

Home Depot ERISA Stock Drop Case: Eleventh Circuit Adopts *Moench* Presumption of Prudence and Rejects Duty to Disclose Non Public Corporate Information under ERISA

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On May 8, 2012, the United States Court of Appeals for the Eleventh Circuit issued its long awaited decision in *Lanfear v. Home Depot, Inc.*, – F.3d –, 2012 WL 1580614 (11th Cir. May 8, 2012). Adopting the presumption of prudence first set forth in *Moench v. Robertson*, 62 F.3d 553 (3d Cir. 1995), the court affirmed the dismissal of a stock drop case brought under the Employee Retirement Income Security Act (ERISA) by participants in a Home Depot retirement plan.

Factual Background

The case was filed by participants in the Home Depot FutureBuilder Plan, an eligible individual account plan (EIAP) that allowed participants to manage investments in their own accounts. The plan included eight investment options, including an employer stock fund. While the plan mandated that a company stock fund be included among the plan's investment options, the plan required only that such company stock fund *primarily* be invested in Home Depot stock.

Plaintiffs contended that Home Depot stock became an imprudent investment because the stock price was artificially inflated due to Home Depot's alleged back-dating of stock options and its "return-to-vendor" (RTV) chargeback practices. As to the former, in June 2006, Home Depot announced the result of an internal investigation finding that the company routinely back-dated stock options between 1981 and 2000, which understated Home Depot's compensation expenses and led to a \$227 million charge in 2006. With respect to the RTV

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chargebacks, plaintiffs asserted that Home Depot's procedures allowed the company to profit improperly from vendors by charging back products that were not defective, damaged or returned. Once the truth concerning these practices was revealed, the price of Home Depot stock allegedly dropped from \$42.02 to \$35.09. Based on the foregoing, plaintiffs maintained that Home Depot and various individuals alleged to be fiduciaries of the plan breached their fiduciary duties under ERISA by failing to withdraw Home Depot stock as an investment option once it became an imprudent investment (the prudence claim) and by misrepresenting and failing to disclose the true risks associated with investing in Home Depot stock (the communication claim).

The District Court's Decision

The district court dismissed the action pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure. *Lanfear v. Home Depot Inc.*, 718 F. Supp. 2d 1364 (N.D. Ga. June 7, 2010). The district court first found that although the plaintiffs did "not directly allege that Defendants failed to diversify the Plan," the prudence claim was in reality a diversification claim. *Id.* at 1378 ("The basis of these allegations is that Defendants should have invested and made matching contributions in stock other than Home Depot stock and/or should have eliminated the Home Depot Stock Fund as an investment option; in other words that Defendants should have diversified the Plan's investments."). The district court therefore dismissed the diversification claim dressed up as a prudence claim because the plan, as an EIAP with employer stock holdings, was exempt from such claims under Section 404(a)(2) of ERISA. *Id.*

Alternatively, the district court held that even if the prudence claim was not a disguised diversification claim barred by Section 404(a)(2), dismissal was justified for two reasons. First, the district court accepted defendants' "hard wire defense," holding that where plan documents—like those governing the Home Depot plan—mandate the investment in company stock, the plan is "immune from judicial inquiry." *Id.* at 1380 (citation omitted). Second, the court determined that plaintiffs failed to rebut the presumption of prudence by alleging only a 16.5% stock price decline, which was not sufficient to demonstrate that Home Depot was on the "brink of financial collapse." *Id.* at 1381.

The district court also rejected the plaintiffs' communication claim, concluding that "representations made in SEC filings are not actionable under ERISA" even if those filings are incorporated by reference into "the prospectus for stock issued through an EIAP plan." *Id.* Further, it held that "ERISA does not impose an obligation to disclose broad categories of non public financial information regarding publicly traded securities." *Id.* (citation omitted).

The Eleventh Circuit Affirms

As an initial matter, the Eleventh Circuit found that the district court erred in holding that plaintiffs' prudence claim was "a camouflaged diversification claim." Slip Op. at 14. According to the court, "plaintiffs allege that the defendants acted imprudently because they knew that Home Depot stock was overpriced, not merely because it made up too large a percentage of the Company Stock Fund." *Id.* at 17.

Like the Second Circuit in *In re Citigroup ERISA Litigation*, 662 F.3d 128 (2d Cir. 2011), the Eleventh Circuit also rejected defendants' "hard wire defense." Although the plan required a company stock fund, it did not mandate that the fund be *exclusively* invested in company stock. It only required that company stock be *primarily* invested in Home Depot stock. *Id.* at 18. As such, the Eleventh Circuit concluded that the plan afforded fiduciaries limited discretion over the investment decision, which is subject to judicial review. *Id.* at 19.

Nevertheless, the Eleventh Circuit affirmed based on the district court's alternative grounds for dismissal under *Moench*, joining the Second, Third, Fifth, Sixth and Ninth Circuits in adopting the *Moench* presumption of prudence. Accordingly, the Eleventh Circuit held that the decision of fiduciaries of an employee stock ownership plan to continue to invest in and hold employer stock is subject to an abuse of discretion standard. *Id.* at 24. Importantly, the court also found that the *Moench* presumption applies at the motion to dismiss stage because it is a standard of review and not an evidentiary presumption. *Id.* at 29.

The Eleventh Circuit further held that plaintiffs can rebut the *Moench* presumption by showing that "the ERISA fiduciary could not have believed reasonably that continued adherence to the ESOP's direction was in keeping with the settlor's expectations of how a prudent trustee would operate." *Id.* at 26 (quoting *Moench*, 62 F.3d at 571). As such, at the motion to dismiss stage, a plaintiff must "plead facts sufficient to raise a plausible inference that the fiduciary abused its discretion by following the plan's directions." *Id.* at 29. Applying that standard, the Eleventh Circuit found that plaintiffs failed to rebut the presumption. According to the appellate court, the 16.5% stock decline followed by a rebound a few months later did not indicate the "type of dire situation which would require defendants to disobey the terms of the plan." *Id.* at 31 (quoting *Edgar v. Avaya, Inc.*, 503 F.3d 340, 348 (3d Cir. 2007)). In doing so, it specifically noted that "[t]he result we reach does not disadvantage the plan participants compared to shareholders generally. Instead, it refuses to provide participants with an unfair advantage over the other shareholders." *Id.* at 32.

As for the plaintiffs' communication claim, the Eleventh Circuit held that the operative misrepresentations contained in SEC filings were not fiduciary communications and therefore not actionable under ERISA. In so holding, the court rejected plaintiffs' argument that incorporating SEC filings into plan documents transforms the corporate communications into fiduciary communications. *Id.* at 35.

Finally, the Eleventh Circuit declined to adopt a general duty to disclose non public corporate information under ERISA. *Id.* at 38. The court opined that, while ERISA contains detailed disclosure rules, it does not "explicitly impose a duty to provide participants with non public information affecting the value of the company's stock." *Id.* at 37. Because the Eleventh Circuit determined that the summary plan description sent to plan participants adequately warned of the general risk of investing in the company stock fund given its concentration in Home Depot stock, it held that plaintiffs failed to state a claim. *Id.* at 39.

Key Point for Insurers

A plaintiff has yet to prevail on liability on summary judgment or at trial in an ERISA stock drop case. Yet, when these cases survive a motion to dismiss, some companies have settled to avoid litigation expenses (especially electronically stored information costs) and the disruption of the company's affairs. The Eleventh Circuit's holding that the *Moench* presumption applies at the motion to dismiss stage confirms that plaintiffs face a high hurdle at the initial pleadings stage in these cases, and insureds can expect greater success in challenging the pleadings as a result.