Second Circuit Opens Potential ERISA Avenue for Plaintiffs in "Stock Drop" Lawsuits

PUBLISHED: January 29, 2019

On December 10, 2018, the United States Court of Appeals for the Second Circuit issued a rare procedural victory to "stock drop" plaintiffs by reversing and remanding a district court's dismissal of a lawsuit against IBM. *Jander v. IBM*, No. 17-3518 (2d Cir. December 10, 2018). The court held that the plaintiffs sufficiently pleaded a prudence claim that relied upon corrective disclosure as a viable alternative course of action for the fiduciaries. On January 18, 2019, the Second Circuit denied the IBM defendants' petition to reconsider the decision *en banc*. The IBM defendants subsequently indicated their intent to file a petition for a writ of certiorari with the Supreme Court on January 24, 2019.

The *Jander* plaintiffs' breach of prudence claims concerned non-public "inside" information relating to an IBM business unit's accounting violations that allegedly inflated IBM's stock price. The plaintiffs alleged that the fiduciaries of IBM's ESOP breached their duties by failing to disclose that IBM's stock was overvalued, and by continuing to permit investment in company stock despite their "knowledge of undisclosed troubles relating to IBM's microelectronics business."

The *Jander* ruling is a notable development that has already and will likely continue to encourage further stock drop litigation, and could also require plan fiduciaries to consider difficult questions about disclosure as a way to potentially limit litigation exposure.

Notably, following the roadmap paved by the Second Circuit, stock drop lawsuits were filed by participants in Johnson & Johnson's defined contribution plans on January 22 and January 25, 2019. *Perrone v. Johnson & Johnson*, No. 2:19-cv-00923 (D.N.J. filed Jan. 22, 2019); *Tarantino v. Johnson & Johnson Pension & Benefits Comm.*, No. 3:19-cv-01115 (D.N.J. filed Jan. 25, 2019). The gravamen of the complaints is that the plan fiduciaries should have made earlier disclosure of non-public information relating to alleged asbestos in products because the "eventual revelation . . . [was] virtually inevitable."

Below, we discuss *Jander* and its potential implications.

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I. Background

The *Jander* plaintiffs alleged that "the plan's fiduciaries knew that a division of the company was overvalued, but failed to disclose that fact," which resulted in the plan holding artificially inflated IBM stock. Specifically, the plaintiffs alleged that IBM's microelectronics business "was on track to incur annual losses of $700 million" and that through questionable accounting practices, "IBM failed to publicly disclose these losses and continued to value the business at approximately $2 billion."

When IBM eventually announced the sale of the affected business unit, it "revealed that IBM would pay $1.5 billion to [the purchaser] to take the business off IBM's hands . . . and that IBM would take a $4.7 billion pre-tax charge, reflecting in part an impairment in the stated value of [the business unit]." This revelation allegedly caused IBM's stock price to drop more than $12.

The plaintiffs alleged that the ESOP fiduciaries continued to permit investment in company stock despite their knowledge of the issues at IBM's microelectronics unit. The plaintiffs also alleged that once the defendants became aware that IBM's stock price was artificially inflated, they should have "either disclosed the truth about [the business unit's] value or issued new investment guidelines that would temporarily freeze further investments in IBM stock."

The district court had rejected the allegations that alternative actions were available and dismissed the lawsuit after finding that, based on the facts pleaded, "a prudent fiduciary could have concluded that earlier corrective disclosure would have done more harm than good."

II. Ambiguity in *Dudenhoeffer* – Standard for Assessing Alternative Actions

On appeal, the plaintiffs contended that both the district court and other courts reviewing stock drop lawsuits have incorrectly applied a "stricter standard" than required under the Supreme Court's decision in *Fifth Third Bancorp v. Dudenhoeffer*, 134 S. Ct. 2459 (2014), "that makes it functionally impossible to plead a duty-of-prudence violation." The plaintiffs sought clarification from the Second Circuit about whether the standard for considering proposed alternative actions requires courts to conclude that a prudent fiduciary in the same circumstances (i) "would" not have viewed an alternative action as more likely to harm rather than help a plan, or (ii) "could" not have concluded that the action would do more harm than good.

The Second Circuit recognized that *Dudenhoeffer* does not clearly state the standard courts should apply when reviewing proposed alternative actions. The "would" standard, the Second Circuit noted, "suggests that courts ask what an average prudent fiduciary might have thought," while the "could" standard "appears to ask . . . whether any prudent fiduciary could have considered the action to be more harmful than helpful."

Importantly, while noting that "[i]t is not clear which of these [standards] determine whether a plaintiff has plausibly alleged that the actions a defendant took were imprudent in light of available alternatives," the Second Circuit did not rule on the issue because it concluded that the plaintiffs plausibly pleaded a duty of prudence claim "even under the more restrictive 'could not have concluded' test."

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III. Corrective Disclosure as Alternative Action

The Second Circuit's holding that the plaintiffs "plausibly establish that a prudent fiduciary in the Plan defendants' position could not have concluded that corrective disclosure would do more harm than good" rested on several significant findings.

A. Risks of Disclosure

The Second Circuit examined the various theories supporting the district court's finding that disclosure was not a plausible alternative. The district court found the pleadings were insufficient because the plaintiffs "failed to account for the risk that 'an unusual disclosure outside the securities laws' normal reporting regime could spook the market, causing a more significant drop in price than if the disclosure were made through the customary procedures." The Second Circuit questioned this finding, observing that "the class period here runs from January through October 2014," and thus that "disclosures could have been included within IBM's quarterly SEC filings and disclosed to the ESOP's beneficiaries at the same time in the Plan defendants' fiduciary capacity." Accordingly, the Second Circuit rejected the shortcoming the district court perceived in the plaintiffs' pleadings.

Significantly, the Second Circuit's analysis seemingly weakens future assertions that corrective disclosures of non-public information are implausible alternatives because they could send negative signals to the market—at least when opportunities to make disclosures about the relevant conduct are available through normal reporting processes.

The Second Circuit also rejected the defendants' claim that public disclosure could cause an overreaction that could harm IBM's stock price. The Second Circuit instead accepted the plaintiffs' argument that, under an efficient market, corrective disclosures "would reduce IBM's stock price only by the amount by which it was artificially inflated," and thus that "a prudent fiduciary need not fear an irrational overreaction to the disclosure of fraud."

B. Merits of Mitigating Harm when Disclosure is Inevitable

The accounting violations at IBM's microelectronics unit were almost certain to be disclosed as part of IBM's efforts to sell the business. In this context—i.e., where disclosure of the conduct that has allegedly inflated the stock is inevitable—the Second Circuit held that the plaintiffs sufficiently pleaded that "no prudent fiduciary . . . could have concluded that earlier disclosure would do more harm than good." Importantly, the Second Circuit agreed with the plaintiffs that "[a] reasonable business executive could plausibly foresee that the inevitable disclosure of longstanding corporate fraud would reflect badly on the company and undermine faith in its future pronouncements." In other words, the Second Circuit appears to have found it plausible that an earlier disclosure would have minimized the stock price correction.

Thus, the Second Circuit appears to be of the view that—at the motion to dismiss stage—a well-pleaded allegation that reputational harm is amplified the longer the fraud remains undisclosed must be taken as true without the need for support (e.g., expert analysis) specific to the facts of the case. This position is contrary to the district court's criticism of the plaintiffs' use of "general" market analysis to bolster their allegation that non-disclosure increased the harm to IBM's stock price.

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Turning to the facts of the case, the Second Circuit observed that "the defendants allegedly knew that disclosure of the truth regarding IBM's microelectronics business was inevitable, because IBM was likely to sell the business and would be unable to hide its overvaluation from the public at that point." The Second Circuit emphasized that this fact—that disclosure was inevitable—was "particularly important," and different from "the normal case," where a "fiduciary is making a comparison only to the status quo of non-disclosure."

Significantly, the Second Circuit stated that when disclosure and a "'drop in the value of the stock already held by the fund' is inevitable," as in IBM's situation, "it is far more plausible that a prudent fiduciary would prefer to limit the effects of the stock's artificial inflation on the ESOP's beneficiaries through prompt disclosure." The Second Circuit further concluded that when "non-disclosure of IBM's troubles was no longer a realistic option . . . a stock-drop following early disclosure would be no more harmful than the inevitable stock drop that would occur following a later disclosure."

IV. Significance and Implications

Since *Dudenhoeffer*, stock drop lawsuits have rarely survived the motion to dismiss stage. Against this backdrop, the Second Circuit's decision to reverse and remand the IBM lawsuit—and in particular, its reasoning with respect to the considerations when evaluating corrective disclosure—is a significant development, and one that could be influential to other courts even beyond the Second Circuit.

As can be seen in the new complaints filed against Johnson & Johnson, plaintiffs have immediately seized upon the roadmap paved by the Second Circuit. Both of the complaints filed against Johnson & Johnson cite *Jander* and emphasize the "inevitability" of the disclosure of non-public information. Specifically, the complaints allege that fraud and concealment on the part of the company led to artificial inflation of the company's stock price; the fiduciaries were aware of this fact; knew that public disclosure was inevitable; and therefore should have disclosed the non-public information.

The Johnson & Johnson lawsuits allege that in light of multi-district litigation relating to allegedly carcinogenic baby powder sold by the company, disclosure of non-public corporate information (which could allegedly demonstrate the company's longstanding concealment of various product hazards) through normal litigation procedures such as discovery was inevitable. Given this eventual disclosure, the plaintiffs argue that the plan fiduciaries breached their duties by failing to make earlier disclosures because delayed disclosure amplified losses, including damages to the company's goodwill. In this regard, the plaintiffs allege that the loss of goodwill allegedly increased the severity of the decline in stock value.

It will be important to keep an eye on developments in the Johnson & Johnson lawsuits. At this stage, perhaps the most important question is whether the District Court of New Jersey—which falls under the Third Circuit and is therefore not bound by *Jander*—will find the Second Circuit's decision persuasive.

Separately, beyond its impact on corrective disclosure arguments, it also remains to be seen whether the Second Circuit's recognition of an apparent ambiguity in *Dudenhoeffer*'s "could not/would not" pleading standard will open the door to more targeted emphasis by plaintiffs on this issue, and perhaps even set the stage for eventual resolution by the Supreme Court.

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