

Second Circuit: Reverses Dismissal of an ERISA Action Alleging Breach of the Duty of Prudence Based on the Plan Defendants' Failure to Issue an Early Corrective Disclosure in the Company's SEC Filings

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On December 10, 2018, the Second Circuit reversed dismissal of an ERISA action against the fiduciaries of a technology company's employee stock ownership plan ("ESOP"). *Jander v. Ret. Plans Comm. of IBM*, 910 F.3d 620 (2d Cir. 2018) (Katzmann, C.J.). Plaintiffs claimed that the Plan defendants breached their duty of prudence by failing to disclose inside information concerning the overvaluation of one of the company's business divisions. The Second Circuit found plaintiffs adequately alleged "that a prudent fiduciary in the Plan defendants' position could not have concluded" that "early corrective disclosure" of the impairment of the overvalued business, "conducted alongside the regular SEC reporting process," would have done more harm than good to the fund. The Second Circuit further held that the dismissal of plaintiffs' parallel securities fraud action for failure to adequately allege scienter did not preclude plaintiffs' ERISA action, because no heightened pleading standard analogous to the Private Securities Litigation Reform Act ("PSLRA") applies to ERISA claims.^[1]

Plaintiffs Adequately Alleged that a Prudent Fiduciary Could Not Have Concluded that Disclosing the Overvaluation Would Have Done More Harm Than Good

In *Fifth Third Bancorp v. Dudenhoeffer*, 134 S.Ct. 2459 (2014), the Supreme Court held that in order "[t]o state a claim for breach of the duty of prudence on the basis of inside information, a plaintiff must plausibly allege an alternative action that the defendant could have taken that would have been consistent with the securities laws and that a prudent fiduciary in the same circumstances would not have viewed as more likely to harm the fund than to help it."^[2] Later in its decision, the *Fifth Third* Court instructed that "lower courts faced with such claims should also consider whether the complaint has plausibly alleged that a prudent fiduciary in the defendant's position could not have concluded that stopping purchases . . . or publicly disclosing negative information would do more harm than good to the fund." The Second Circuit in *Jander* observed that the *Fifth Third* Court's first articulation of the "more harm than good" test "suggests that courts ask what an average prudent fiduciary might have thought," while the Court's "latter formulation appears to ask . . . whether *any* prudent fiduciary could have considered the action to be more harmful than helpful." The Second Circuit stated that it was "not clear which of these tests determine whether a plaintiff has plausibly alleged that the actions a defendant took were imprudent in light of available alternatives."^[3]

The Second Circuit found it unnecessary to resolve this question because the court found plaintiffs “plausibly [pled] a duty-of-prudence claim even under the more restrictive ‘could not have concluded’ test.” First, the court found that “the Plan defendants allegedly knew that [the company’s] stock was artificially inflated through accounting violations.” Second, the court deemed it significant that two of the Plan defendants “had primary responsibility for the public disclosures that had artificially inflated the stock price.” The court found plaintiffs plausibly alleged that “disclosures could have been included within [the company’s] quarterly SEC filings and disclosed to the ESOP’s beneficiaries at the same time in the Plan defendants’ fiduciary capacity.” Third, plaintiffs cited economic analyses demonstrating that the longer a fraud is concealed, the greater the reputational harm the company suffers and the larger the ultimate stock drop. The court found that “[w]hile these economic analyses will usually not be enough on their own to plead a duty-of-prudence violation, they may be considered as part of the overall picture.” Fourth, because plaintiffs alleged that the market for the company’s stock was efficient, the court found no basis for a prudent fiduciary to “fear an irrational overreaction to the disclosure of fraud.”

Finally, the Second Circuit found it “particularly important” that the company was “likely to sell the business and would be unable to hide its overvaluation from the public at that point.” The court noted that “[i]n the normal case, when the prudent fiduciary asks whether disclosure would do more harm than good, the fiduciary is making a comparison only to the status quo of non-disclosure.” Here, “however, the prudent fiduciary would have [had] to compare the benefits and costs of earlier disclosure to those of later disclosure—non-disclosure [was] no longer a realistic point of comparison.” The court explained that the company ended up making a \$1.5 billion payment to the buyer of the business at issue, “the announcement of which constituted a corrective disclosure to the public markets in this action.” The Second Circuit determined that the allegations concerning the sale of the business “tip[ped] the scales toward plausibility.”

The Dismissal of Plaintiffs’ Parallel Securities Fraud Action Did Not Preclude Plaintiffs’ ERISA Suit

The Second Circuit also considered “the relevance, if any, of the parallel securities fraud suit” which the district court had dismissed for failure to adequately allege scienter. Defendants contended that “allowing [plaintiffs’] ERISA claim to go forward on essentially the same facts would lead to an end run around the heightened pleading standards set out in the [PSLRA].” The Second Circuit held that the dismissal of the securities fraud action was “not preclusive” as to the ERISA action “because the PSLRA does not apply to ERISA actions.” The court explained that plaintiffs in ERISA actions “are accusing defendants only of violating a fiduciary duty of prudence, which does not carry the same stigma” as an action for fraud. The Second Circuit reasoned that “ERISA and the securities laws ultimately have differing objectives pursued under separate statutory schemes designed to protect different constituencies.” The court stated that “[i]f plaintiffs do begin to abuse ERISA in the way Congress felt they have abused the securities laws, then Congress can amend ERISA accordingly.”

The Second Circuit emphasized, however, that the dismissal of the securities fraud action was not entirely irrelevant to plaintiffs’ ERISA action. While the court found plaintiffs “plausibly allege[d] that the Plan defendants had the requisite knowledge of overvaluation to raise fiduciary responsibilities,” the court instructed that plaintiffs “may not allege directly or indirectly that the Plan defendants committed securities fraud.”

[1] On January 18, 2019, the Second Circuit denied defendants’ petition for a rehearing. Defendants have indicated that they intend to file a petition for certiorari.

[2] Please [click here](#) to read our discussion of the Supreme Court’s decision in *Fifth Third*.

[3] In *Amgen v. Harris*, 136 S.Ct. 758 (2016), the Supreme Court found that the Ninth Circuit incorrectly held that plaintiffs adequately alleged a duty of prudence claim based on inside information. The *Amgen* Court stated that the Ninth Circuit “failed to assess whether” plaintiffs “‘plausibly alleged’ that a prudent fiduciary in the same position ‘could not have concluded’ that the alternative action would do more harm than good.” The Second Circuit in *Jander* observed that *Amgen* could be read as an endorsement of the *Fifth Third* Court’s “could not have concluded” formulation of the “more harm than good” test. Alternatively, the court noted that *Amgen* could also be viewed as holding simply that “allegations about why an alternative action would do more good than harm must appear in the complaint itself.” Please [click here](#) to read our discussion of the Supreme Court’s decision in *Amgen*.

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