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The Case Against the Presumption of Prudence

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Some members of the Employee Retirement Income Security Act defense bar would have you believe that ERISA company stock cases, which involve massive losses to tax code Section 401(k) plans and employee stock ownership plans based on defendant/fiduciaries imprudent management of plan assets, are "dead."

Indeed, we have read numerous motions to dismiss in which defendants urge the court to join the so-called "wave of other courts" dismissing plaintiffs' claims for breach of fiduciary duty.

To borrow an often borrowed phrase, rumors of the death of ERISA company stock cases are greatly exaggerated. While some company stock cases have been dismissed, many others have been upheld.[1] Some, but not all of the dismissals can be explained by thin pleadings that lacked "factual content." Others involve a rejection in toto of the concept that company stock investments are subject to ERISA's fiduciary duties.

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The plaintiffs' bar obviously disagrees with this latter approach and believes that, contrary to the purpose of ERISA, it puts at risk a substantial portion of the nation's retirement savings. Appeals are pending, and we shall see whether the extreme view urged in particular by Chamber of Commerce members, including those who benefited from taxpayer bailouts on the eve of bankruptcy—after hundreds of millions of dollars of participants' retirement savings were squandered—will carry the day.

The majority of the decisions have upheld company stock breach of fiduciary duty claims, finding that they present viable causes of action against breaching fidu-

[1] *See, e.g., In re Morgan Stanley ERISA Litig.*, 696 F. Supp. 2d 345 (S.D.N.Y. 2009) (denying motions to dismiss); *In re Regions Morgan Keegan ERISA Litig.*, 692 F. Supp. 2d 944, 49 EBC 1208 (W.D. Tenn. 2010) (46 PBD, 3/11/10; 37 BPR 575, 3/16/10) (same).

ciaries who failed to prudently and loyally manage plan assets. As noted, not all have done so, and a comparison of upheld and dismissed cases shows the many points of disagreement.

Fiduciaries' Hands Aren't Tied

One issue that courts have grappled with of late is whether a plan can ''hard wire'' an investment into a plan document. Often, defendant/fiduciaries will argue that their hands are tied by the text of the plan document, which, they continue, purportedly ''requires'' investment in company stock. This argument, however, is contrary to the text of ERISA, which establishes that a fiduciary may follow plan terms only insofar as they are consistent with ERISA.[2]

Not only is there no basis in ERISA for the ''hands are tied'' argument, it also defies common sense. It cannot be that ERISA—whose fundamental purpose is to prevent misuse and mismanagement of plan assets[3]—can be circumvented through the simple expediency of drafting plan language requiring a particular investment. Were that the case, a plan could require any investment—e.g., lottery tickets, ponzi schemes—with no recourse to participants whose retirement savings are squandered.

Communications From Executives

Another issue is whether ERISA plan participants have a viable claim when an executive officer, such as a chief executive officer, touts the performance of the company and tells employees that the future is good, that negative information is unfounded, that the company stock is a good buy, etc., when none of that is true.

Courts have held that communications regarding company stock that are directed at employees of a company that offers its stock as a plan investment option can be fiduciary communications based on the rationale of *Varity Corp. v. Howe*, 516 U.S. 489, 502-07, 19 EBC 2761 (1996) (holding that ''[c]onveying information about the likely future of plan benefits, thereby permitting beneficiaries to make an informed choice about continued participation,'' constitutes an act of plan administration under ERISA, and explaining that ''lying is inconsistent with the duty of loyalty owed by all fiduciaries codified in section 404(a)(1) of ERISA'').[4]

This result makes sense when you consider the effect that statements of this type have on participants. It is a common perception—right or wrong—that the executive officers of a company are in a position to know and understand what activities the company is involved in and the risks it faces going forward. Participants then make decisions based on what they hear from the ''people in the know.'' If the executive officers were to sound the alarm bell instead, participants could then make informed decisions regarding their plan investments in company stock.

The *Moench* Presumption

A third issue, which is a bit more arcane is the question of the ''presumption of prudence'' that some courts have found apply to decisions by plan fiduciaries to invest in company stock. The presumption was product of a 1996 decision by the Third Circuit, *Moench v. Robertson*.[5] In *Moench*, a plan participant sued an ESOP committee for breach of fiduciary duty based on its continued investment in employer stock when the employer's financial condition deteriorated.[6] The Third Circuit held that a fiduciary's decision to continue holding employer stock in an ESOP is entitled to an evidentiary presumption that the fiduciary acted consistent with ERISA, and that the presumption could only be overcome by establishing that the plan's fiduciary abused its discretion by investing in employer securities.[7]The court then reversed summary judgment for the defendants because the facts alleged (a precipitous drop in stock prices, committee members' knowledge of the impending collapse, and their conflicted loyalties as corporate insiders and fiduciaries), if proven, could overcome the presumption.[8]

As the U.S. Department of Labor has explained,[9] contrary to the *Moench* court's reasoning, there is nothing in the text of ERISA that supports relaxing ERISA's strict fiduciary duties[10]—''the highest known to the law,'' *Donovan v. Bierwirth*, 680 F.2d 263, 272 n.8, 3 EBC 1417 (2d Cir. 1982)—in favor of the judicial creation of a presumption of prudence in favor of employer stock.

The Third Circuit adopted the *Moench* presumption for two reasons. The first was to follow what it thought was the trust-law principle that a trustee must administer the trust consistent with the settlor's intent. Yet, while a trust fiduciary was normally obligated to comply with the terms of a trust, he was also required to act prudently in administering it. Thus, if retaining certain investments became imprudent, the trustee could be held liable for losses that resulted when he failed to deviate from a trust instrument that authorized those investments. This same limitation is in fact written into

[2] *See* ERISA Section 404(a)(1)(D) (plan fiduciaries are required to act ''in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the [duties of prudence and loyalty under ERISA § 404(a)(1)(A) and (B)]''); *see also Cent. States, Se. & Sw. Areas Pension Fund v. Cent. Transp., Inc.,* 472 U.S. 559, 568, 6 EBC 1665 (1985) (''trust documents cannot excuse trustees from their duties under ERISA'').

[3] *See Mass. Mut. Life Ins. Co. v. Russell,* 473 U.S. 134, 140 n.8, 6 EBC 1733 (1985)

[4] *See, e.g., Stein v. Smith,* 270 F. Supp. 2d 157, 173-74, 30 EBC 2421 (D. Mass 2003)(130 PBD, 7/9/03; 30 BPR 1537, 7/15/03) (finding that statements made by the CEO that addressed ''in particular [employees'] investments in [company] stock'' are fiduciary communications under *Varity* for which liability may be imposed under ERISA).

[5] 62 F.3d 553, 19 EBC 1713 (3d Cir. 1995).

[6] 62 F.3d at 558-59.

[7] *Id.* at 571.

[8] *Id.* at 572.

[9] Brief of Amicus Curiae Hilda L. Solis, Secretary of the United States Department of Labor in Support of Appellant Requesting Reversal, *In re Citigroup ERISA Litig.*, No. 09-3804 (2d Cir. filed Dec. 28, 2009)(16 PBD, 1/27/10; 37 BPR 268, 2/2/10); Brief of Amicus Curiae Hilda L. Solis, Secretary of the United States Department of Labor in Support of Appellants Requesting Reversal, *Gearren v. McGraw-Hill Cos., Inc.*, No. 10-792 (2d Cir. filed June 7, 2010)(126 PBD, 7/2/10; 37 BPR 1545, 7/6/10).

[10] ERISA requires fiduciaries to exercise ''the care, skill, prudence, and diligence'' that ''a prudent man'' in similar circumstances and with similar goals would have exercised. ERISA Section 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B).

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ERISA itself.[11] To hold otherwise would eviscerate ERISA's protections for plan participants, permit the settlor to draft plan language requiring that plan assets be invested in particular assets at particular prices without regard to whether those determinations were prudent, and would defeat ERISA's carefully wrought scheme designed to assure that a fiduciary is responsible for all plan investment decisions.

The second justification that the Third Circuit gave for the presumption was a purported congressional intent to encourage employer stock ownership. Though *Moench* was right to say that Congress sought to encourage employee ownership through ESOPs, there is no evidence that Congress intended for ESOP fiduciaries (or fiduciaries of any individual account plan that holds employer stock) to be immune from ERISA's normal standards of prudence and loyalty when purchasing and holding employer stock. To the contrary, by exempting ESOP fiduciaries from the prudence requirement ''only to the extent that it requires diversification,'' Congress made it clear that ESOP fiduciaries remained subject to the same duty of prudence that binds all other ERISA fiduciaries.[12]

In addition to not being supported by the text of ERISA, the *Moench* presumption is inconsistent with public policy. In defined contribution plans, workers' retirement benefits are not guaranteed, but instead are entirely dependent on the investments earnings on contributions.[13] As the Supreme Court recently noted, defined contribution plans (such as 401(k) plans and ESOPs) unlike in the past ''dominate the retirement plan scene today."[14] Where a substantial percentage of the assets held by 401(k) and ESOPs are composed of employer stock, there is good reason to question whether it is either sensible or consistent with ERISA's fundamental purpose of protecting retirement savings to water down ERISA's strict standards of prudence and loyalty for company stock.

We have brought claims on behalf of tens of thousands of plan participants whose retirement savings have been decimated, many of whom have had to postpone retirement, as a result of corporate misdeeds that imperiled their companies. It makes no sense to provide plan fiduciaries with a ''presumption'' that they acted prudently, when in fact it was their (or their colleagues') derelictions of duty that caused the harm to the plan and the plan's participants and beneficiaries.

How can it be presumptively prudent to provide company stock as a plan investment option, when the company is engaged in securities fraud or other illegal activity? How can the decision to offer the investment be presumptively prudent if, as often is the case, the fiduciaries did not actually consider the prudence of the stock, and instead, did nothing as the prospects for the company dimmed?

Instead of some pleading obstacle that assumes a decision is prudent, the more sensible approach is to treat fiduciaries as fiduciaries who are bound by the ''highest duty known to law,'' instead of some different class of fiduciaries whose actions are presumed prudent even in the face of compelling evidence that shows their actions were not (such as the decimation of the investment the fiduciaries were supposed to manage).

Company Stock Claims Remain Viable

There is a growing circuit divide regarding the application of the *Moench* presumption, as well as the contours of a presumption, should it apply. The First, Fifth and Sixth Circuits have adopted some version of the *Moench* presumption.[15] The Seventh Circuit has cited it with approval, though has not explicitly adopted it.[16]The Ninth Circuit has declined to adopt it.[17] Additionally, district court decisions involving the *Moench* presumption have recently been appealed to several circuit courts—including the Second, Fourth, Ninth and Eleventh Circuits—making the presumption a potential candidate for Supreme Court review.

Whatever the outcome of the circuit split—differing standards across the country, or a Supreme Court decision that puts the matter to rest—ERISA company stock claims remain viable. Indeed, numerous courts have upheld company stock claims even applying the presumption of prudence.

Most courts—including every circuit court to have applied the presumption—have concluded that the presumption is rebutted with some combination of allegations of serious corporate misconduct (such as securities fraud), a precipitous decline in the stock price, and dire financial circumstances besetting the company.

The circuit courts (and many district courts) have resolutely rejected the notion that in order to overcome the presumption, the company must be facing ''imminent collapse,'' or be on the ''eve of bankruptcy.'' As the Ninth Circuit explained in *In re Syncor ERISA Litig.*,[18] 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.''[19]

These decisions also carry with them the strong weight of common sense. As the court explained in *Ford*, an imminent collapse standard ''is akin to requiring monitoring of a patient only after he is dead.''[20]

Thus, while the presumption of prudence may present an obstacle for a case based only on a minor and temporary decline in a stock price (what the defense affectionately calls a ''stock drop case''), most courts agree that it is not a bar to a case based on seri-

[11] *See* ERISA Section 404(a)(1)(D), 29 U.S.C. § 1104(a)(1)(D) (fiduciaries must follow the plan document only ''insofar as such documents and instruments are consistent with the provisions of this subchapter").

[12] ERISA Section 404(a)(2), 29 U.S.C. § 1104(a)(2).

[13] *See* 29 U.S.C. § 1002(34).

[14] *LaRue v. DeWolff, Boberg & Assocs., Inc.*, 552 U.S. 248, 255, 42 EBC 2857 (2008)(34 PBD, 2/21/08; 35 BPR 467, 2/26/08).

[15] *Bunch v. W.R. Grace & Co.*, 555 F.3d 1, 45 EBC 2505 (1st Cir. 2009)(19 PBD, 2/2/09; 36 BPR 244, 2/3/09); *Kirschbaum v. Reliant Energy, Inc.*, 526 F.3d 243, 43 EBC 2281 (5th Cir. 2008)(82 PBD, 4/29/08); 35 BPR 1034, 5/6/08); *Kuper v. Iovenko,* 66 F.3d 1447, 19 EBC 1969 (6th Cir. 1995).

[16] *Pugh v. Tribune*, 521 F.3d 686, 43 EBC 1772 (7th Cir. 2008)(64 PBD, 4/3/08; 35 BPR 776, 4/8/08).

[17] *In re Syncor ERISA Litig.*, 516 F.3d 1095, 43 EBC 1005 (9th Cir. 2008)(33 PBD, 2/20/08; 35 BPR 474, 2/26/08).

[18] 516 F.3d 1095, 1102, 43 EBC 1005 (9th Cir. 2008)(33 PBD, 2/20/08; 35 BPR 474, 2/26/08).

[19] *See also Edgar v. Avaya,* 503 F.3d 340, 349 n.13, 41 EBC 2249 (187 PBD, 9/27/07; 34 BPR 2365, 10/2/07)(''[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.")

[20] *In re Ford Motor Co. ERISA Litig.*, 590 F. Supp. 2d 883, 908, 45 EBC 2057 (E.D. Mich. 2008)(246 PBD, 12/24/08;

ous mismanagement resulting in significant losses to participants' retirement savings.

Conclusion

ERISA breach of fiduciary company stock cases trace their origins to corporate scandals such as Enron and WorldCom in which plan fiduciaries offered company stock as a plan investment option while at the same time the companies engaged in high-level accounting fraud that imperiled the companies. These cases proceeded past motions to dismiss and class certification and resulted in significant recoveries of lost retirement savings for plan participants.

A series of settlements in the Enron case, for example, returned in excess of $250 million for class members. Many cases followed—some strong, others weak, and there is now a large number of mostly district court decisions that address the variety of legal issues that the cases present.

The ERISA defense bar seeks to bar any and all actions against plan fiduciaries for failing to prudently and loyally manage their plans' investment in company stock. Their approach ignores the history behind the cases—fiduciaries who squandered hundreds of millions of dollars of participants retirement savings by acting imprudently and disloyally. We all know what happens when we ignore history.

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