Company Stock Update

Subcommittee on Fiduciary Responsibility & Plan Investments

ABA Section of Taxation
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Introduction

Background

• Up until 2014, most courts extended a “presumption of prudence” to fiduciaries with respect to decisions regarding company stock.

• This meant that plaintiffs had to demonstrate an abuse of discretion to succeed on fiduciary breach claims.

_Dudenhoeffer Decision_

• In its 2014 _Dudenhoeffer_ decision, the Supreme Court **rejected the presumption of prudence** and effectively created two standards for “stock drop” cases depending on whether the claim is based on public or non-public information.
Company Stock Claims

Company Stock Claims Are Relatively Unique

• Generally, plan investment claims under ERISA focus on alleged underperformance relative to a benchmark.
• But there is usually no appropriate benchmark for company stock.
• Company stock claims usually focus on whether the stock’s value is accurate, and whether the plan/participants paid too much for the stock.
• Plaintiffs often argue that company stock was inaccurately valued due to –
  • Market inefficiency.
  • Material non-public information.
Company Stock Claims

Claims Based on Public Information

• Under *Dudenhoeffer*, plaintiffs must demonstrate “special circumstances” that made the market price unreliable.

• Otherwise, allegations that a fiduciary should have recognized from publicly available information that the market was overvaluing or undervaluing the stock are **implausible as a general rule.**
Company Stock Claims

Claims Based on Non-Public (Inside) Information

• Plaintiffs must allege:

  an alternative action that the fiduciary could have taken that would have been consistent with the securities laws,

  and

  demonstrate that a prudent fiduciary in the same circumstances could not have concluded that the alternative action would do more harm than good to participants.
Stock Drop Litigation Trends

**Snapshot**

- The post-`Dudenhoeffer` litigation landscape has been overwhelmingly defendant-friendly.

- Plaintiffs have generally failed to succeed on both public information and inside information based claims, and victories have almost exclusively come in the form of settlements.

- Significantly, in December 2018, the Second Circuit issued a rare plaintiff-friendly ruling on an “inevitable disclosure” theory for an inside-information based claim.
Stock Drop Litigation Trends

**Snapshot**

- Prior to IBM, there was one notable plaintiff-friendly ruling.
  - In *Gedek v. Perez*, W.D.N.Y. 2014, the court ruled that claims that a stock is excessively risky may survive the implausibility standard at the motion to dismiss stage.
- Notably, stock drop lawsuits are often filed following highly-publicized adverse corporate events.
  - *E.g.*, Wells Fargo (false account scandal), American Express (loss of exclusive Costco relationship), Boeing (airline safety), Johnson & Johnson (asbestos in products), BP (oil spill).
Stock Drop Litigation Trends

Claims Based on Public Information

• The emerging trend is that courts are applying the general rule of “implausibility” to both claims alleging that a publicly-traded stock is artificially inflated and claims that a publicly-traded stock is excessively risky.

• The Second, Sixth, and D.C. Circuits see no distinction between artificially inflated and excessive risk claims.

• As a result, plaintiffs must generally allege special circumstances in order to succeed on either type of claim.
Stock Drop Litigation Trends

Claims Based on Public Information

• Plaintiffs have been relatively unsuccessful in convincing courts that “special circumstances” exist.

• Notably, *Dudenhoeffer* did not describe what “special circumstances” means, other than to suggest that such circumstances would be those that call into question the *reliability* of the publicly-traded price.

• Significantly, a number of courts have *narrowly construed* the concept of “special circumstances,” making it very difficult for plaintiffs.
Stock Drop Litigation Trends

Claims Based on Public Information

- The Eleventh Circuit has suggested that the standard is very high and that only conduct such as fraud, improper accounting, and other illegal acts might meet the standard.

- In the Lehman Brothers stock drop litigation, the Second Circuit held that even an order issued by the Securities and Exchange Commission largely prohibiting short selling of Lehman stock during the financial crisis did not constitute a “special circumstance.”

- Importantly, courts have been reluctant to accept that “special circumstances” exist based on a company’s financial distress (including the risk of bankruptcy and general risk profile).

- For example, in RadioShack, the court found that the company’s decline into bankruptcy did not constitute a “special circumstance” that would make the market price unreliable or artificially inflated.
Stock Drop Litigation Trends

Claims Based on Non-Public (Inside) Information

- Plaintiffs are also losing on inside information claims.
- Many plaintiffs have failed to convince courts that alternative courses of action consistent with the federal securities laws exist.
  - Some courts refuse to accept that halting additional stock purchases or disclosing non-public information to the market would be consistent with the securities laws.
  - For example, in the HP stock drop litigation, the court held that restricting additional investments in HP stock or publicly disclosing inside information about improper accounting practices would be inconsistent with the federal securities laws.
Stock Drop Litigation Trends

Claims Based on Non-Public (Inside) Information

• Sometimes, courts accept that alternative actions consistent with the securities laws exist.

• However, these courts also find that prudent fiduciaries could reasonably conclude that public disclosure of inside information or other alleged alternative actions (e.g., stock freezes) could do more harm than good to the plan.

• For example –
  • In the Wells Fargo litigation, the court accepted a claim that public disclosure of questionable sales practices could have been consistent with the federal securities laws but the court was not convinced that a prudent fiduciary could not have concluded that action would cause “more harm than good” to the plan.
Stock Drop Litigation Trends

Claims Based on Non-Public (Inside) Information

• A 2016 Fifth Circuit decision regarding BP stock has made the standard for succeeding on a non-public claim even more difficult.

• Specifically, per the Fifth Circuit, the standard requires demonstrating a course of action that is “so clearly beneficial” that a prudent fiduciary could not conclude that it would be more likely to harm rather than help the plan.
Stock Drop Litigation Trends

Claims Based on Non-Public (Inside) Information

*Second Circuit’s IBM Decision*

- On December 10, 2018, 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.
- The Second Circuit considered whether the plaintiffs had sufficiently alleged that plan fiduciaries could have made corrective public disclosure of non-public “inside” information concerning the value of IBM’s stock.
- The plaintiffs alleged that the fiduciaries of IBM’s ESOP breached their duties by failing to publicly 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.”
Stock Drop Litigation Trends

Claims Based on Non-Public (Inside) Information

Second Circuit’s IBM Decision

• In ruling for the plaintiffs, the Second Circuit concluded that when disclosure of inside information is inevitable, prudent fiduciaries would make earlier disclosure rather than later disclosure.

• In this regard, the Second Circuit 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.”
  • 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.”
Stock Drop Litigation Trends

Claims Based on Non-Public (Inside) Information

Second Circuit’s IBM Decision

• The ruling is a notable development that has already and will likely continue to encourage further stock drop litigation based on inevitable disclosure theories.

• Thus, plan fiduciaries of plans that offer company stock may need to consider difficult questions about disclosure of sensitive non-public information as a way to potentially limit litigation exposure.
Stock Drop Litigation Trends

**Claims Based on Non-Public (Inside) Information**

**Second Circuit’s IBM Decision**

- Unsurprisingly, several lawsuits have been filed in the wake of the Second Circuit’s decision alleging “inevitable disclosure” theories.
  - E.g., two lawsuits were filed against Johnson & Johnson regarding non-public information relating to alleged asbestos in products; a lawsuit was filed against Kraft Heinz relating to non-public information relating to the value of its goodwill and other intangibles.

- Notably, one court has already considered an “inevitable disclosure” theory and ruled in favor of the defendants.
  - *Fentress v. Exxon Mobil* (S.D. Tex. Feb 4, 2019) (concluding that because state attorney general investigations “are often long and may not result in any charges . . . Exxon’s eventual disclosure was probably foreseeable, but the Court cannot say it was inevitable”)


Stock Drop Litigation Trends

Claims Based on Non-Public (Inside) Information

Second Circuit’s IBM Decision

• The Supreme Court has accepted IBM for its fall 2019 term and will hear oral arguments on November 6.

• The Court will specifically consider the issue of whether, when disclosure is inevitable, there is greater harm to a plan the longer a fraud remains undisclosed.

• In an amicus brief joined by DOL officials, the U.S. Solicitor General argues that absent “extraordinary circumstances,” fiduciary duties require the disclosure of non-public, inside information “only when the securities laws require such a disclosure.”
RadioShack (5th Cir. 2018)
- Fiduciaries did not breach duties by relying on market price.
- Plaintiffs failed to show that market price did not incorporate negative public information.
- Negative financial situation, including heavy debt load, did not constitute special circumstance.
- Prudent fiduciary could have concluded that alleged alternatives, such as freezing stock, disclosing inside info, or liquidating holdings, could have done more harm than good to the plan.

Hewlett-Packard (9th Cir. 2018)
- Rejected alleged alternative actions that fiduciaries could have frozen additional stock investment or made public disclosures about stock risks.
- Prudent fiduciaries could have concluded that alleged alternatives could have caused more harm than good.
- “Prudent fiduciary must first investigate problems before acting.”

Wells Fargo (D. Minn 2017)
- Early disclosure of unethical sales practices was an alternative action that would have been consistent with the securities laws.
- “The presence of ongoing fraud may weigh in favor of earlier disclosure. But other factors may weigh in favor of later disclosure.”
- But prudent fiduciary could have concluded that delaying disclosure of internal fraud could benefit the plan.

Whole Foods Market (W.D. Texas 2016)
- Plaintiffs had sufficiently alleged that there were alternative actions consistent with the securities laws--public disclosure of price overcharging or preventing further stock purchases.
- However, prudent fiduciary in the same circumstances could have concluded that these alternatives could have caused a negative impact (lower stock price) that could have caused more harm than good.
Snapshot of Recent Case Law

**Plaintiff Friendly Rulings**

**IBM (2d Cir. 2018)**
- The Second Circuit concluded 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.”

**Kodak (W.D.N.Y. 2014)**
- A claim that a stock is excessively risky may survive the implausibility standard at the motion to dismiss phase.
- Court distinguished *Dudenhoeffer* from allegations that a “company’s downward path was so obvious and unstoppable that, regardless of whether the market was ‘correctly’ valuing the stock, the fiduciaries should have halted or disallowed further investment in it.”
Questions?