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Everything Old Is New Again: Stock Drop Lawsuits on the Rise

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The U.S. Court of Appeals for the Second Circuit's decision in *Jander v. Retirement Plans Committee of IBM*[1] appears to be breathing new life into an old legal theory. The employer stock fund cases — often called stock drop cases — that once reliably accompanied most securities fraud lawsuits, and sometimes popped up even without them, have been on the wane in the years since the U.S. Supreme Court's decisions in *Fifth Third Bancorp v. Dudenhoeffer*[2] and *Harris v. Amgen, Inc.*[3]

The Supreme Court Decisions

There is good reason for that. In those decisions, the Supreme Court rejected the (widely mispronounced) *Moench* presumption, a doctrine that applied a presumption of prudence to purchases of employer stock where the existence of an employer stock fund was written into governing plan documents. This presumption had largely had been adopted by federal courts of appeals, and had become a favorite weapon of defendants seeking dismissal of stock drop complaints. But the pleading standard the Court adopted instead was arguably even more difficult for plaintiffs attempting to state a breach of fiduciary duty claims, and has been an effective tool for defendants, apparently discouraging such claims.

In *Dudenhoeffer*, the Supreme Court articulated specific criteria for pleading fiduciary breach claims that many observers have viewed as all but impossible for a plaintiff to meet. The Court held that there is no

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presumption of prudence. However, in order to state a claim for a breach of that duty on the basis of a failure to act on inside information (as defined by securities laws), "a plaintiff must plausibly allege an 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."[4] Finally, and importantly, the Court also held definitively that ERISA creates no obligation for a plan fiduciary to violate federal securities laws by trading on inside information.[5] Following *Dudenhoeffer*, lower courts applied this standard to dismiss many ERISA fiduciary breach claims that did not satisfy the Court's new exacting standard.[6]

The Jander *Decision*

In December 2018, the Second Circuit issued its opinion in *Jander*, reversing a district court dismissal of an ERISA breach of fiduciary duty claim. In so doing, the court handed an exceedingly rare post-*Dudenhoeffer* victory to stock drop plaintiffs. The district court, applying the *Dudenhoeffer* standard, had concluded that Jander "failed to state a duty-of-prudence claim under ERISA because a prudent fiduciary could have concluded that the three alternative actions proposed in the complaint [...] would [have done] more harm than good to the fund."[7]

The Second Circuit disagreed. It first noted that, in *Amgen*, the only case in which the Supreme Court has meaningfully discussed the *Dudenhoeffer* standard, the Court's primary criticism was that the U.S. Court of Appeals for the Ninth Circuit had failed to fully delve into the factual allegations of the complaint. It then engaged in a relatively exhaustive examination of the extremely detailed complaint allegations, and concluded that Jander had sufficiently pled a claim for breach of the duty of prudence. It held that Jander's allegations that making a corrective disclosure to the market was a viable alternative course of action for the IBM plan fiduciaries was sufficient in light of the other facts pled in the complaint.[8]

Those other facts are key. Jander alleged that the plan's fiduciaries, first, were privy to inside information relating to violations of standard accounting practices by an IBM business unit that allegedly inflated IBM's stock price, and, second, were aware of the impending sale of the business unit that eventually led to the violations becoming public, resulting in an adjustment in the stock price. [9] The Second Circuit held that these allegations made out a colorable claim that IBM's ESOP fiduciaries breached their duties by failing to disclose the underlying violations, and by continuing to allow investments in company stock despite the undisclosed problems and the alleged inevitability of their discovery. That last part was very important to the court, which held that although "in the normal case," a fiduciary is weighing the risks of disclosure against the risks of non-disclosure, the impending sale meant that "non-disclosure is no longer a realistic point of comparison," and that a prudent fiduciary would most likely "prefer to limit the effects of the stock's artificial inflation on the ESOP's beneficiaries through prompt disclosure."[10]

Not surprisingly, the defendants in *Jander* are petitioning for certiorari, and in all likelihood, it will be some time before the case is finally resolved. In the meantime, though, it appears that plaintiffs' attorneys view the *Jander* decision as charting a course through the perilous straits created by the *Dudenhoeffer* decision. Given the importance of Second Circuit precedent for securities litigation in general, this point of view is understandable.

New Lawsuits Following Jander

Plaintiffs wasted no time trying to follow Jander's template. The Second Circuit's decision has quickly become a jumping-off point for a new set of "stock drop" litigation against employers charged with failing to disclose, or otherwise act on, information that allegedly impacted the value of its company stock.

For example, two class actions were filed shortly after the *Jander* decision came down alleging that plan fiduciaries were aware of, and failed to disclose, risks related to the presence of asbestos in talc baby powder. On January 22 and 25, 2019, two separate class action lawsuits were filed in New Jersey District Court against Johnson & Johnson and individual members of its pension and benefits committee for alleged breaches of their fiduciary duties under ERISA, including their alleged failure to make corrective disclosures regarding the presence of asbestos in Johnson & Johnson's talc baby powder.[11]

In both cases, plaintiffs sued on behalf of participants in Johnson & Johnson's defined contribution plans, which offered an employer stock fund as an investment option. They alleged that Johnson & Johnson's stock price had been artificially inflated for years because its talc baby powder, a flagship product, allegedly contains small amounts of asbestos. They claim that the company's senior leadership hid the truth from the public, even when it was "inevitable" that it would be revealed through products liability litigation.

In December 2018, Reuters published an article reporting that Johnson & Johnson's executives had been aware of the presence of asbestos in talcum powder, and actively concealed it from the public. According to the complaints, Johnson & Johnson's stock price then dropped by more than 12 percent, resulting in a $30 billion drop in the company's market capitalization. Plaintiffs allege that the damage to the company's goodwill and reputation was compounded by the company's continued refusal to admit that its products contain asbestos. Plaintiffs further alleged that, because corrective disclosures were not made, participants in the plans continued to purchase Johnson & Johnson stock at inflated prices.

Plaintiffs allege that plan fiduciaries were aware of the asbestos issue, and that their duty of prudence required them to take steps to protect plan participants from the harm of additional purchases of artificially inflated stock, notwithstanding any requirement in the plans' documents that a company stock fund remain an investment option in the plans.

Signs that these plaintiffs are following the blueprint laid out in *Jander* are readily apparent. The plaintiffs have picked up on the Second Circuit's discussion of the "inevitability" of disclosure of inside information. They also incorporate detailed factual allegations that seem to be aimed at establishing that inevitability, and at framing out a scenario where fiduciaries were in no position to control *whether* potentially damaging information was disclosed, but could have — and failed to — control *when* that disclosure took place in a way that directly impacted the value of plan investments.

The problem with this approach, from the fiduciaries' perspective, is that hindsight can easily be used to argue that any eventual disclosure was "inevitable" all along. Recognizing this issue, the *Jander* court expressly disclaimed reliance on hindsight. It held that it was the plan fiduciaries' alleged knowledge of the planned sale of the business unit impacted by the accounting irregularities, and the diligence that would necessarily entail by potential buyers, that rendered disclosure inevitable. In contrast, an assumption that outsiders like members of the press (or products liability attorneys) will "inevitably" discover a product issue seems harder to prove without a significant assist from hindsight. Following *Jander*, however, it is reasonable to expect that many variations on that theme will be tested out.

What Comes Next

It remains to be seen whether the Supreme Court will look on the Second Circuit's attempt to apply *Dudenhoeffer* with any more favor than it did the Ninth Circuit's. In the meantime, plan fiduciaries should be prepared for a potential uptick in employer stock class actions among plaintiffs while the ramifications of the *Jander* decision are being sorted out. They should also expect that at least some of these cases may proceed — as *Jander* has — even where plaintiffs are unable to plead a parallel securities fraud case under the heightened standards applicable to such claims.

Notes

1. 910 F.3d 620 (2d Cir. 2018).
2. 143 S. Ct. 2459 (2014).
3. 136 S.Ct. 758 (2016).
4. *Dudenhoeffer*, 143 S. Ct. at 2472.
5. *Id.*

6. In fact, the *Jander* court observed that "no duty-of-prudence claim against an ESOP fiduciary has passed the motion-to-dismiss stage since *Amgen*." 910 F.3d at 630.

7. *Id.*

8. *Id.* at 631.

9. *Id.* at 630-32.

10. *Id.* at 632.

11. Tarantino v. Johnson & Johnson Pension and Benefits Committee, No. 3:19-cv-1115 (D. N.J. Jan. 25, 2019); Perrone v. Johnson & Johnson, No. 3:19-cv-923 (D. N.J. Jan. 22, 2019).