No. 11-1531

In The Supreme Court of the United States

STEPHEN GRAY, ET AL., PETITIONERS

v.

CITIGROUP, INC., ET AL

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF FOR PETITIONERS

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Although respondents attempt to bury it, see BIO 18-19, they concede that there is a square conflict in the circuits on whether a presumption of prudence applies at the motion to dismiss stage. The question is arising, and is outcome-determinative, in an ever increasing number of cases, which are dismissed in the Second and Eleventh Circuits but permitted to proceed in the Sixth Circuit. Respondents do not dispute that this question affects many millions of ERISA plan participants, see Pet. 34, is squarely presented in this case, see Pet. 35-36, and is a particular concern of the Department of Labor, see Pet. 34. Those facts alone are sufficient to establish that certiorari is warranted.

Beyond respondents' concession, the conflict extends to the broader question of the substantive prudence standard governing ERISA fiduciaries with responsibility for plans that invest in employer stock. In the Sixth Circuit, the presumption of prudence is a modest evidentiary presumption that does not alter the fundamental statutory "care, skill, prudence, and diligence" standard. By contrast, the Second and other Circuits have converted that evidentiary presumption into an extra-statutory rule of law that fiduciaries need not act to address imprudent investment in employer stock unless and until the employer is in a "dire situation" or near bankruptcy. The division on the substantive standard is outcome-determinative in this and many other cases, and it too warrants this Court's review.

A. The Conflict on Whether the Presumption Applies at the Pleading Stage Warrants Further Review

1. Respondents concede that the Sixth Circuit in *Pfeil v. State Street Bank & Trust Co.*, 671 F.3d 585, 592 (2012), petition for cert. filed, Jun. 14, 2012 (No. 12-256), held that "the presumption of reasonableness . . . does not apply at the motion to dismiss stage" and that the Sixth Circuit thus "disagreed with the Second Circuit and other courts of appeals." BIO 18. In the few short months since *Pfeil* was decided, the Sixth Circuit has twice more held that the presumption does not apply at the motion to dismiss stage. *Dudenhoefer v. Fifth Third Bancorp*, 2012 WL 3826969, at *5 (Sept. 5, 2012); *Griffin v. Flagstar Bancorp*, 2012 WL 2989231, at *3 (July 23, 2012). The Second Circuit has also continued to apply its contrary holding that the presumption *does* apply at the motion to dismiss stage. See, *e.g.*, *In re Glaxo SmithKline ERISA Litig.*, 2012 WL 3798260 (2d Cir. Sept. 4, 2012); *Fisher v. JP Morgan Chase & Co*, 469 Fed. Appx. 57 (May 8, 2012), petition for cert. filed, Jul. 16, 2012 (No. 12-298); *Gearren v. McGraw-Hill Companies, Inc.*, 660 F.3d 605 (2011) (companion case to *Citigroup*), petition for cert. filed, Jun. 22, 2012 (No. 11-1550). The frequency with which the issue continues to arise demonstrates the need for this Court's review.

2. Respondents appear to argue (BIO 18-19) that the conflict nonetheless need not be resolved because (they assert) there is no conflict on the substantive question presented in the petition: whether plan fiduciaries may take no steps at all to protect plan

participants unless the employer is in a "dire situation" or the like. Respondents are mistaken that there is no conflict on that question. See pp. 4-9, *infra*. But even if respondents were correct, the procedural issue alone would warrant further review, because it is important, arises frequently, and will generally be outcome-determinative.

The Second Circuit affirmed the dismissal in this case only because it required the Complaint to satisfy the court's "dire situation" standard. Pet. App. 21a-22a. The court did not suggest that it would have resolved this case in the same way if that standard did not apply, nor did it disagree with Judge Straub's conclusion in dissent that, without the need to allege a "dire situation," the Complaint stated a valid claim for relief. See Pet. App. 52a.

The Sixth Circuit, which rejects application of a special "dire situation" standard at the motion to dismiss stage, held the complaints in *Pfeil*, *Dudenhoefer*, and *Griffin* sufficient because in each case they plausibly alleged that "a prudent fiduciary acting under similar circumstances would have made a different investment decision." 671 F.3d at 593; see *Dudenhoefer*, 2012 WL 3826969, at *4; *Griffin*, 2012 WL 2989231, at *4. That is precisely the inquiry that Judge Straub in dissent undertook in this case, with no added "dire situation" overlay. The majority's application of its "dire situation" standard at the motion to dismiss stage was outcome-determinative in this case, as it will be in many others.

B. The Conflict on the Substantive Standard Warrants Further Review

1. The circuits are equally in conflict on the substantive standard governing ERISA fiduciaries whose plans invest in employer stock. Respondents' argument (BIO 17) that "[n]either the Sixth Circuit nor any other court has held that there are substantive differences among the circuits in an ESOP fiduciary's duty of prudence" is not tenable.

a. In *Pfeil*, the Sixth Circuit held precisely that there *are* substantive differences between its standard and that applied in other circuits. The court noted that other circuits had "adopted more narrowly-defined tests for rebutting the presumption," specifically rejecting the Second and Third Circuits' holdings that drastically dilute the ERISA fiduciary duty standard. 671 F.3d at 594-596. The Sixth Circuit explained that, "*[i]n contrast to our sister circuits*," it does not "require[] proof that the company faced a 'dire situation,' something short of the 'brink of bankruptcy' or an 'impending collapse.'" *Id*. at 595 (emphasis added).[1] The court did not distinguish the cases from other circuits on factual grounds; rather, it disagreed with the legal standards they applied and explained why its rule was required by ERISA.

[1] Contrary to respondents (BIO 18 n.8), the Eleventh Circuit too acknowledged the substantive circuit conflict. After noting that the Sixth Circuit had concluded that the presumption of prudence "does not apply at the motion to dismiss stage," the Eleventh Circuit in *Lanfear* added that the Sixth Circuit "*also* puts less deference behind the presumption than the Second or Third Circuits do." *Lanfear v. Home Depot, Inc.*, 679 F.3d 1267, 1281 n.16 (2012) (emphasis added).

In *Dudenhoefer*, the Sixth Circuit again explained that "*[u]nlike these other circuits*," its standard "makes sense because it closely tracks the statutory language of [ERISA] § 404(a)(1)(B)." 2012 WL 3826969, at *5 (emphasis added). By contrast, the Second Circuit's "dire situation" requirement has no relation to the statutory text. See Pet. 27-28. And the Sixth Circuit "imposes identical standards of prudence and loyalty on all fiduciaries, including ESOP fiduciaries." 2012 WL 3826969, at *5; see *Eaves v. Penn*, 587 F.2d 453, 460 (10th Cir. 1978) (same). By contrast, the Second Circuit "reject[ed] [petitioners'] argument . . . that we should analyze the decision to offer [employer stock] *as we would a fiduciary's decision to offer any other investment option*." Pet. App. 15a (emphasis added).

b. These differences are not ones of mere "verbal formulation[]." BIO 17. A showing that the employer is in a "dire situation" or near bankruptcy is different, and far more demanding, than a showing that investment in the employer's stock would foreseeably result in very significant losses and was therefore imprudent. See Pet.27-28. Had the Second Circuit applied the Sixth Circuit's standard here, its analysis would have mirrored that of Judge Straub, and it would have reversed, not affirmed. See pp. 3-4, *supra*.

The Sixth Circuit's decision in *Dudenhoefer* clinches the point. In *Dudenhoefer*, plaintiffs alleged that an investigation by fiduciaries would have revealed that the employer bank "engaged in lending practices that were equivalent to participation in the subprime lending market, that [the fiduciaries] were aware of the risks of such investments by the start of the class period, and that such risks made [the employer's stock] an imprudent investment." 2012 WL 3826969, at *6. The Sixth Circuit held those allegations sufficient to survive a motion to dismiss. This case, however, involves essentially the same or stronger allegations. See Pet. 5-8. Yet the Second Circuit held that the complaint in this case was *in*sufficient because it did not adequately allege a "dire situation." The conflict in substantive standards could not be clearer.

c. Respondents mistakenly argue (BIO 16-17) that there would be no conflict in a case in which plan terms do not require the fiduciary to offer employer stock to plan participants. As noted, the Sixth Circuit's reasoning and result in *Pfeil* and subsequent cases settled that plaintiffs in the Sixth Circuit need not show a "dire situation" or the like. Indeed, in the seminal Sixth Circuit case, the court did not disagree with the fiduciary's argument "that the terms of the plan did not give [the fiduciaries] any discretion to diversify or liquidate the ESOP funds." *Kuper v. Iovenko*, 66 F.3d 1447, 1457 (6th Cir. 1995). The court therefore accepted that, as in this case, the plan's terms *required* offering employer stock. Nonetheless, the court applied the same standard as in *Pfeil* and the other more recent cases (and in Judge Straub's dissent): "[a] plaintiff may . . . rebut th[e] presumption of reasonableness by showing that a prudent fiduciary acting under similar circumstances would have made a different investment decision." *Id.* at 1459; see *id.* at 1460 (whether a reasonable fiduciary "would have continued to hold [the employer's] stock" based on its investment characteristics). Regardless of plan terms, the "dire situation" standard has no application in the Sixth Circuit.

The Second Circuit's cases establish that its conflicting standard ("dire situation") also applies generally, regardless of whether a particular plan requires holding employer stock. In *Fisher*, plaintiffs argued that *Citigroup* did not control their claim because "unlike the ERISA plans at issue in *Citigroup* . . . , here the Plan's fiduciaries had unfettered discretion whether to offer [employer stock] as a Plan investment option." 469 Fed. Appx. at 59 (internal quotation marks omitted). The Second Circuit rejected that contention, holding that C*itigroup* "adopted the presumption of prudence as applying to *all* . . . ESOPs," *id*. at 60, regardless of the extent to which the plan documents favor or require offering employer stock. The court therefore applied its "dire situation" standard to the complaint in *Fisher*. See *id*. at 59 (complaint did "not sufficiently allege[] that defendants knew or should have known that JP Morgan was in a dire situation"). Accord *Glaxo SmithKline*, 2012 WL 3798260, at *2 ("dire situation" standard applies where plan terms "strongly favor" – but do not require – fiduciaries to offer employer stock). The Second Circuit would thus have applied its dire situation standard in each of the Sixth Circuit cases, in direct conflict with the Sixth Circuit's approach.

2. Respondents argue (BIO 13-15) that the Court need not be concerned with the conflict because the various circuits all apply an abuse-of-discretion standard when evaluating fiduciaries' conduct with

respect to employer stock. The Petition notes (Pet. 31) that fiduciaries do have substantial discretion to choose among a very wide range of prudent investments. ERISA, however, requires that they act with "care, skill, prudence, and diligence." 29 U.S.C. 1104(a)(1)(B). ERISA fiduciaries do not have discretion to make imprudent investment decisions.

Indeed, the conflict in the circuits focuses precisely on defining the degree of discretion possessed by a fiduciary when evaluating investments in employer stock. Under the Second Circuit's standard, ERISA fiduciaries who know to a certainty that employer stock held by the plan is substantially overvalued or otherwise imprudent have the discretion to take no steps at all to protect participants; they need not cease purchasing the stock, divest it, or even warn participants of the known risk (or hire an independent fiduciary who could take those steps) – so long as the employer is not in a "dire situation" or near bankruptcy.[2] Under the Sixth Circuit's standard, by

[2] With respect to the duty to warn participants, respondents concede that the Petition "argues that the Second Circuit erred by affirming the dismissal of th[e] 'communications' claim," but respondents strangely argue that this issue is not raised in the question presented. BIO 7 n.3. The first question presented asks whether fiduciaries are "permitted to take no steps to protect plan participants and beneficiaries" when they know of imprudent investment in employer stock. Pet. i. The Petition repeatedly emphasizes that the "steps" they should have taken include communications to plan participants about the risks. See Pet. 2 ("inform plan participants of the high risks"), 7 ("inform Plan participants of the new risks"), 13 ("warn participants of the known risk"), 23 ("disclose those facts to the beneficiaries so that they may protect their own interests"), 29-30 & n.5

contrast, a presumption of reasonableness is rebutted – and a showing is made that fiduciaries abused their discretion – "by showing that a reasonable fiduciary acting under similar circumstances would have made a different investment decision." *Pfeil*, 671 F.3d at 591; see also *Dudenhoefer*, 2012 WL 3826969, at *10 & n.2 (holding that complaint adequately alleged fiduciaries failed to take these steps). Fiduciaries in the Sixth Circuit do not have the discretion to sit on their hands so long as the employer is not in a dire situation or near bankruptcy.

3. Respondents do not dispute that the question whether fiduciaries are required to act in these circumstances is squarely presented by this case. See Pet. 35-36. Nor do they dispute that the questions in this case, as the Department of Labor has emphasized, "are of exceptional importance . . . because they put hundreds of billions of dollars in pension plan assets at undue risk." Pet. App. 144a; see Br. of Amicus AARP et al 5-9. Further review to resolve the substantive standard governing fiduciaries, and to restore ERISA's protections as Congress intended, is warranted.

C. The Court of Appeals Erred

1. On the merits, respondents err in arguing (BIO 26) that petitioners' rule would "create an[] exception to" insider trading prohibitions. The Complaint survives so long as any one of the actions the Complaint alleges they should have taken was legal-

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(similar traditional trust law principles). There can be no serious question that the Petition squarely presents this claim.

ly permissible. In fact, all of them are.

One step that respondents could have taken would have been to cease purchasing Citigroup stock for the plans. Respondents themselves note that the securities laws prohibit "*trading* on material non-public information." BIO 26 (emphasis added). Because the relevant securities laws address conduct "in connection with the purchase or sale of any security," they do not prohibit a decision *not* to purchase stock. 25 U.S.C. 78j; 17 C.F.R. 240.10(b)(5); see, *e.g.*, *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*, 552 U.S. 148, 160-161 (2008). Respondents therefore could have ceased purchasing Citigroup stock without implicating the securities laws.

In addition, nothing in the securities laws prohibits warning plan participants (and others); to the contrary, disclosure is an important goal of those laws. See, *e.g.*, *SEC v. Zandford*, 535 U.S. 813, 819 (2002) ("philosophy of full disclosure"). Accordingly, respondents could have disclosed the special risks of investment in Citigroup stock without implicating the securities laws.

The securities laws could arguably be implicated only if respondents' duty of prudence required them to sell the plans' Citigroup stock based on nonpublic information. Selling a stock could pose its own risks by driving the price down, and it therefore may not be required in all circumstances in which investment in the stock has become imprudent. See Pet. 23. When divestment is appropriate, however, disclosure of the nonpublic facts driving the divestment would eliminate any possible difficulty under the securities laws. See *Dirks v. SEC*, 463 U.S. 646, 654 (1983) (insider liable "only where he fails to disclose material nonpublic information before trading on it").

In short, respondents had ample means to comply with their ERISA fiduciary duties without coming near a violation of the securities laws. Any remaining doubt on this question can await a case in which the specific steps the fiduciary must take under ERISA are established and can be compared with the requirements of the securities laws. The securities laws certainly provide no warrant for dismissing the Complaint or tinkering more generally with ERISA's "care, skill, prudence, and diligence" standard.

2. Respondents defend the dilution of ERISA's fiduciary duties as necessary to accommodate Congress's desire to encourage ESOPs. BIO 12-15. The fact that Congress provided numerous *other* incentives to encourage ESOPs, see BIO 5 & n.2, however, serves to highlight that Congress did *not* find it appropriate to exempt ESOP investments from the prudence requirement or substantially dilute it.

To be sure, Congress did specifically address the tension between the prudence requirement and ESOP ownership. See Pet. 24-26. But it did so in a carefully worded provision that provides an exemption "only to the extent that [the prudence requirement] requires diversification." 29 U.S.C. 1104(a)(1)(D). The Second Circuit's broad extension of the exemption to cases *not* involving claims of lack of diversification was an improper interference with Congress's determination that the prudence requirement at the very heart of ERISA, see 29 U.S.C. 1001(b), remain otherwise intact.[3]

[3] Respondents' hesitant assertion (BIO 6) that the exemption for diversification "arguably bars all claims against ESOP fiduciaries based on allegations that it was imprudent to maintain company stock as an investment option" is wrong. The claims in this case concern only the imprudence of investment in Citigroup stock because it was substantially overvalued. Even the Eleventh Circuit and Fifth Circuits, which in other respects agreed with the court below, have recognized that claims of imprudent investment are different from claims of failure to diversify and are not barred by Section 1104(a)(1)(D). See Lanfear, 679 F.3d at 1276; *Kirschbaum v. Reliant Energy, Inc.*, 526 F.3d 243, 249 (5th Cir. 2008); see also Br. of Amici Law Profs. 10-16.

CONCLUSION

The petition for a writ of certiorari should be granted. Alternatively, in light of the Department of Labor's longstanding and consistent interest in this issue, the Court may wish to invite the Solicitor General to express the views of the United States in this case.

Respectfully submitted.

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