Moench* is difficult to reconcile with ERISA's exemption of EIAP fiduciaries from the duty to diversify (and the duty of prudence insofar as it requires diversification), in effect suggesting that the *Moench* presumption is insufficiently protective of such fiduciaries. *Id.* at 1097. Nonetheless, the court held that even if *Moench* controlled, plaintiffs' factual allegations not only failed to overcome the presumption of prudence but "effectively preclude[d] a claim under *Moench*." *Id.* at 1098. The court noted that published accounts of the employer's earnings and financial fundamentals during the relevant period, which were attached to the complaint, demonstrated that the company "was far from the sort of deteriorating financial circumstances involved in *Moench* and was, in fact, profitable and paying substantial dividends throughout that period." *Id.* at 1099.

XI. Presumption Cannot Be Used Against Fiduciary Who Sold

An interesting twist on the *Moench* presumption of prudence was presented in *Bunch v. W.R. Grace & Co.*, 555 F.3d 1 (1st Cir. 2009), where the First Circuit

rejected plaintiffs' argument that the presumption of prudence should be applied *against* a fiduciary that divests the plan of company stock after which the stock rises.

W.R. Grace's 401(k) plan offered participants 28 investment options, including a fund invested in Grace stock. Facing potential liability in industry-wide asbestos-related personal injury suits, Grace filed for reorganization under Chapter 11, and the plan committee appointed State Street as an independent investment manager to avoid potential conflicts of interest in determining whether to continue the stock fund. After obtaining expert advice, State Street concluded that Grace stock was an inappropriate investment because of the risks to the stock price posed by the potential liability in the asbestos litigation. State Street notified Grace and the plan participants, and then sold the plan's Grace holdings.

Plaintiffs sued claiming that Grace and State Street breached their fiduciary duty when State Street sold the Grace stock at a low price. The First Circuit affirmed the district court's grant of defendants' motion for summary judgment, holding that State Street's "thorough investigative and decisional process that preceded the divestment of the Grace stock," which considered the totality of the circumstances, and Grace's decision to delegate the decisional power to an independent third party, both "unquestionably [met] the prudent man standard embodied in ERISA." *Id.* at 7-8. The court rejected plaintiffs' argument that divesting the Grace stock violated the presumption of prudence favoring retention of company stock: "The presumption favoring retention in a 'stock drop' case serves as a shield for a prudent fiduciary. If applied verbatim in a case such as our own, the purpose of the presumption is controverted and the standard transforms into a sword to be used against the prudent fiduciary. This presumption has not been so applied, and we decline to do so here, as it would effectively lead us to judge a fiduciary's actions in hindsight." *Id.* at 10.

ENDNOTES

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