EMPLOYEE BENEFITS FIDUCIARY RESPONSIBILITIES AND PLAN INVESTMENTS UPDATE

ABA Section of Taxation, 2019 Midyear Meeting
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Section of Taxation - Subcommittee on Fiduciary Responsibility and Plan Investments

Panelists: Jeffrey Lieberman, Skadden Arps Slate Meagher & Flom (Co-Chair)
Yongo Ding, Miller & Chevalier (Vice-Chair)
Arsalan Malik, Groom Law Group (Assistant Vice-Chair)
Erin M. Sweeney, Miller & Chevalier (Former Chair)
Fritz Richter III, Bass Berry & Simms (Former Chair)

Fiduciary Responsibility and Plan Investment Regulatory Developments

- **ACA Constitutionality: The 2019 Season**

- **DOL’s Proposed Regulations on Association Retirement Plans and Other Multiple-Employer Plans** – ERISA § 3(5)

- **Stock Drop Litigation Update**

- **Duty to Monitor “Non-Core” Investment Options**
- **SEC Proposed Best-Interest Regulation**

- **DOL Fall 2018 Regulatory Agenda**
Second Circuit Delivers Rare Victory to Plaintiffs in IBM “Stock Drop” Lawsuit

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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 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. In this regard, the plaintiffs alleged that the fiduciaries of IBM’s ESOP breached their duties by their failure 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 ruling is a notable development that could encourage further stock drop litigation, and also require plan fiduciaries to consider difficult questions about disclosure as a way to potentially limit litigation exposure.

I. Background

The 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 a more than $12 drop in IBM’s stock price.

The plaintiffs alleged that despite their knowledge of the issues at IBM’s microelectronics unit, the ESOP fiduciaries continued to permit investment in company stock. 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 it concluded 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

In appealing the dismissal, 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.” In this regard, the plaintiffs requested that the Second Circuit clarify 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* contains an ambiguity regarding the standard to apply when reviewing proposed alternative actions. In this regard, the Second Circuit noted that the “would” standard “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 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.”

**III. Corrective Disclosure as Alternative Action**

The Second Circuit reversed the district court and concluded 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.” This conclusion rested on several significant findings.

**A. Risks of Disclosure**

The Second Circuit examined the various theories accepted by the district court as to why 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, in this regard, 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. In this regard, the Second Circuit 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

Under the facts of this case, the disclosure of the accounting violations at IBM’s microelectronics unit was seemingly inevitable given 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.

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.”

III. Significance and Implications

Since Dudenhoeffer, stock drop litigation has been overwhelmingly defendant-friendly, and cases have rarely survived the motion to dismiss stage. Against this backdrop, while likely not a “game changer” in the litigation landscape, 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 certainly a significant development, one that could be influential to other courts even beyond the Second Circuit.

Moreover, the Second Circuit’s recognition of an apparent ambiguity in Dudenhoeffer’s pleading standard could 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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