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ERISA UPDATE

By Nicholas Wamsley

Second Circuit Throws Potential Lifeline to ERISA Stock-Drop Lawsuits

The Supreme Court's 2014 decision in *Fifth Third Bancorp v. Dudenhoeffer*[1] and subsequent reaffirmation in *Amgen Inc. v. Harris*[2] dismantled the judicially created presumption of prudence in favor of ESOP fiduciaries and, at the same time, imposed a heightened pleading standard in ERISA employer stock cases. Subsequently, courts appeared to have closed the door on participants' stock-drop lawsuits. But just as those claims seemed all but dead, a recent decision out of the US Court of Appeals for the Second Circuit may have breathed new life into them. In *Jander v. Retirement Plans Committee of IBM*,[3] the Second Circuit advanced a claim beyond the motion to dismiss stage, reversing the district court's dismissal and breaking with the position taken by nearly all federal courts since *Dudenhoeffer* and *Amgen*.

Recall that, under the standard announced in *Dudenhoeffer*, a plaintiff must allege alternative action that the fiduciary could have taken that would not have violated securities laws and that a prudent fiduciary could not have concluded would do more harm than good to the stock fund. Participants in dozens of suits strove mightily to articulate the alternative actions that fiduciaries could take that, under this standard, would not have done more harm than good. Every circuit court rejected those efforts, uniformly affirming the dismissals of those cases.[4] Every circuit court, that is, before the Second Circuit decided *Jander*.

The plaintiffs in *Jander* participated in the IBM Company Stock Fund, an ESOP within IBM's 401(k) plan.[5] They claimed that the IBM Retirement Plans Committee and certain individual fiduciaries who oversaw the 401(k) plan's management and occupied senior leadership positions within IBM (collectively, the IBM fiduciaries) violated their ERISA duty of prudence by continuing to allow participants to invest in IBM stock despite knowing that IBM's microelectronics unit was struggling and was overvalued in corporate disclosures.[6] According to the complaint, IBM began hiding the losses in 2013 and eventually sold the business unit in 2014, in a write-down indicative of the overvaluation. Subsequently, IBM's stock value declined by more than $12 per share, or about 7 percent.[7]

On appeal, the plaintiffs in *Jander* argued that the IBM fiduciaries should have made an earlier disclosure of the true value of the struggling microelectronics unit.[8] The US District Court for the Southern District of New York rejected this theory and granted the IBM fiduciaries' motion to dismiss, but Chief Judge Robert A. Katzmann, writing for a unanimous Second Circuit panel, disagreed.[9]

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How Did the IBM Plaintiffs Succeed?

All plaintiffs in earlier circuit court stock-drop cases failed to clear the "alternative action" pleading hurdle, so what did the IBM plaintiffs do differently? Did they present a clever alternative action not encountered by prior courts, or were their facts stronger or presented particularly well in their complaint?

In response to the first possible reason for the IBM plaintiffs' success, they did not present any novel alternative actions that the IBM fiduciaries could have taken. In fact, the plaintiffs pleaded just one alternative action on appeal: "early corrective disclosure of the [struggling branch], conducted alongside the regular SEC reporting process."[10] Since *Dudenhoeffer* and *Amgen*, plaintiffs in *every* circuit court stock drop case advocated early corrective disclosure as an alternative action, and *every* circuit court rejected it.[11] Not only had every circuit court rejected that particular alternative action, but they rejected all *other* alternatives presented to them, including that fiduciaries should have divested or frozen purchases of company stock or shifted a portion of the company stock fund's holdings into a hedging product to counterbalance the company stock's financial performance.

The strength of the underlying facts does little to explain the plaintiffs' success; the facts are unremarkable and generally track those of prior stock drop cases. If the facts can be distinguished, it is on the ground of the relatively minimal decline in value suffered by the IBM stock. Specifically, the IBM stock fell 7.11 percent over one weekend, smaller than the "drop" in any other circuit court case (the next smallest is 11 percent, suffered by the Whole Foods stock in *Martone v. Robb*).[12] This relatively modest decline in value arguably supported *affirmance* of the dismissal and should have raised plausibility or causation concerns for the court, particularly in light of the result in the securities case, in which the district court found no fraud and, to the contrary, found a "reasonable basis" for the financial projections. Given that other circuits had rejected claims when a stock lost up to 95 percent of its value, the Second Circuit tabbing this case to move forward seems surprising.[13] These facts may present a challenge for the plaintiffs on remand, as one of the key questions will be whether the stock value would have declined by less than 7 percent had earlier disclosure been made.

Finally, the plaintiffs did not support their early disclosure alternative with details or facts that were noticeably stronger than those pleaded in prior stock-drop cases. In fact, the allegations that the *Jander* panel found convincing had each been explicitly rejected by other courts. For example, the *Jander* panel held that a reasonable business executive could have determined that the harm would only increase the longer that the fraud continued, but the Fifth Circuit had dismissed that reasoning as a "generalized allegation."[14] The *Jander* panel also found that plaintiffs' citations to economic studies supported early disclosure as a viable alternative action, but, again, the Fifth Circuit dismissed a reference to similar economic principles as too "widely-known and generally-applicable" to support a specific allegation.[15] The key fact relied upon by the *Jander* panel was the inevitability of the disclosure (that is, IBM would eventually sell its struggling branch and would be required to disclose at that point). The panel explained that in such a case, a prudent fiduciary may "prefer to limit the effect of the stock's artificial inflation . . . through prompt disclosure."[16] However, disclosure was inevitable in other stock-drop suits faced by the circuit courts (for example, disclosure of securities fraud in an earlier Second Circuit case), and unlike the *Jander* court, the courts in those cases did not consider similar inevitabilities "particularly important."[17] Nevertheless, plaintiffs are quickly seizing on the Second Circuit's "inevitability" distinction. The US District Court for the District of New Jersey already faces an ERISA stock-drop claim in which the plaintiffs cite to the Second Circuit's opinion in *Jander* and repeatedly reference the "inevitability" of the disclosure at issue.[18] Even plaintiffs in litigation initiated before the *Jander* decision have latched onto its reasoning to argue reversal of motions to dismiss

previously granted at the lower court level, so more circuit court guidance may be forthcoming.[19]

So, why *did* the *Jander* plaintiffs succeed? The Second Circuit panel appears to have simply applied a lower pleading standard than other circuit courts faced with stock-drop claims. According to other circuit court panels, the *Dudenhoeffer* standard imposes a "significant burden" on the plaintiffs and forbids a lower court from "simply presum[ing] that the plaintiff's proposed alternatives would satisfy the *Fifth Third* standards."[20] Nonetheless, the Supreme Court "neglects to offer any guidance about what facts a plaintiff must plead."[21] Given this lack of guidance and admitted confusion regarding the *Dudenhoeffer* standard, the development of a split regarding its application comes as no surprise. In adopting a more plaintiff-friendly approach, the *Jander* panel issued a reminder that "the standard [at the motion to dismiss stage] is plausibility—not likelihood or certainty," which could be the panel's attempt to distinguish its opinion from those circuits that have applied a stricter pleading standard.[22]

The Supreme Court issued its opinion in *Dudenhoeffer* because the existing pleading standard "ma[de] it impossible" for a plaintiff to state a claim.[23] Nevertheless, since *Dudenhoeffer*, plaintiffs have found it largely impossible to do just that. Absent discovery, plaintiffs will rarely have access to the details seemingly required to meet the *Dudenhoeffer* standard in some circuits, such as proof of the fiduciaries' knowledge of a company's business condition at a particular point in time. The *Jander* opinion seems to give plaintiffs a greater opportunity to develop the facts needed to prevail on stock-drop claims, and for that reason, the opinion may align more with the Supreme Court's intent than post-*Dudenhoeffer* opinions issued by other circuit court panels.

What Questions Does *Jander* Not Answer?

As an initial matter, the *Jander* opinion only addresses the motion to dismiss stage, so the evidence plaintiffs would need to prevail at summary judgment or trial could be challenging. Beyond that, the Second Circuit's opinion leaves open many issues with respect to the pleading standard. In fact, the Second Circuit chose not to reach perhaps the most significant issue: the actual language of the standard. The Second Circuit explained that the Supreme Court left unclear whether plaintiffs must show that an *average* fiduciary *would not* have viewed the alternative actions as more likely to do harm than good to the stock fund, or whether plaintiffs must show that *any* fiduciary *could not* have taken that view. Because the Second Circuit found that the IBM participants satisfied either standard, it felt no need to weigh in. Finally, by advancing a claim with the smallest per share stock decline of any stock-drop case to reach the circuit courts, the Second Circuit muddied the waters with respect to the plausibility and causation that participants must demonstrate. The Second Circuit's choice to advance a claim with such a minimal decline could well encourage another onslaught of employer stock litigation.

Next Steps in *Jander*

IBM filed a petition for *en banc* review on December 21, 2018,[24] but the Second Circuit denied the petition,[25] an unsurprising result given that the Second Circuit grants *en banc* review only on exceedingly rare occasions.[26] IBM has since asked the Second Circuit to stay the issuance of its decision, as IBM intends to file a writ of *certiorari* with the Supreme Court, arguing a circuit split.[27] If the Supreme Court grants *certiorari*, courts and stakeholders can hope for guidance on the facts necessary to plead a stock-drop claim, but in the meantime, the Second Circuit has thrust stock-drop claims back into relevance.

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NOTES

1. 134 S. Ct. 2459 (2014).
2. 136 S. Ct. 758 (2016).
3. 910 F.3d 620 (2d Cir. 2018).
4. *See, e.g.*, *Laffen v. Hewlett-Packard Co.*, 721 Fed. App'x 642, 644 (9th Cir. 2018); *Martone v. Robb*, 902 F.3d 519, 525-27 (5th Cir. 2018); *Saumer v. Cliffs Nat. Res., Inc.*, 853 F.3d 855, 864 (6th Cir. 2017); *Rinehart v. Lehman Bros. Holdings Inc.*, 817 F.3d 56, 68 (2d Cir. 2016); *Loeza v. Doe*, 659 Fed. App'x 44, 45-46 (2d Cir. 2016); *Whitley v. BP, P.L.C.*, 838 F.3d 523, 529 (5th Cir. 2016).
5. *Jander*, 910 F.3d at 623.
6. *Id.* at 623-24.
7. *Id.* at 623-24. In addition to the ERISA suit, plaintiffs filed a parallel securities suit. Interestingly, the securities suit was dismissed on grounds that the plaintiffs "'fail[ed] to raise a strong inference that the need to write-down [the business unit] was so apparent to Defendants before the announcement, that a failure to take an earlier write-down amounts to fraud,'" or that the IBM fiduciaries' financial projections "'lacked a reasonable basis when they were made.'" *Id.* at 631 (quoting *Int'l Ass'n of Heat & Frost Insulators & Asbestos Workers Local #6 Pension Fund v. Int'l Business Machines Corp.*, 205 F. Supp. 3d 527, 537-38 (S.D.N.Y. 2016)).
8. *Id.* at 623-24. At the district court level, the plaintiffs also alleged that the fiduciaries should have frozen further investments by the ESOP in IBM stock or "purchased hedging products to mitigate potential declines." These claims were not pursued on appeal.
9. *Id.* at 624.
10. *Id.* at 628.
11. *See supra* n. 4.
12. *See Jander v. Ret. Plans Comm. of IBM*, 272 F. Supp. 3d 444, 447 (S.D.N.Y. 2017); *see also Martone*, 902 F.3d at 522.
13. *See Saumer*, 853 F.3d at 858 (stock lost 95% of value between 2011 and 2015, compared to 50 percent gain for the market overall).
14. *Martone*, 902 F.3d at 526.
15. *Martone*, 902 F.3d at 526-27.
16. *Jander*, 910 F.3d at 630.
17. *See id.* at 630; *see also Loeza*, 659 Fed. App'x at 45-46.
18. *Perrone v. Johnson & Johnson*, Case No. 2:19-cv-00923, Complaint (Jan. 22, 2019), Doc. 1.
19. *See, e.g.*, *O'Day v. Chatila*, Case No. 18-2621-cv(L), Reply Brief for Plaintiffs-Appellants (Jan 14, 2019), Doc. 68; *In re Allergan ERISA Litig.*, Case No. 2:17-cv-01554-SDW-LDW, Reply Brief for Appellants (Jan. 25, 2019), Doc. 35.
20. *See Whitley*, 838 F.3d at 528.
21. *Saumer*, 853 F.3d at 865.
22. *Jander*, 910 F.3d at 631.
23. *Fifth Third Bancorp*, 134 S. Ct. at 2470.
24. *Jander v. Ret. Plans Comm. of IBM*, No. 17-3518, Petition for Rehearing *En Banc* (Dec. 21, 2018), Doc. 48.
25. *Jander v. Ret. Plans Comm. of IBM*, No. 17-3518, Order Denying Petition for Rehearing *En Banc* (Jan. 18, 2019), Doc. 51.
26. Martin Flumenbaum & Brad S. Karp, "The Rarity of En Banc Review in the Second Circuit," 256 *N.Y. Law Journal* (Aug. 24, 2016), available at *https://www.paulweiss.com/media/3679578/24august2016flumenbaumkarp.pdf*.
27. *Jander v. Ret. Plans Comm. of IBM*, No. 17-3518, Motion to Stay the Issuance of the Mandate Pursuant to Federal Rule of Appellate Procedure 41(d)(1) (Jan. 24, 2019), Doc. 52.

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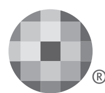
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