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Second Circuit Joins Five Other Circuits in Ruling Company Stock Investments in 401(k) Plans Are Presumptively Prudent

On October 19, 2011, the Second Circuit Court of Appeals became the latest Circuit Court to adopt the "presumption of prudence" test for retirement plans holding company stock as an investment option. *In re Citigroup ERISA Litig.*, No. 09-3804, 2011 WL 4950368 (2d Cir. Oct. 19, 2011); *Gearren v. McGraw-Hill Cos., Inc.*, Nos. 10-792, 10-934, 2011 WL 4952628 (2d Cir. Oct. 19, 2011). The "presumption of prudence" doctrine now governs a federal court's consideration of ERISA "stock drop" class action claims in the Second, Third, Fifth, Sixth, Seventh, and Ninth Circuits.

Two different groups of plaintiffs filed suit against Citigroup and against McGraw Hill alleging the 401(k) plan's fiduciaries violated ERISA by continuing to offer company stock as a plan investment option. Plaintiffs alleged the 401(k) plan fiduciaries "knew or should have known" each company's subprime mortgage exposure made company stock a poor retirement plan investment.

In *Gray v. Citigroup, Inc.*, plaintiffs claimed that Citigroup breached its fiduciary duties by failing to remove company stock as a 401(k) investment when the price of Citigroup's stock declined by 50 percent as a result of the collapse of the subprime mortgage markets. Citigroup's fiduciaries also allegedly "failed to disclose" to the 401(k) plan's participants that Citi's exposure to subprime mortgages would cause hundreds of millions in 401(k) plan losses.

The *Citigroup* court, in affirming a motion to dismiss, found that the presumption of prudence was consistent with ERISA's statutory text and trust law principles. By presuming that a plan fiduciary acted prudently in selecting company stock as a plan investment, the court aimed to strike the appropriate balance between the Congressional goal of promoting employee ownership of company stock and ERISA's goal of ensuring proper management of these plans.

The Second Circuit observed that the presumption of prudence alleviates the pressure on plan fiduciaries to predict the future of the company stock fund's performance. The presumption makes it less likely that a plan fiduciary would be tempted to use insider information to divest company stock, since continued investment in company stock will be presumed prudent. To overcome the presumption of prudence, plaintiffs must allege facts calling into question the company's viability as an ongoing concern. For example, plaintiffs could allege a "precipitous decline" in the company's stock price in conjunction with evidence that the company is "on the brink of collapse" or is "undergoing serious mismanagement."

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The Second Circuit also noted that each 401(k) plan's language will help inform the court as to the appropriate amount of deference available for the questioned conduct. To meet their pleading burden, plaintiffs must allege there were "publicly known facts that would trigger the kind of careful and impartial investigation by a reasonable fiduciary," and allege the plan's fiduciary failed to perform that investigation. In *Citigroup,* writing for the majority, Circuit Judge John Walker further held that Citigroup did not have a fiduciary duty to disclose nonpublic information about how it expected the stock to perform.

Circuit Judge Chester J. Straub dissented. He called the decision an "alarming dilution" of federal law governing retirement plans and said it left no legal remedy for workers who lost years of savings by investing in Citigroup's 401(k) plans, at the bank's "cajoling," which misrepresented its "dismal financial outlook and its massive subprime exposure."

The companion *Gearren v. McGraw-Hill Cos., Inc.* case separately upheld the dismissal of the same claims against McGraw-Hill Cos., the owner of the Standard & Poor's credit rating agency.

Given the Second Circuit's embrace of the presumption of prudence standard, it is incumbent on all 401(k) plan fiduciaries to again review their 401(k) plan's company stock investment language. Properly drafted company stock language may help ensure the presumption of prudence is applied in the event the price of company stock rapidly declines.

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