

AN UNTRUSTWORTHY PRESUMPTION: REPLACING THE *MOENCH* PRESUMPTION WITH A SOUND STANDARD FOR STOCK- DROP LITIGATION

CHRISTOPHER J. BRYANT†

INTRODUCTION

Nearly thirty million private employees participate in retirement plans that offer their employers' stock (company stock) as a required or optional investment.¹ About twenty million of those employees invest in company stock.² In the aggregate, their retirement plans contain more than \$1 trillion in company stock,³ and average about \$50,000 individually.⁴ Over the past two decades, employees who have invested in company stock through these plans have filed numerous lawsuits when the prices of their companies' stocks—and the values of their retirement accounts—drop.⁵ The employees allege that plan

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† Duke University School of Law, J.D. expected 2014; Duke University, A.B. in economics, 2008. Many thanks to Professor Deborah DeMott for advising me through the Note process, Jacob Charles for being a great friend and top-notch note editor, and everyone who put up with me talking about ERISA and the *Moench* presumption.

1. See JACK VANDERHEI, ET AL., EMPLOYEE BENEFITS RESEARCH INSTITUTE, 401(K) PLAN ASSET ALLOCATION, ACCOUNT BALANCES, AND LOAN ACTIVITY IN 2011 26 (2012) (noting that the sample database contained 9.2 Million 401(k) plan participants, which represents approximately half of the universe of plan participants); Florence Olsen, *ESOPs: Report Lists Assets of About \$870 Billion Held in Employee Stock Ownership Plans*, 39 PENS. & BENEFITS R. 345 (Feb. 2, 2012) (noting that around 10 million employees participate in ESOPs).

2. See VANDERHEI ET AL., *supra* note 1, at 26 (noting that 4.6 million surveyed participants actually invest in company stock); *A Statistical Profile of Employee Ownership*, NAT'L CENTER FOR EMPL. OWNERSHIP (Feb. 2012), <http://www.nceo.org/articles/statistical-profile-employee-ownership> (last visited Feb. 20, 2013) (noting that about fifteen million individuals participate in plans that invest exclusively or primarily in company stock).

3. Olsen, *supra* note 1.

4. Some contain substantially more, others substantially less. See VanDerhi et al., *supra* note 1, at 26 (noting that the percent of money invested in company stock by each 401(k) plan participant varies from 0 percent to greater than 80 percent).

5. See generally Michael J. Dell & Michael J. Nassau, *Stock Drop Cases and the Presumption of Prudence: When it Applies, How it is Overcome*, J. RETIRE. PLAN., Nov.–Dec. 2009, at 13 (describing several of the more prominent cases). The defense bar refers to these cases with the “catchy and pejorative moniker” of “stock-drop” cases. See Derek W. Loeser, Erin M. Riley, & Benjamin Gould, *2010 ERISA Employer Stock Cases: The Good, the Bad, and*

administrators breached their fiduciary duties by continuing to invest in company stock or failing to warn employees of an impending drop in stock prices. Because the Employee Retirement Income Security Act of 1974 (ERISA)⁶ governs the administration of these retirement plans,⁷ it serves as the source for the standards courts use to adjudicate these claims.

ERISA outlines a prudent person standard of care for retirement plan fiduciaries, and lists duties designed to ensure that fiduciaries act “solely in the interest of the participants and beneficiaries.”⁸ These include the duties to: (1) act “for the exclusive purpose of . . . providing benefits to [plan] participants and their beneficiaries,” (2) employ the “care, skill, prudence, and diligence” that a prudential person acting in a similar capacity would use to conduct a similar plan, (3) follow plan documents to the extent that they do not conflict with ERISA, and (4) diversify plan investments to minimize the risk of large losses unless diversification would be imprudent.⁹

ERISA exempts the fiduciaries of most plans that contain company stock from the duty to diversify.¹⁰ The Supreme Court has not yet offered the definitive interpretation of this provision, but since the Third Circuit decided *Moench v. Robertson*¹¹ in 1995, circuit courts have consistently held that this exemption establishes a broad presumption of prudence for fiduciaries of plans designed to invest in company stock.¹² This is commonly referred to as the *Moench* presumption.

Under the *Moench* presumption, judicial review of fiduciaries’ decisions to purchase, hold, or sell company stock is subject to an abuse-of-discretion standard.¹³ To overcome the *Moench* presumption, plaintiffs must show the existence of a “dire situation” that threatens a company’s viability or renders the stock essentially

the In Between—Plaintiffs’ Perspective, PENS. & BENEFITS DAILY, 01/28/2011, at 1, 2. Plaintiffs refer to these cases as employer stock cases. *Id.* This Note uses the term stock-drop cases for consistency and its visually descriptive nature, but does not align itself with either bar.

6. Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (codified as amended in scattered sections of 29 U.S.C.).

7. See Part I.

8. 29 U.S.C. § 1104(a)(1).

9. *Id.*

10. See 29 U.S.C. § 1104(a)(2).

11. *Moench v. Robertson*, 62 F.3d 553 (1995).

12. See Part II.B.

13. *Moench*, 62 F.3d at 571. For more discussion, see Part II.

worthless.¹⁴ Plaintiffs in stock-drop cases have experienced great difficulty in meeting this standard,¹⁵ which has effectively insulated fiduciaries from liability in all but the most extreme circumstances.¹⁶ Consider the following examples, which are based on actual stock-drop cases:

1. Plan fiduciaries have observed Big Finance, Inc. substantially increase its ties to the risky subprime securities market over the past few years, but continue to purchase and hold company stock. Plan documents require the fiduciaries to invest 20 percent of the plan assets in company stock. The stock price drops by more than 50 percent.¹⁷
2. The plan documents for Electronic Chain Stores call for fiduciaries to invest up to 50 percent of plan funds in company stock. Despite knowing that the company made false statements about its earnings and inventory, plan fiduciaries continue to invest in company stock. When Electronic Chain Store takes actions inconsistent with its previous statements, the stock price drops 8 percent.¹⁸
3. Global Eyecare Corporation's foreign subsidiaries' dishonest accounting practices have inflated its stock price. In addition, one of its major products is causing eye infections in markets around the world and will

14. See, e.g., *Edgar v. Avaya, Inc.*, 503 F.3d 340, 348 (3d Cir. 2007) (“We cannot agree, however, that these developments, or the corresponding drop in stock price, created the type of dire situation which would require defendants to disobey the terms of the Plans . . .”); Part II.

15. See Corey Rosen, *Courts Continue to Favor Defendants in Recent ‘Stock Drop’ Cases*, 39 PENS. & BENEFITS R. 77 (Jan. 10, 2012) (“[S]ince July of 2010, courts have largely continued to favor defendants.”).

16. See *In re Fannie Mae 2008 ERISA Litig.*, 09 CIV. 1350 PAC, 2012 WL 5198463, at *4–5 (S.D.N.Y. Oct. 22, 2012) (noting that if evidence of the growing rate of foreclosures, concerns about the housing market, concerns about lessened underwriting standards, claims that there would be further deterioration of the housing market in the event of a bubble bursting, concerns about increased exposure to the subprime market, internal risk officers’ warning, and a decrease in plan assets of more than 90 percent was not sufficient to overcome the *Moench* presumption, “it is not clear what would be sufficient”).

17. *In re Citigroup ERISA Litig.*, 662 F.3d 128, 134 (2d Cir. 2011), *cert. denied*, 133 S. Ct. 475 (2012).

18. *In re RadioShack Corp. “ERISA” Litig.*, 547 F. Supp. 2d 606 (N.D. Tex. 2008).

need to be recalled. Plan fiduciaries know this information, but they continue to invest 100 percent of plan funds in company stock. Plan participants allege that the fraudulent accounting practices and the recall have caused the stock price to drop by 25 percent, and that plan fiduciaries breached their duty to deviate from the terms of the plan.¹⁹

4. The terms of Superpower Energy's plan require nearly 100 percent investment in company stock. Plan fiduciaries know that Superpower Energy's stock trading practices over the period of two years have artificially inflated the price of the company stock, but they continue to follow the plan terms and invest in company stock. When the trading practices—the same ones used by Enron—become public knowledge, the stock price drops by more than 40 percent.²⁰

In each of the previous scenarios, the plaintiffs failed to overcome the *Moench* presumption. Fiduciaries and other commentators have faulted the standard because it establishes duties that are contrary to ERISA's provisions²¹ and provides inadequate guidance to the courts.²²

This Note argues that the *Moench* presumption—as currently applied by the courts—is unsound in both theory and practice because it is unsupported by legal doctrine and public policy. The Note proposes that the *Moench* presumption should be replaced by a

19. *In re Bausch & Lomb Inc. ERISA Litig.*, 06-CV-6297, 2008 WL 5234281 (W.D.N.Y. Dec. 12, 2008).

20. *Kirschbaum v. Reliant Energy, Inc.*, 526 F.3d 243 (5th Cir. 2008).

21. *See* Petition for Writ of Certiorati, *Robertson v. Moench*, 1995 WL 17036143 (No. 95-917) (“The decision below frustrates that Congressional intent by holding that ESOP fiduciaries may be sued under ERISA for making the very investment in employer securities that ESOPs are designed to make.”).

22. *See* Dana M. Muir & Cindy A. Schipani, *The Challenge Of Company Stock Transactions For Directors' Duties Of Loyalty*, 43 HARV. J. ON LEGIS. 437, (2006) (“Beyond the *Moench* presumption of prudence, which is troubling in itself, the ERISA employer stock cases have not established any clear guidance as to what factual allegations present a threat of fiduciary breach of loyalty.”) (footnote omitted); *cf. In re Fannie Mae 2008 ERISA Litig.*, 09 CIV. 1350 PAC, 2012 WL 5198463, at *4-5 (S.D.N.Y. Oct. 22, 2012) (noting that the Second Circuit provided no clear guidance for determining whether a plaintiff has overcome the presumption of prudence).

narrowly defined reasonableness standard that is more in line with ERISA's prudent person standard. Simply stopping the discussion here, however, places plan fiduciaries in an unenviable position. If they fail to deviate from the plan terms, they will be subject to liability for breach of fiduciary duty. But if fiduciaries deviate from the terms of the plan, they risk exposing plan participants and the plan itself to new and substantial tax liabilities—at least in theory—which could constitute additional breaches of fiduciary duty.

This Note identifies two potential solutions to the fiduciaries' problem. First, Congress could amend the tax provisions governing the plans in question so that a fiduciary's deviation from plan terms under these circumstances does not create any new tax liabilities. Alternatively, plan drafters could include language instructing plan fiduciaries to stop investing in company stock when the reasonableness standard renders continued investment in company stock imprudent. Replacing the *Moench* presumption and protecting well-intentioned fiduciaries through legislative or practical changes would simultaneously provide litigants—and the courts—with an objective framework to assess stock-drop claims, protect the retirement assets of private employees, and dissuade employers from engaging in activities that are legally, ethically, or financially questionable.

The *Moench* presumption rests on the premise that “basic principles of trust law require that the interpretation of the terms of the trust be controlled by the settlor's intent.”²³ Although this statement is true,²⁴ the court did not accurately identify or define the settlor's intent in *Moench*.²⁵ A settlor's intent is often coextensive with a plain language interpretation of the written terms of the trust in traditional trust law, but this proposition does not necessarily hold when a statutory context requires the inclusion of certain language and the consideration of underlying policy concerns. Thus, the *Moench* court was imprecise in determining whether the fiduciaries' actions fulfilled the settlor's intent. Several doctrinally suspect decisions followed *Moench* because no circuit court has revisited *Moench*'s analysis of the underlying trust law.

23. *Moench v. Robertson*, 62 F.3d 553, 570 (3d Cir. 1995).

24. Restatement (Third) of Trusts § 4 (2003) (“The phrase “terms of the trust” means the manifestation of intention of the settlor with respect to the trust provisions expressed . . .”).

25. See Part II.D.

From a public policy perspective, the *Moench* presumption is also deficient. Because the framework lacks solid doctrinal grounding, courts have been forced to develop the presumption's contours without true common-law or statutory guideposts.²⁶ As a consequence, fiduciaries do not know the true scope of their responsibilities and potential litigants cannot approach a dispute enlightened with a clear understanding of the law and how it will be applied, which increases inefficiencies and costs for all interested parties.

Perhaps most importantly, the *Moench* presumption does little to nothing to curb business conduct that has a direct and detrimental impact on stock prices and employees' retirement accounts. Recognizing that making "[plan] fiduciaries virtual guarantors of . . . financial success" would make retirement plans that hold company stock unattractive options for corporate plan sponsors, the Third Circuit declined to impose any semblance of strict judicial second-guessing.²⁷ But instead of encouraging businesses to make prudent decision by enabling retirement plan fiduciaries to make truly prudent investments, the *Moench* presumption places the retirement assets of millions of private employees at risk by insulating fiduciaries from any meaningful judicial review.

The literature almost uniformly acknowledges the high bar plaintiffs face in bringing stock-drop suits,²⁸ but authors' normative characterizations of the *Moench* presumption and stock-drop cases vary. On the heels of *Moench v. Robertson*, two prescient student notes decried the opinion for its doctrinal problems and the implications of the resulting relaxation of ERISA's fiduciary standards.²⁹ But an article written just over a decade after the decision lauded *Moench* for its usefulness as a standard, despite its flaws,³⁰

26. See *infra* notes 88–91 and accompanying text.

27. *Moench v. Robertson*, 62 F.3d 553, 570 (3d Cir. 1995).

28. See, e.g., Dell, *supra* note 3, at 16 (noting that the court has continually favored stock-drop defendants).

29. Kenneth Hayes, Note, *Moench v. Robertson: When Must an Esop Fiduciary Abandon A Sinking Ship?*, 49 RUTGERS L. REV. 1231 (1997) (providing an early critique of the decision and lamenting the high burden of proof it placed on plaintiffs); John M. Wilson, Note, *Are All ERISA Fiduciaries Created Alike? Moench v. Robertson*, 58 U. PITT. L. REV. 255 (1996) (criticizing the decision for its failure to follow precedent, disregard for other ERISA duties, and a failure to recognize important public policy implications).

30. See Craig C. Martin, Matthew J. Renaud, and Omar R. Akbar, *What's Up On Stock-Drops? Moench Revisited*, 39 J. MARSHALL L. REV. 605, 634 (2006) (arguing that *Moench*

while another article argues that stock-drop and securities suits are redundant, and—because plaintiffs’ lawyers file these suits only to fee shop—all stock-drop litigation involving stock price misrepresentation should be pursued through securities laws litigation, not ERISA suits.³¹ Many commentators acknowledge the difficulty in creating an appropriate standard to which to subject plan fiduciaries,³² but none proposes a doctrinally sound alternative to the *Moench* presumption.³³

This Note is the first to articulate a doctrinally sound framework that protects both plan participants and plan fiduciaries and that is also supported by the common law of trusts, ERISA’s prudent person standard, and relevant policy considerations. Part I briefly introduces ERISA and retirement plans that contain company stock. Part II then traces the origins and development of the *Moench* presumption, analyzing its theoretical and practical effectiveness and limitations. Next, Part III proposes replacing the *Moench* presumption with an objectively defined reasonableness standard fully grounded in the law of trusts. Finally, Part IV puts the proposed standard through the paces, contrasting its effectiveness with the *Moench* presumption.

provides a useful standard that should apply even though its logical extension “contradicts ERISA’s explicit exemption from the duty to diversify”).

31. Mark Casciari & Ian Morrison, *Should The Securities Exchange Act Be The Sole Federal Remedy For An ERISA Fiduciary Misrepresentation Of The Value Of Public Employer Stock?*, 39 J. MARSHALL L. REV. 637 (2006).

32. See, e.g., Neil A. Capobianco & Jose Martin Jara, *Hot Topics in ERISA Litigation: From Ongoing Class Action Challenges To The Upcoming Fee Disclosure Deluge*, 2011 WL 190437, at *8 (“While the appropriate standard for stock drop litigation is still up in the air, there is virtually no available alternate standard except for *Moench*. No court has come up with any other viable standard.”); Ellen M. Doyle, Stephen M. Pincus, *Restoring Retirement Nest Eggs: Managers of 401(k) Retirement Plans Owe a Fiduciary Duty of Care, Loyalty, and Prudence to Plan Participants. When Fiduciaries Breach These Duties, Participants Can Recover Their Losses through an ERISA Class Action*, 45-APR Trial 46 (2009) (briefly discussing the difficulty in “determining the right point, or even range of right points, for an ESOP fiduciary to break the plan and start diversifying”).

33. The only recent work to propose an alternative standard is Meredith L. Gray’s note, *A Presumption Without Prudence: Replacing Moench v. Robertson With A Prudent “When In Doubt, Don’t” Standard For ESOP And 401(K) Company Stock Fund Fiduciaries*, 2010 WIS. L. REV. 907. Although Gray’s proposed “When in doubt, don’t” standard is appealing from a policy perspective, it fails to address ERISA’s exemption of EIAPs from the duty to diversify. The standard, which she equates to a chef “vouching for the integrity of everything on her menu” or fiduciaries “invest[ing] their own mother’s core retirement savings in company stock without reasonable assurance that the investment would not be lost,” also lacks both doctrinal support and meaningful objective guidance for plan fiduciaries. *Id.* at 948.

I. STATUTORY BACKGROUND:
ERISA AND ELIGIBLE INDIVIDUAL ACCOUNT PLANS

To understand the *Moench* presumption's role and shortcomings, one must begin with the basics of ERISA and the eligible individual account plans (EIAPs) that ERISA exempts from the duty to diversify. This Part briefly reviews the structure of ERISA, introduces the most common EIAPs, and discusses the rationale behind investing in company stock.

A. *A Brief Overview of ERISA*

ERISA regulates the creation, administration, amendment, and termination of certain employer-provided employee benefit plans.³⁴ During the century leading up to 1974, a mix of state and federal laws governed these plans.³⁵ Enacted to protect employee benefit plans from abuse,³⁶ ERISA's broad preemption clause means that federal law now governs when a case "relates to" a covered employee benefit plan.³⁷

ERISA borrows heavily from the language and law of trusts.³⁸ Covered retirement plans generally take the form of trusts, the fiduciaries of covered retirement plans generally function as trustees, and employees and retirees are beneficiaries.³⁹ ERISA imposes certain duties on plan fiduciaries, including the duty of loyalty, the duty of prudence, the duty to diversify plan assets, and the duty to follow plan terms that do not violate ERISA.⁴⁰ Under ERISA, the Secretary of Labor, other fiduciaries, plan participants, and beneficiaries may all sue for breach of fiduciary duty.⁴¹ Although the statutory framework precludes individual compensation in most

34. ERISA covers employee welfare plans like health benefits, and employee benefit plans like traditional pensions, employee stock ownership plans, 401(k) plans, and some 403(b) plans. It does not cover government plans, church plans, or plans required to remain compliant with workers' compensation laws. PAUL J. SCHNEIDER & BRIAN M. PINHEIRO, *ERISA: A COMPREHENSIVE GUIDE* § 2.01 n.1 (3d ed. 2008).

35. *Id.* § 1.02.

36. *Id.* § 1.04.

37. *Id.* § 9.01.

38. *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101, 110 (1989) ("ERISA abounds with the language and terminology of trust law.") (citing several provisions).

39. *Id.*

40. 29 U.S.C. § 1104(a)(1).

41. 29 U.S.C. § 1132(a).

scenarios,⁴² fiduciaries who breach their duties are personally liable to the plan for losses causally connected to the breach.⁴³

B. *Eligible Individual Account Plans (EIAPs)*

Eligible Individual Account Plans (EIAPs) are a type of employee pension benefit covered by ERISA. Unlike the traditional pensions common through the middle of the twentieth century,⁴⁴ these plans do not provide retirees with guaranteed defined benefits upon retirement. Instead, EIAPs are defined contribution plans that require employers to pay a defined amount into each eligible employee's retirement account at specified intervals.⁴⁵ Employees then invest this money in various assets through a menu of plans offered by their employers, which exposes their retirement accounts to the risks and rewards inherent in each investment.⁴⁶ When employees retire, they have a choice between receiving a lump sum payment or placing the amount in their EIAPs into individual retirement accounts (IRAs).⁴⁷ ERISA exempts EIAP trustees from the duty to diversify,⁴⁸ and the Internal Revenue Service (IRS) affords special tax treatment to EIAPs, their participants, and the businesses that contribute to them. For example, plans need not pay taxes on the earnings made by retirement plans until they are distributed,⁴⁹ the IRS does not deem plan participants' EIAP contributions to be taxable income until it is distributed,⁵⁰ and employers may take deductions for contributions to EIAPs.⁵¹ The two most common EIAPs are Employer Stock Ownership Plans (ESOPs) and 401(k)

42. 29 U.S.C. § 1132(a)(4); *cf. In re Schering-Plough Corp. ERISA Litig.*, 420 F.3d 231, 232 (3d Cir. 2005) ("Plaintiffs may seek money damages on behalf of the fund, notwithstanding the fact the alleged fiduciary violations affected only a subset of the saving plan's participants.").

43. See SCHNEIDER ET. AL, *supra* note 34, § 8.04[B] (discussing proper defendants in ERISA civil enforcement actions).

44. *Id.* § 3.03[A].

45. *Id.* § 3.03[B].

46. *Id.*

47. *Id.* §§ 3.11–3.12. Employees may also receive distributions from their plans before they retire, but that is beyond the scope of this Note.

48. 29 U.S.C. § 1104(a)(2).

49. 26 U.S.C. § 402(a).

50. *Id.*

51. 26 U.S.C. § 404(a).

plans.⁵² Over 50 percent of the nonfarm private workforce has access to an EIAP.⁵³

1. *ESOPs*. About 10 million employees participate in ESOPs.⁵⁴ To maintain their favorable tax status, ESOPs must “invest primarily in qualifying employer securities.”⁵⁵ Accordingly, plans invest exclusively in company stock or in a combination of cash and company stock.⁵⁶ ESOPs are attractive for several reasons. Some companies use ESOPs as a mechanism to motivate their employees.⁵⁷ Many believe an ESOP incentivizes employees to take an interest in the positive performance of the company’s stock by directly linking employees’ wealth to the price of company stock.⁵⁸ In addition, companies also use the favorable tax treatment of ESOPs⁵⁹ to finance strategic corporate moves. For example, ESOPs can be used as an anti-takeover defensive strategy or to buy shares of a departing owner’s stock in a closely held company.⁶⁰ Finally, although it does not provide funding for retirement in amounts as definite as the income generated by a traditional pension plan, the rationale for an ESOP’s existence is, in no small part, to provide employees with retirement income.

52. SCHNEIDER ET. AL, *supra* note 34, § 3.03[B].

53. See William J. Wiatrowski, *Changing Landscape of Employment-Based Retirement Benefits*, BUREAU OF LABOR STATISTICS (Sept. 29, 2011), <http://www.bls.gov/opub/cwc/cm20110927ar01p1.htm>.

54. Olsen, *supra* note 1.

55. 26 U.S.C. § 4975(e)(7).

56. Joel Hobbs, *Employee Stock Ownership Plans (ESOPs), Including S Corporation ESOPs and Anti Abuse Measures*, 8-7-8-9, available at <http://www.irs.gov/pub/irs-tege/epchd804.pdf>.

57. *Id.* at 8-9.

58. Although this is a commonly held view, the empirical research supporting this belief is mixed. Compare Douglas Kruse, *Research Evidence on Prevalence and Effects of Employee Ownership* (2002), <http://www.nceo.org/articles/research-prevalence-effects-employee-ownership> (“Most studies find higher organizational commitment and identification under employee ownership, while studies are mixed between favorable and neutral findings on job satisfaction, motivation, and other behavioral measures.”) with *id.* (“There is clearly no automatic improvement of attitudes and behavior associated with being simply an employee-owner.”).

59. See notes 49-51.

60. Hobbs, *supra* note 56, at 8-9.

2. *401(k) Plans*. Since their inception in 1981,⁶¹ 401(k) plans have become one of the most popular forms of retirement savings for private employees.⁶² In these plans, employees direct employers to place a portion of their pre-tax earnings into an individual account in lieu of cash compensation.⁶³ Employers often match this amount, up to a statutory limit.⁶⁴ The matching component of the 401(k) plans incentivizes employees to maximize their contributions.⁶⁵ These plans typically offer several investment options, including stocks, bonds, funds, and other investment vehicles such as company stock.⁶⁶ In 2010, approximately 20 million individuals participated in 401(k) plan that offered company stock as an investment option, and about half of these plan participants actually invested in company stock.⁶⁷

II. THE *MOENCH* PRESUMPTION OF PRUDENCE

As first articulated by the Third Circuit, the *Moench* presumption states “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.”⁶⁸ Plaintiffs may rebut this presumption by introducing evidence of circumstances unknown to the settlor that would “defeat or substantially impair the purposes of the trust.”⁶⁹

This Part first reviews the seminal case of *Moench v. Robertson* and traces the adoption and expansion of the *Moench* presumption at the circuit court level. It then analyzes whether the presumption has adequately addressed the questions and concerns the Third Circuit

61. The Revenue Act of 1978 established the structure for 401(k) plans. Pub. L. 95-600, 92 Stat. 2763. The IRS did not issue regulations for these plans until 1981.

62. *401k Retirement Plans*, NATIONWIDE, <http://www.nationwide.com/401k-retirement-plans.jsp> (last visited Jan. 15, 2013).

63. 26 U.S.C. § 401(k)(2).

64. See 26 U.S.C. § 401(m).

65. See 26 U.S.C. § 401(k)(4)(A) (permitting employees to use matching contributions to incentivize employee participation in 401(k) plans).

66. See *Smart 401(k) Investing: Investing in Your 401(k)*, FINRA <http://www.finra.org/Investors/SmartInvesting/Retirement/Smart401kInvesting/investing/> (last visited Jan. 15, 2013) (“The average plan offers between 8 and 12 [investment] alternatives . . .”).

67. VANDERHEI ET AL., *supra* note 1, at 26.

68. *Moench v. Robertson*, 62 F.3d 553, 571 (3d Cir. 1995).

69. *Id.* (citing Restatement (Second) § 227, cmt. g).

raised. Part II concludes by challenging the presumption's doctrinal soundness.

A. *Moench v. Robertson*

In 1992, Charles Moench, a former employee who had participated in the ESOP of his employer (Statewide) during the preceding three years filed a class action suit on behalf of the Statewide ESOP.⁷⁰ Between July 1989 and May 1991, the price of Statewide stock fell from \$19.25 to less than \$0.25.⁷¹ Moench's amended complaint included claims against Statewide's ESOP Committee—the plan fiduciaries—for breaches of fiduciary duty for continuing to acquire company stock during the price drop and failing to warn plan participants about “Statewide's condition.”⁷² He also sought to hold the ESOP Committee liable for their co-fiduciaries' alleged breaches of duty.⁷³

The district court held that according to plan documents, the ESOP Committee—which acknowledged its role as an ERISA fiduciary—lacked the discretion to invest ESOP funds in anything other than company stock.⁷⁴ Because the plan was compliant with ERISA, the district court dismissed the breach of fiduciary claims on a summary judgment motion.⁷⁵ On appeal, the Third Circuit vacated the district court's grant of the defendant's summary judgment motion.⁷⁶ But this was far from a victory for Mr. Moench and the Statewide ESOP.

The Third Circuit “look[ed] to the common law of trusts for guidance” in adjudicating the matter.⁷⁷ After acknowledging the basic principle that a settlor's intent controls interpretation of the terms of the trust, the court stated that “ignoring the general intent behind [ESOPs] in favor of giving beneficiaries the maximum opportunity to recover their losses” failed to honor the principle.⁷⁸ It then addressed the issue of asset diversification, noting that the duty to diversify is

70. *Id.* at 559.

71. *Id.* at 556.

72. *Id.* at 559.

73. *Id.*

74. *Id.* at 560.

75. *Id.*

76. *Id.* at 556.

77. *Id.* at 564.

78. *Id.* at 570.

waivable in the common law of trusts.⁷⁹ Because ERISA explicitly waived the duty to diversify, and, as a general rule, “ESOP fiduciaries should not be subject to breach-of-duty liability for investing plan assets in the manner and for the . . . purposes that Congress intended,”⁸⁰ the court declined to apply a reasonableness standard of review to the ESOP Committee’s investment decisions.⁸¹

Next, the court looked to the language of the ESOP’s documents, which directed the ESOP Committee to primarily invest in company stock, to determine the appropriate standard at which to hold plan fiduciaries liable for a breach of fiduciary duty. The court stated that fiduciaries had an obligation to follow a mandatory investment directive, unless doing so was impossible or illegal or a court approved a deviation.⁸² In contrast, fiduciaries with permissive investment directives needed to “exercise care, skill, and caution in making decisions to obtain or acquire the investment.”⁸³ Noting that ESOP fiduciaries are “not absolutely required to invest in employer securities but [are] more than simply permitted to make such investments,”⁸⁴ the court established a standard falling squarely in the middle. Instead of making ESOP fiduciaries’ continued investment in company stock “immune from judicial inquiry” or subjecting their investment decisions to “a de novo review,” the court determined that they should be entitled to a rebuttable presumption of prudence, subject only to an abuse of discretion standard.⁸⁵

B. Additional Circuit Courts Have Adopted the Moench Presumption

Since 1995, the Second, Fifth, Sixth, Seventh, Ninth, and Eleventh Circuits have followed the Third Circuit’s lead and applied some variation of the *Moench* presumption of prudence in stock-drop suits.⁸⁶ Every appellate court to consider the *Moench* presumption has

79. *Id.* at 571 (citing Restatement (Third) of Trusts § 227(b) [from the Prudent Investor Rule]).

80. *Id.* (quoting *Martin v. Feilen*, 965 F.2d 660, 670 (8th Cir. 1992)) (quotation marks removed and omission in original).

81. *See id.* at 572 (establishing the abuse of discretion standard).

82. *Id.* at 571 (citing Restatement (Third) § 228, cmt. d [Prudent Investor Rule]).

83. *Id.* (quoting Restatement (Third) § 228, cmt. f [Prudent Investor Rule]).

84. *Id.*

85. *Id.* at 572.

86. *See White v. Marshall & Ilsley Corp.*, 714 F.3d 980, 987–97 (7th Cir. 2013) (adopting the *Moench* presumption of prudence in stock-drop cases); *Lanfear v. Home Depot, Inc.*, 679

adopted it.⁸⁷ The Second Circuit, a recent adopter of the *Moench* presumption, formulated it as follows:

[O]nly circumstances placing the employer in a dire situation that was objectively unforeseeable by the settlor could require fiduciaries to override plan terms. The presumption is to serve as a substantial shield that should protect fiduciaries from liability where there is room for reasonable fiduciaries to disagree as to whether they are bound to divest from company stock. The test of prudence is . . . one of conduct rather than results, and the abuse of discretion standard ensures that a fiduciary's conduct cannot be second-guessed so long as it is reasonable.⁸⁸

As courts have applied the *Moench* presumption to new facts, they have elaborated on its scope and effect. *Moench v. Robertson* involved only an ESOP, but subsequent cases extended the *Moench* presumption to all EIAPs.⁸⁹ Courts have struggled to outline criteria for facts that would be sufficient to rebut the presumption of prudence and overcome the abuse of discretion standard.⁹⁰ To date, the only potentially significant circuit split is whether the *Moench* presumption is a pleading or evidentiary standard.⁹¹ The Supreme Court declined a petition for certiorari that addressed the issue in the

F.3d 1267, 1271 (11th Cir. 2012) (same); *In re Citigroup ERISA Litig.*, 662 F.3d 128 (2d Cir. 2011), *cert. denied*, 133 S. Ct. 475 (2012) (same); *Quan v. Computer Sciences Corp.*, 623 F.3d 870 (9th Cir. 2010) (same); *Kirschbaum v. Reliant Energy, Inc.*, 526 F.3d 243 (5th Cir. 2008) (same); *Kuper v. Iovenko*, 66 F.3d 1447 (6th Cir. 1995) (same).

87. *In re Citigroup ERISA Litig.*, 662 F.3d at 138 (2d Cir. 2011). The Ninth Circuit initially declined to adopt the *Moench* presumption, but it did not has since joined the other circuits.

88. *In re Citigroup ERISA Litig.*, 662 F.3d 128, 140 (2d Cir. 2011), *cert. denied*, 133 S. Ct. 475 (U.S. 2012) (quoting several cases) (quotation marks and citations omitted).

89. See *Edgar v. Avaya, Inc.*, 503 F.3d 340 (3d Cir. 2007) (extending the *Moench* presumption to all EIAPs based on ERISA's exemption of all EIAPs from the duty to diversify). Subsequent cases have recognized this precedent. *E.g.*, *In re RadioShack Corp. "ERISA" Litig.*, 547 F. Supp. 2d 606, 613 (N.D. Tex. 2008) (noting that it was irrelevant whether certain retirement plans qualified as ESOPs since the *Moench* presumption extended to all EIAPs).

90. See *Summers v. State St. Bank & Trust Co.*, 453 F.3d 404, 411 (7th Cir. 2006) ("[T]he plaintiffs can take some solace from the fact that determining the 'right' point, or even range of 'right' points, for an ESOP fiduciary to break the plan and start diversifying may be beyond the practical capacity of the courts to determine.").

91. In *Pfeil v. State St. Bank & Trust Co.*, the Sixth Circuit declined to follow the Second Circuit, which had recently adopted the *Moench* presumption, in applying it at the motion to dismiss stage. 671 F.3d 585, 592 (6th Cir. 2012), *cert. denied*, 12-256, 2012 WL 4009309 (Dec. 3, 2012).

2012 October Term,⁹² but granted certiorari in a relevant case one year later.⁹³

C. Did Proposed Alternatives Pose Significant Problems?

In *Moench*, the court stated that creating a rebuttable presumption of prudence for ESOP fiduciaries was more palatable than the alternatives suggested by the plan plaintiff or the Department of Labor.⁹⁴ The court identified several problems it believed the Department of Labor's suggested standards would leave unsolved:

[B]y subjecting an ERISA fiduciary's decision to invest in employer stock to strict judicial scrutiny, we essentially would render meaningless the ERISA provision excepting ESOPs from the duty to diversify. Moreover, we would risk transforming ESOPs into ordinary pension benefit plans, which then would frustrate Congress' desire to encourage employee ownership. After all, why would an employer establish an ESOP if its compliance with the purpose and terms of the plan could subject it to strict judicial second-guessing?⁹⁵

At a minimum, any acceptable standard would need to address these issues, and, according to the Third Circuit, the *Moench* presumption fit the bill. But was it ever a real possibility that the duty to diversify would be obviated or that ESOPs would be transformed into "ordinary pension benefit plans?" The answers, respectively, are no and maybe.

The court overemphasized the significance of ERISA's exemption of trustees from the duty to diversify. In the common law of trusts, the duty to diversify encapsulates modern portfolio theory.⁹⁶ Because of market, industry, and firm risk, a failure to adequately diversify trust assets is imprudent unless some special circumstance

92. *Id.*

93. *Dudenhoefer v. Fifth Third Bancorp*, 692 F.3d 410 (6th Cir. 2012), *cert. granted in part*, No. 12-751, 2013 WL 6510745 (U.S. Dec. 13, 2013).

94. *Moench v. Robertson*, 62 F.3d 553, 570 (3d Cir. 1995).

95. *Id.*

96. See John H. Langbein, *The Uniform Prudent Investor Act and the Future of Trust Investing*, 81 IOWA L. REV. 641, 646-47 (1996) (noting that the Uniform Prudent Investors Act—which lays out many concepts involved in the common law of trusts—emphasizes diversification of assets because of modern portfolio theory).

warrants a highly concentrated investment.⁹⁷ The duty to diversify is a default rule, meaning that settlors may direct trustees to make noncapricious, undiversified investments.⁹⁸ When plaintiffs bring a claim for breach of fiduciary duty for the imprudent continued investment in company stock, it is distinct from a claim for failure to diversify under the default rule.⁹⁹ When plaintiffs sue fiduciaries for continued investment in company stocks, they are suing because they believe the investment was imprudent in light of the circumstances, not because failure to diversify is *per se* imprudent. The fact that other courts have not followed *Moench*'s formalistic interpretation¹⁰⁰ demonstrates that the risk of obviating the exemption from the duty to diversify was minimal at best. But courts have continued to highlight the risk of turning ESOPs into “ordinary pension benefit plans” through increased judicial scrutiny of fiduciaries’ decisions to continue to invest in company stock.¹⁰¹

D. *Settlor’s Intent or Congressional Intent?*

In *Moench*, the Third Circuit superimposed the common law of trusts over ERISA’s statutory provisions to determine the scope of ESOP fiduciaries’ duties.¹⁰² Following the Supreme Court’s lead, it noted that “ERISA abounds with the language and terminology of trust law,”¹⁰³ and ERISA’s legislative history made it clear that Congress intended to task ERISA fiduciaries with the duties that

97. *Id.* at 647.

98. John H. Langbein, *Mandatory Rules in the Law of Trusts*, 98 NW. U. L. REV. 1105, 1112 (2004).

99. *See* *Quan v. Computer Sciences Corp.*, 623 F.3d 870, 881 (9th Cir. 2010) (“We do not read the *Moench* presumption to apply to a ‘diversification’ claim, because a presumption of prudence is unnecessary where fiduciaries are not subject to a prudence requirement to begin with. On the other hand, where employer stock is only one of the possible plan investments, and plaintiffs assert a claim that the fiduciary should have divested the plan of employer stock, the fiduciaries would be entitled to the presumption that investment in employer stock was prudent.”).

100. *See, e.g., id.* (declining to equate a claim for a breach of fiduciary duty stemming from continued investment in company stock with a simple claim for failure to diversify investments).

101. *See, e.g., In re Citigroup ERISA Litig.*, 662 F.3d 128, 138 (2d Cir. 2011), *cert. denied*, 133 S. Ct. 475 (U.S. 2012) (adopting the *Moench* presumption, in part, because “it provides the best accommodation between the competing ERISA values of protecting retirement assets and encouraging investment in employer stock”).

102. *Moench v. Robertson*, 62 F.3d 553, 564 (3d Cir. 1995).

103. *Id.* (quoting *Martin v. Feilen*, 965 F.2d 660, 670 (8th Cir. 1992)).

originated in trust law.¹⁰⁴ It also noted that trust law principles require that the settlor's intent control its interpretation of the terms of the trust. To provide support for the *Moench* presumption, the Third Circuit made one major doctrinal move: defining the settlor's intent as increasing employee ownership through investing in company stock.¹⁰⁵ Upon close inspection, this definition appears to be too narrow.

The Restatement (Second) of Trusts¹⁰⁶ defines the phrase "terms of the trust" as any words or actions that manifest the settlor's externally expressed intent at the time the trust was created.¹⁰⁷ The comments provide that the terms of the trust "may be determined by interpretation of the words or conduct of the settlor in the light of all the circumstances."¹⁰⁸ Potentially relevant circumstances include the relationship between the settlor and beneficiaries, their financial circumstances, the type of property included in the trust, business custom, and the "circumstances under which the trust is to be administered."¹⁰⁹

But the *Moench* court conducted limited inquiries into the words or actions of Statewide or its agents at the time of the ESOP's creation. In fact, the only reference to Statewide's words or actions at the time of the ESOP's creation is the fact that plan documents included the directive to invest "primarily" in company stock.¹¹⁰ But when it interpreted the terms of the plan, the court appeared to conflate the trust law concept of settlor's intent—the words, actions, and circumstances that manifest the settlor's intent—with boilerplate plan language. This language signifies no more than the fact that Statewide intended the trust to take the form of an ESOP. Federal regulations require all ESOP documents to include such

104. *Id.*

105. *See id.* at 568.

106. This Note uses the Restatement (Second) of Trusts to analyze the court's decision and to create a new standard for EIAP fiduciaries because the Restatement (Third) was incomplete when *Moench* was decided. The Restatement (Third) of Trusts and the emerging benefit-the-beneficiaries rule provide additional support for the proposed standard, but that is beyond the scope of this Note.

107. Restatement (Second) of Trusts § 4 (1959).

108. *Id.* § 4, cmt. a.

109. *Id.*

110. *See Moench*, 62 F.3d at 567 ("For instance, the plan documents state that assets are to be invested primarily in Statewide stock. Therefore, it seems counterintuitive for the Committee to interpret the plan as requiring it to invest exclusively in Statewide stock.").

terminology.¹¹¹ Instead of providing some insight into the underlying purpose of the Statewide ESOP, the “primarily” language shows only that Statewide intended to set up a plan that complied with federal regulations.

In defining the settlor’s intent, the court also singled out one of the circumstances under which the Statewide ESOP was to be administered. The court focused, albeit quite narrowly, on the ESOPs’ role within ERISA’s statutory framework. After distinguishing ESOPs from traditional pension plans and noting that ESOPs’ lack of diversification placed employees’ retirement assets at a greater risk than plans subject to ERISA’s diversification requirements,¹¹² the court briefly discussed the “original rationale” behind the ESOP—“expanding the national capital base among employees.”¹¹³ Stopping just short of explicitly stating that increased employee ownership of companies was the settlor’s intent, the court stated that the extent of ESOP fiduciaries’ duties should conform to the “general intent behind such plans.”¹¹⁴

The court failed adequately to assess the words, actions, and circumstances surrounding the creation of the Statewide ESOP. In the court’s eyes, the prescribed means of investment—primarily purchasing company stock—was the ESOP’s purpose. But it improperly imputed special meaning to a boilerplate phrase and substituted congressional intent for settlor’s intent.

III. DEVELOPING A NEW STANDARD

Because ERISA is replete with the language of trusts, trust law should serve as the foundation for any new standard of fiduciary obligation.¹¹⁵ Determining the full extent of a trustee’s fiduciary duty requires first identifying the settlor’s intent, or purpose, for creating the trust.¹¹⁶ When the express terms of the trust no longer reflect the

111. See 26 C.F.R. § 54.4975-11(b) (“A plan constitutes an ESOP only if the plan specifically states that it is designed to invest primarily in qualifying employer securities.”).

112. *Moench*, 62 F.3d at 568.

113. *Id.*

114. *Id.* at 570.

115. *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101, 110 (1989) (“ERISA’s legislative history confirms that the Act’s fiduciary responsibility provisions, 29 U.S.C. §§ 1101-1114, ‘codif[y] and mak[e] applicable to [ERISA] fiduciaries certain principles developed in the evolution of the law of trusts.’” (quoting H.R. Rep. No. 533, 1974 U.S.C.C.A.N. 4639, 4649)).

116. See Restatement (Second) of Trusts § 4 (1959) (noting that the terms of the trust are a manifestation of the settlor’s external intent).

settlor's intent, fiduciaries may be liable for continuing to adhere to the offending terms.¹¹⁷ These basic principles undergird the proposed standard.

This Part first identifies the default settlor's intent for ESOPs and 401(k) plans, distinguishing the static terms of the plan from the "terms of the trust" that are coextensive with the settlor's intent. It then delineates a framework to determine when plan fiduciaries have an obligation to deviate from the static terms of the plan. Finally, Section C addresses some practical considerations that adopting the new standard would present.

A. Identifying the Default Settlor's Intent for ESOPs and 401(k) Plans

Case law and scholarship define the settlor's intent as the settlor's purpose for creating the trust at the time of the trust's creation.¹¹⁸ The trust's written terms may evince the settlor's intent but are not conclusive.¹¹⁹ Trust law instructs the court to look beyond the written terms of the trust to the actions of the settlor and the circumstances surrounding the trust's creation to determine the settlor's intent in unclear situations.¹²⁰ Because federal regulations dictate some of the trust's language,¹²¹ the circumstances surrounding the creation of the trust—particularly the relationship between the settlor and the beneficiaries, their financial situations, and the statutory overlay—take on an increased importance.

Settlors of ESOPs and 401(k) plans do not enter into a contractual agreement with future plan participants at the time the plans are created. Nonetheless, contract principles are helpful in understanding the relationship between initial plan settlors and future

117. See *id.* § 167(3) (“[T]he trustee is subject to liability for failure . . . to deviate from the terms of the trust[] if he knew or should have known of the existence of [unanticipated] circumstances [that would defeat or substantially impair the purpose of the trust.]”)

118. See generally John H. Langbein, *Burn the Rembrandt? Trust Law's Limits on the Settlor's Power to Direct Investments*, 90 B.U. L. REV. 375, 377 (2010) (discussing the origins and limitations of the settlor's intent).

119. Restatement (Second) of Trusts § 4, cmt. a. (noting that the surrounding circumstances inform the interpretation of the settlor's intent where the written and oral words are insufficient).

120. *Id.*

121. See note 111 and accompanying text.

plan participants vis-à-vis the settlor's intent.¹²² The initial settlor and plan participants bargain for their mutual benefit, and ERISA's statutory overlay shapes both the contract's language and its underlying public policy considerations. Initial plan participants defer present cash compensation for increased capital ownership and future financial security.¹²³ This increased future financial security includes consideration for the interests of plan participants' beneficiaries, whose interests are substantially similar to those of future plan participants. Therefore, the interests of present and future plan participants are effectively identical.

The settlor exchanges ownership of company stock and matching cash contributions for an incentivized workforce and favorable tax treatment.¹²⁴ In theory ESOPs, which invest primarily in company stock, incentivize beneficiaries by aligning their interests with those that will increase the company's stock price and the value of their retirement accounts.¹²⁵ It logically follows that company stock ownership through 401(k) plans would create similar incentives, with a slight variation. Increased diversification in plan assets may shift beneficiaries' incentives from a simple alignment with the price of company stock to a more complex sense of loyalty tied to an increased likelihood of future financial security. In each case, the default settlor's intent, or purpose for creating the plan, is incentivizing beneficiaries through some combination of capital and cash contributions that provide future financial security and engender goodwill.

122. Discussing a different issue involving fiduciary duties under ERISA, Professor Langbein suggested that the contract framework may be helpful in interpreting plan terms because, unlike donative transfers, EIAPs "arise from contract rather than gratuity." John H. Langbein, *The Supreme Court Flunks Trusts*, 1990 SUP. CT. REV. 207, 211 (1990). The piece discusses the Court's decision not to use contract law to determine the terms of a benefits plan at some length, and suggests that it would have provided more "candor" than attempting to operate exclusively in trust law. *Id.* at 223–29.

123. See generally DOUGLAS KRUSE ET AL., *MOTIVATING EMPLOYEE-OWNERS IN ESOP FIRMS: HUMAN RESOURCE POLICIES AND COMPANY PERFORMANCE* (2004), available at http://eprints.lse.ac.uk/19930/1/Motivating_Employee_Owners_in_ESOP_Firms_Human_Resource_Policies_and_Company_Performance.pdf (discussing the incentive structure and effectiveness of ESOPs).

124. See Douglas L. Kruse, *Why Do Firms Adopt Profit-Sharing and Employee Ownership Plans?*, 34 BRIT. J.I.R. 515 (1996).

125. See Kruse, *supra* note 58 (discussing the empirical research on the motivational effect of ESOPs).

B. A Framework to Determine When the Settlor's Intent Requires Plan Fiduciaries to Deviate from Fixed Plan Terms

As long as the settlor's intent is not illegal, impossible, or against public policy, the trustee generally has an obligation to adhere to the terms of the trust.¹²⁶ But the doctrine of deviation, which is notably absent from the *Moench* opinion, requires fiduciaries to depart from the static terms of the trust when they know or should know that, due to unanticipated circumstances, the terms no longer effectuate the settlor's intent.¹²⁷ The following framework proposes a process for identifying when unanticipated circumstances require EIAP fiduciaries to deviate from the terms of the plan.

1. *What Percentage of the EIAP's Assets are Invested in Company Stock?* ERISA requires non-EIAP retirement plans to diversify their investments¹²⁸ and forbids them from holding more than 10 percent of their assets in company stock.¹²⁹ All EIAPs are exempt from these requirements, and different plans use this exemption to create a wide range of investment portfolios. ESOPs, by definition, invest primarily in company stock.¹³⁰ In comparison, some 401(k) plans offer no company stock, while others permit plan participants to hold more than 80 percent of their assets in company stock.¹³¹ Accordingly, one must first identify the type of plan to determine whether a fiduciary's decision to continue to invest in company stock—either through new acquisitions or continued holdings—was contrary to the settlor's intent.

The proposed standard would apply only to EIAPs that authorize or require fiduciaries to invest more than 20 percent of the plan's assets in company stock. This threshold intentionally shields the decisions of many EIAP fiduciaries to continue to invest in company stock from strict scrutiny.¹³² The trust law duty to diversify

126. *Moench v. Robertson*, 62 F.3d 553, 571 (3d Cir. 1995) (citing Restatement (Third) § 228, cmt. d [Prudent Investor Rule]).

127. See Langbein, *supra* note 118, at 394 n.141 (discussing the doctrine of deviation).

128. 29 U.S.C. § 1104(a)(1).

129. 29 U.S.C. § 1107.

130. See Part I.B.1.

131. See VANDERHEI ET AL., *supra* note 1, at 26 (noting that 6 percent of the survey respondents participated in 401(k) plans that invested more than 80 percent of their assets in company stock).

132. Many 401(k) plans do not offer an investment option that includes company stock. *Id.* at 24, 26.

essentially tracks onto modern portfolio theory.¹³³ And modern-portfolio-theory-based investment advice counsels against holding more than 20 percent of available funds in a single asset.¹³⁴ Holding an EIAP fiduciary who invests no more than 20 percent of the plan assets in company stock to a reasonableness standard would render meaningless ERISA's exemption from the duty to diversify.¹³⁵ For EIAPs investing minimally in company stock, the current *Moench* presumption should remain the standard for assessing fiduciary liability.

2. *What Qualifies as an Unanticipated Circumstance?* When trust fiduciaries know or should know of some circumstance unknown to and unanticipated by the settlor that would “defeat or substantially impair the purposes of the trust,” they may be held liable for failing to deviate from the terms of the trust.¹³⁶ In the contract law framework discussed in Part III.A, the circumstances known or anticipated to the settlor become those known, anticipated, and bargained for by the initial EIAP settlor and plan participants.

Assuming that EIAP settlors and beneficiaries are rational and savvy businesspeople,¹³⁷ they would anticipate changes in the price of

133. See note 96.

134. Retirement planners, taking modern portfolio theory's principle of diversification into account, counsel employees against investing more than 20 percent of their assets in company stock. See e.g., VANGUARD, *Avoid These Common Pitfalls*, <https://retirementplans.vanguard.com/VGApp/pe/pubeducation/retirement/Startingtosave/pitfalls/Pitfalls.jsf?SelectedSegment=StartingtoSave&Article=Avoid+these+common+pitfalls> (last visited Dec. 13, 2012). Under modern portfolio theory, firm risk accounts for 20 percent of the risk in a stock's price. Langbein, *supra* note 96, at 647 (citing R.A. BREALEY, AN INTRODUCTION TO RISK AND RETURN FROM COMMON STOCKS 117 (2d ed. 1983)).

135. Taking action for variations less than 20 percent due to unanticipated circumstances would technically not be the same thing as holding fiduciaries accountable for the duty to diversify from which they are exempted. But it functionally has the effect of requiring them to manage more risk than is generally acceptable as regular firm risk under modern portfolio theory. See note 134.

136. See Restatement (Second) of Trusts § 167.

137. This is a generous assumption that favors the settlors, but is important to permit companies to continue to operate with the level of risk permitted by the business judgment rule. Most beneficiaries make irrational investment decisions, especially where company stock is concerned. See Marvin H. Stroud, “Don't Put Your Eggs In One Basket”: *Reforming 401(K) Pensions To Address The Educational And Psychological Issues That Drive Good Employees To Make Bad Investment Decisions*, 41 MCGEORGE L. REV. 437 (2010) (discussing the fact that employees typically aren't savvy investors and make poor investing decisions, especially when presented with an investment option that includes company stock).

company stock due to market fluctuations.¹³⁸ They also anticipate price changes resulting from industry-related hiccups,¹³⁹ and recognize that decisions made by the business firm and its agents would affect the stock price. But does the resulting EIAP represent beneficiaries' acquiescence in all forces that may affect stock price, whether stemming from financial markets, the company's industry, the firm itself, or natural forces? Rational settlers and beneficiaries realize that they are incapable of controlling the market, specific industries, natural disasters, and potentially costly fluke litigation. But all should be understood to bargain with the understanding that they are rational individuals and that the company will be managed rationally. When viewed as a contract between two rational parties, EIAP documents should be understood to implicitly exclude irrational business decisions from the list of acceptable reasons for changes in the price of the company's stock. Therefore, unanticipated circumstances that may warrant deviation from the terms of an EIAP include situations in which companies and their agents conduct themselves irrationally.

The business judgment rule provides ample guidance for determining when business decisions are irrational. The business judgment rule affords corporate directors or officers a presumption that they fulfilled their duties of care in partaking in a business judgment, provided, in part, that they:

- (2) [are] informed with respect to the subject of the business judgment . . . reasonably believe[d] to be appropriate under the circumstances; and
- (3) rationally believe[] the business judgment is in the best interests of the corporation.¹⁴⁰

This has been a high standard for most plaintiffs to meet,¹⁴¹ but EIAP fiduciaries need not litigate the business-judgment rule to the

138. See Langbein, *supra* note 96, at 647, n.47 (noting that individuals familiar with modern portfolio theory ascribed very specific risk profiles firm risk, market risk, industry risk, etc.).

139. *Id.*

140. AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01(c) (2012); see also Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (articulating the business judgment rule to require that directors and officers act "on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company").

141. Douglas M. Branson, *The Rule That Isn't a Rule: The Business Judgment Rule*, 36 VAL. U. L. REV. 631, 631 (2002) ("[T]he business judgment rule] could be called a standard of non-

fullest extent. Instead, if a reasonable plan fiduciary would conclude that company directors' actions were irrational because they were made in bad faith or on improper information,¹⁴² EIAP fiduciaries should recognize that an unanticipated circumstance has occurred.

3. *Is Continued Investment in Company Stock Still Consistent with the Settlor's Intent?* Under trust law, trustees may be subject to liability for failing to deviate from the terms of the trust if complying with the terms no longer effectuates the settlor's intent.¹⁴³ The manner in which the court determines whether a fiduciaries' deviation was justified depends on the circumstances when the deviation took place, and, in some instances, the circumstances when the deviation is before the court. If the deviation occurred during an "emergency," the court will approve the deviation if the court would have approved the deviation based on the information available at the time of the deviation.¹⁴⁴ If the court would not have approved the decision based on information available at the time of the deviation, it will not approve the deviation.¹⁴⁵ In nonemergency situations, the court will approve the deviation if it would have approved the deviation based on the information available at the time of the deviation, and the court would still approve the deviation based on information available "at the time the deviation is before the court."¹⁴⁶ It may approve the deviation if the court would not have approved the deviation at the time it occurred, but would have at the time it is before the court.¹⁴⁷ But, in nonemergency situations, the court will not approve a deviation from the terms of the trust "if the deviation is such that the court would not have authorized it at the time when the propriety of the deviation is before the court."¹⁴⁸

For practical purposes discussed in Part III.C, it makes sense to use the emergency standard to assess an EIAP fiduciary's decision to

review, entailing no review of the merits of a business decision corporate officials have made." (citing DOUGLAS M. BRANSON, CORPORATE GOVERNANCE §§ 7.01-720 (1993)).

142. See *Stone v. Ritter*, 911 A.2d 362 (Del. 2006).

143. Restatement (Second) of Trusts § 167. The Restatement permits trustees to petition the court for the ability to deviate for plan documents, but for reasons discussed in Part III.C, this discussion only discusses instances where the trustee deviates from the express terms of the trust without first seeking the court's permission.

144. *Id.* § 167, cmt. f.

145. *Id.*

146. *Id.*

147. *Id.*

148. *Id.*

continue with or deviate from plan terms. If company stock makes up more than 20 percent of an EIAP's assets, and an unanticipated circumstance occurs, EIAP fiduciaries must determine whether continued investment in company stock is consistent with the settlor's intent of incentivizing beneficiaries through providing retirement income and engendering goodwill. At what specific point must reasonable EIAP fiduciaries deviate from the express terms of the plan? The answer to this question will vary case-by-case, depending on the probable effect of the unanticipated circumstance on the price of the stock and the total percentage of company stock in the EIAP. In ESOPs and other EIAPs with high concentrations of company stock, the potential of relatively small decreases in stock price—15 to 25 percent—that result from unanticipated circumstances that a reasonable fiduciary would attribute to violations of the business judgment rule would trigger a duty to deviate from the terms of the plan.¹⁴⁹ But as an EIAP's concentration of company stock approaches 20 percent, the potential decrease in stock price necessary to trigger a duty to deviate from the terms of the plan would also increase. And, as discussed in Part III.B.1, the *Moench* presumption would continue to apply to EIAPs that invest no more than 20 percent of their assets in company stock.¹⁵⁰

At first glance, this sliding-scale inverse standard seems to evade ERISA's exemption of EIAPs from the duty to diversify. However, the relationship only empowers fiduciaries to carry out the settlor's intent of incentivizing employees' performance. Following the same logic used to support ESOPs, employees become demoralized, not incentivized, when they lose large amounts of their retirement savings due their employer's irrational business activities. This standard simply accounts for the unarticulated agreement between an EIAP settlor and initial—and future—plan participants.

149. Reasonable minds will differ on the low-end percentage of the stock price decrease range. On one hand, it is conceivable to want to compensate EIAPs for any losses due to irrational business decisions, regardless of how small. And these suits could serve as an encouragement for companies to refrain from making decisions that violate the business-judgment rule. On the other hand, there is a point where the cost of defending and settling these cases outweighs the benefit they bring to the plans. Because modern portfolio theory attributes 20 percent of a stock's performance to the company's business decisions, I set the range around this mark.

150. I am grateful for Professor Deborah DeMott's analogy between this approach and the Second Circuit's definition of reasonable care in *United States v. Carroll Towing Co.*, 159 F.2d 169 (2d Cir. 1947).

C. *Practical Considerations*

This proposed standard presents several practical challenges. First and foremost, EIAPs, employers, and employees risk losing their favorable tax treatment when plan fiduciaries deviate from the expressly written terms of the plan.¹⁵¹ Employees, employers, and plan participants would all face immediate tax liabilities.¹⁵² Congress could fix this problem by changing the Internal Revenue Code to exempt necessary deviations from new tax liability. But encouraging plan drafters to include a clause that permits deviation from the plans' initial terms in the case of unanticipated circumstances may offer a more simple solution.¹⁵³ The Department of Labor could force the point by issuing new regulations mandating terms to be included in all EIAPs—akin to the Internal Revenue Service's regulation of terms that must appear in ESOPs.¹⁵⁴

After addressing the tax issue, the question of how plan fiduciaries on the ground will deviate from the initial plan terms remains. As noted in Part III.B.3, the Restatement permits trustees to petition the court for permission to deviate from the terms of the trust and establishes liability for breach of fiduciary duty when they fail to petition the court under certain circumstances. But EIAP fiduciaries instructed by plan documents to invest in company stocks face a problem when they petition the court. As this Note articulates the proposed rule, EIAP fiduciaries would petition the court only when they reasonably believed continuing to invest in company stock was imprudent, in light of what they reasonably understood to be conduct inconsistent with the business judgment rule. But if fiduciaries actually petitioned the court in such a manner, they would risk

151. Failure to follow term plans results in plan disqualification. Revenue Procedure 94-62, 1994-2 C.B. 778. See also *Tax Consequences of Plan Disqualification*, <http://www.irs.gov/Retirement-Plans/Tax-Consequences-of-Plan-Disqualification> (last visited Jan. 15, 2013) (citing Rev. Rul. 2007-48, 2007-30 I.R.B. 129 and Rev. Rul. 74-299, 1974-1 C.B. 154).

152. *Tax Consequences of Plan Disqualification*, *supra* note 151.

153. See Restatement (Second) of Trusts § 167, cmt. d (“Where terms of the trust provide for change of circumstances. The settlor may manifest an intention to authorize the trustee, in the event of a change of circumstances, to do acts not otherwise authorized, if such acts are necessary to prevent a defeat or substantial impairment of the purposes of the trust. In such case it is not necessary for the trustee to apply to the court for permission to do the act, since it is not a deviation from the terms of the trust to do the act.”).

154. See 26 C.F.R. § 54.4975-11(b) (“A plan constitutes an ESOP only if the plan specifically states that it is designed to invest primarily in qualifying employer securities.”).

exacerbating the feared decrease in stock price. Accordingly, an extrajudicial deviation—as the Restatement provides for¹⁵⁵—would likely be necessary to minimize any additional negative impact on the stock’s price. In a similar vein, deviating EIAP fiduciaries would face the difficult task of determining the proper method of deviation. Because an EIAP often holds substantial amounts of company stock, a sell-off risks decreasing the price of the company’s stock, which is precisely what the fiduciary seeks to avoid.¹⁵⁶ These concerns may have the long-term effect of limiting EIAP options that invest more than 20 percent of their assets in company stock.¹⁵⁷

IV. APPLYING THE PROPOSED STANDARD TO EIAP FIDUCIARIES

As a threshold matter, the proposed standard successfully addresses several concerns raised by *Moench* and its progeny. It provides clear, objective standards for when an EIAP fiduciary has an obligation to deviate from the terms of a plan. It does not subject EIAP fiduciaries to the duty to diversify or threaten to turn ESOPs into ordinary pension benefit plans. In the absence of congressional action on the tax issue, plan drafters can simply add a clause that allows temporary deviation. And, depending on the reason why and manner in which an EIAP fiduciary deviates from the terms of the plan, it may not raise any insider-trading concerns.¹⁵⁸

155. Restatement (Second) Trusts § 167, cmt. f, illus. 23.

156. See *Kirschbaum v. Reliant Energy, Inc.*, 526 F.3d 243, 256 (5th Cir. 2008) (“[F]rom a practical standpoint, compelling fiduciaries to sell off a plan’s holdings of company stock may bring about precisely the result plaintiffs seek to avoid: a drop in the stock price.”).

157. Creating a playbook for the deviating EIAP fiduciary is beyond the scope of this Note, but here are a few brief suggestions for how a fiduciary might handle this issue. Because the entire purpose of the EIAP is to align the interests of the settlor and beneficiaries, fiduciaries may look to the company for help in stabilizing the stock price during and after a deviation. Perhaps, provided securities regulations allow, the company could buy back some of the EIAPs’ outstanding stocks. As an additional option, EIAP fiduciaries could attempt to decrease its holdings and maintain the stock price by selling off the stock in large blocks and repurchasing small percentages. Alternatively, the EIAP could maintain its holding of company stock at current levels, but decrease the volume of stock it purchases, offsetting its exposure with OTC equity swaps. Again, resolving this issue is beyond the scope of this note, but adoption of the proposed standard will require fiduciaries to develop a system of best practices for deviating from express plan terms.

158. Courts have yet to tackle the question of insider trading relating to stock-drop suits because the case has yet to present itself. It is plausible, in light of the countervailing policy concerns of maintaining the retirement account, that the S.E.C. would refrain from prosecuting for insider trades related to fulfilling EIAP fiduciary duties. It is also not clear that deviating EIAP fiduciaries would meet the scienter requirement. See *S.E.C. v. Obus*, 693 F.3d 276, 286 (2d

To compare and contrast the proposed standard and the *Moench* presumption, consider the examples from the Introduction.¹⁵⁹ In each of these scenarios, the plaintiffs failed to overcome the *Moench* presumption because the company's viability was not threatened. The standard proposed in this Note would likely reach the same conclusion in all but one of these scenarios, albeit for different reasons.¹⁶⁰

In the first example, the EIAP does not meet the new standard's threshold requirement of mandating more than a 20 percent investment in company stock. Thus, the *Moench* presumption applies. Because a "dire situation" did not threaten the company's viability or future existence—but more importantly, because 20 percent is within the diversification range for single assets posited by modern portfolio theory—continued investment in the company stock was not imprudent.

In contrast, the EIAP from the second example would meet the 20 percent investment requirement. And because a reasonable fiduciary could consider the company's false statements to violate the business judgment rule, an unanticipated circumstance has occurred. But the decrease in stock price is too small to "defeat or substantially impair" the plan's purpose—here, incentivizing employees by increasing their capital ownership, providing them with a retirement account, and aligning their goals with those of the company.¹⁶¹

The third example is less straightforward than the first two sets of facts, thereby highlighting the emphasis the proposed standard would place on pleading adequate facts to state a claim. The plan meets the threshold company stock requirement, but the fact pattern does not provide enough information to determine whether plan fiduciaries have an obligation to deviate from the terms of the plan document. The major deficiency is that the fact pattern does not specify whether anticipated circumstances—recalls are routine business practice—or unanticipated circumstances—the fraudulent accounting practices—caused the decrease in price. To plead

Cir. 2012) ("Liability for securities fraud requires proof of scienter, defined as 'a mental state embracing intent to deceive, manipulate, or defraud.'" (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 & n.12 (1976))).

159. *Supra* notes 17–22 and accompanying text.

160. These cases do not contain information about what fiduciaries would have estimated the decreased stock price to be, based on the available information. I assume that a reasonable fiduciary would estimate somewhere within 5 percent of the actual figures.

161. *See generally* Krouse, *supra* note 123.

sufficient facts to state a claim, the plan plaintiffs would need to disaggregate the causes of the stock drop and plausibly allege that the fraudulent accounting practices accounted for an adequate portion of the decrease in the price drop. Using the new standard, a court would likely dismiss the complaint without prejudice and grant the plaintiffs leave to amend the complaint instead of outright dismissing it, as would happen under *Moench*.

The proposed standard's divergence from the *Moench* presumption is most evident in the fourth and final example. In *Kirschbaum v. Reliant Energy*,¹⁶² the case underlying this scenario, corporate officers with knowledge of the stock trading practices that artificially inflated the stock's price served as EIAP fiduciaries.¹⁶³ The SEC mounted an investigation into Reliant Energy's practices,¹⁶⁴ the company was forced to restate its earnings,¹⁶⁵ and it settled a sizeable lawsuit stemming from claims associated with its trading practices.¹⁶⁶ Despite the overwhelming evidence of deceptive practices and the large losses to the company's EIAP, the court found no breach of fiduciary duty. Instead, the case enshrined the *Moench* presumption in the Fifth Circuit.¹⁶⁷

Applying the proposed standard, a court should reach a different conclusion. The plan greatly exceeded the 20 percent company stock requirement. And in light of the fact that plan fiduciaries knew of the trading activities and those activities prompted an SEC investigation, a reasonable plan fiduciary should easily conclude that the conduct in question fell outside the business judgment rule. Finally, the magnitude of the plan's concentration of company stock and the potential decrease in stock price increased the statistical likelihood of large losses in employees' retirement accounts, which implies that the plan's fiduciaries would have an obligation to deviate from the terms of the plan to continue to fulfill the settlor's intent of incentivizing employees.

These illustrations demonstrate that, like the *Moench* presumption, the proposed standard focuses neither on maximizing

162. *Kirschbaum v. Reliant Energy, Inc.*, 526 F.3d 243 (5th Cir. 2008).

163. *Id.* at 247.

164. Stephen Taub, *Reliant, Deloitte Settle with Investors*, CFO.COM, <http://www.cfo.com/article.cfm/4243831>, Aug. 1, 2005.

165. *Id.*

166. *Id.*

167. *See Kirschbaum*, 536 F.3d at 254 ("The *Moench* presumption logically applies to any allegations of fiduciary duty breach for failure to divest an EIAP or ESOP of company stock.").

plans' profits nor minimizing plan losses. Unlike the *Moench* presumption, however, the proposed standard seeks to honor the settlor's intent in an objective, logical, and doctrinally supported manner.

CONCLUSION

When it decided *Moench v. Robertson*, The Third Circuit left several questions unanswered:

How is an ESOP fiduciary to determine when diversification is in the best interest of the beneficiaries? Is the fiduciary always to seek the return-maximizing investment, or is there some nontangible loyalty interest served by retaining ESOP investments in employer stock? Additionally, to what extent should ESOPs be considered retirement plans, notwithstanding the qualification contained in most of them, including Statewide's, that they are not designed to guarantee retirement income?¹⁶⁸

By providing an objective framework within which plan participants and trustees may set their expectations and evaluate the merits of claims and defenses, the proposed standard answers the first two questions posed in *Moench*. The emergence of ESOPs and 401(k) plans as the most popular retirement accounts for private employees answers the last question.

From a public policy perspective, the United States should not adhere to a standard that does not recognize and protect the social policy that undergirds ERISA retirement plans—even those plans that it exempts from the duty to diversify. EIAP fiduciaries will need to develop methods for deviating from the plans of the term without exacerbating price drops resulting from companies' violations of the business judgment rule. But perhaps the real value of the proposed standard is the work it does in aligning the goals of plan beneficiaries, fiduciaries, and the companies that sponsor the plans.

This Note glossed over one final detail, which is that corporate directors and officers frequently serve as EIAP fiduciaries. One possibility is that the proposed standard might encourage companies to establish EIAPs with company stock ownership requirements in the range of conventionally acceptable risk that would be subject only

168. *Moench v. Robertson*, 62 F.3d 553, 570 (3d Cir. 1995).

to the *Moench* presumption. Considering the fact that the retirement accounts of over fifteen million Americans are at stake, many would consider this to be a welcome development. But this outcome is unlikely. If companies abandoned EIAPs, they would miss the favorable tax treatment and the ability to use the plans as tools of corporate finance. By holding fiduciaries accountable for companies' irrational business decisions that decrease the value of employees' retirement accounts, the standard should encourage certain fiduciaries—namely those who are also corporate directors or officers—to self-regulate their behavior and police the behavior of their nonfiduciary counterparts who are also company agents to limit potential liability while continuing to reap the benefits of EIAPs.