Justices' IBM Ruling Gives Life To ERISA Disclosure Liability

By **James Carroll, Eben Colby, Michael Hines, Jonathan Marcus, Mary Grinman and Emily Kline** (January 21, 2020, 7:02 PM EST)

In a closely watched decision, the U.S. Supreme Court in Retirement Plans Committee of IBM v. Jander[1] **vacated and remanded** for further proceedings a plaintiff-friendly ruling by the U.S. Court of Appeals for the Second Circuit in a stock drop case brought under the Employee Retirement Income Security Act.

James Carroll

Although the Second Circuit's prior decision is now vacated, the Supreme Court's remand leaves unresolved the potential conflict between ERISA-based duties and disclosure obligations imposed by the federal securities laws underscored in the original Second Circuit decision, giving viability to the so-called inevitable disclosure theory as a basis for potential ERISA liability.

The respondents in Jander were participants in IBM's 401(k)-plus plan who invested in the IBM stock fund, or employee stock ownership plan, and allegedly suffered losses from the ESOP's investment in IBM stock. The plan participants allege that IBM misrepresented the value of its microelectronics business, thus artificially inflating the value of IBM stock, and that, as corporate insiders, the ESOP's fiduciaries (the petitioners) were aware of the alleged fraud and should have disclosed it. The plan participants allege that by failing to disclose the overvaluation of the microelectronics business, the ESOP fiduciaries breached their fiduciary duty of prudence under ERISA.

Eben Colby

The Supreme Court previously grappled with the challenges inherent in being an insider fiduciary to an ESOP in 2014 in Fifth Third Bancorp v. Dudenhoeffer.[2] Prior to Dudenhoeffer, most federal courts viewed a decision to invest in employer stock as presumptively prudent, regardless of a fiduciary's potential insider information suggesting that the stock was overvalued.

Michael Hines

The Supreme Court rejected a presumption of prudence in Dudenhoeffer, holding that ESOP participants can defeat a motion to dismiss if they "plausibly allege an alternative action that the [ESOP fiduciary] 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 [ESOP] than to help it."[3]

The court reasoned that this standard appropriately took into account both the need to protect participants and the reality that an ESOP fiduciary may find himself "between a rock and a hard place" when deciding whether the ESOP should continue investing in company stock, because he or she could be accused of imprudence for retaining the stock but accused of disobeying plan documents for reducing the stock.[4] In Dudenhoeffer's wake, courts have dismissed most suits alleging imprudent retention of employer stock in an ESOP under the Dudenhoeffer pleading standard.

At issue in Jander was whether the pleading standard established in Dudenhoeffer can be satisfied by generalized allegations that the harm of an inevitable discovery of alleged fraud generally increases over time.


Jonathan Marcus

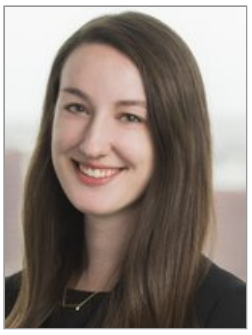
The U.S. District Court for the Southern District of New York held that plan participants had failed to satisfy Dudenhoeffer, but the Second Circuit reversed, holding that the participants had plausibly alleged a breach of fiduciary duty because the disclosure of problems at one of IBM's business units was inevitable, and therefore fiduciaries could not have concluded that a corrective disclosure would do more harm than good.

On appeal to the Supreme Court, however, both the petitioners and the government, according to the Supreme Court's opinion, "focused their arguments primarily upon other matters" that had not been raised previously.[5] Specifically, the petitioners asserted that ERISA could not impose a duty on an ESOP fiduciary to disclose inside information, and the government argued that an ERISA-based duty to disclose would conflict with the objectives of the federal securities laws.


Mary Grinman

In a per curiam opinion, the Supreme Court declined to address those arguments, observing that they had not yet been addressed by the lower courts. The court vacated and remanded the case to the Second Circuit, leaving it up to that court to decide whether to address the petitioners' and the government's arguments.

Justice Elena Kagan (joined by Justice Ruth Bader Ginsburg) and Justice Neil Gorsuch filed separate concurring opinions. Justice Kagan opined that, as an initial matter, the Second Circuit may decline to consider the arguments raised by the petitioners and the government if it determines that they were not properly preserved.[6]


Emily Kline

In addition, Justice Kagan opined that contrary to the petitioner's position, Dudenhoeffer "makes clear that an ESOP fiduciary at times" has a duty to act on insider information.[7] Justice Kagan further observed that although a fiduciary is not required to take actions that violate or conflict with the federal securities laws, Dudenhoeffer explains that if there is no such conflict, then "it might fall within an ESOP fiduciary's duty — even if the securities laws do not require it."[8]

Justice Gorsuch, on the other hand, stated that the Second Circuit should consider the merits of the petitioners' and the government's arguments, which, if not addressed, would "only prove unavoidable later."[9] Justice Gorsuch also opined that it would be odd if insider ESOP fiduciaries could be held liable under ERISA for failing to make a corrective disclosure, observing that such fiduciaries "necessarily would be acting in their capacities as corporate officers, not ERISA fiduciaries. Run-of-the-mill ERISA fiduciaries cannot, after all, order corporate disclosures on behalf of their portfolio companies."[10]

The Jander decisions highlight the myriad difficulties faced by ESOP fiduciaries who are also corporate insiders. Although the Second Circuit's initial decision has now been vacated, the Supreme Court's decision to remand leaves unresolved the potential tension between ERISA and the federal securities laws.

That tension could potentially lead to a further uptick in ERISA stock drop cases, as plaintiffs may attempt to argue that even if allegations fail as securities claims, those same allegations — based on the same alleged fraud and the same nonpublic information — can survive as ERISA claims. Indeed, in the wake of the Second Circuit's plaintiff-friendly Jander decision, several ERISA-based lawsuits alleging inevitable disclosure quickly followed.

It remains to be seen how the Second Circuit addresses these important questions on remand, including whether the Second Circuit adopts the Supreme Court's view to solicit input from the U.S. Securities and Exchange Commission regarding the intersection of ERISA's duty of prudence and the

disclosure requirements of the federal securities laws. Either way, the Second Circuit's decision on remand, and how it decides to proceed with remand, will be closely watched by both ERISA and securities practitioners alike as to the continued viability of inevitable disclosure theories of liability.

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[1] No. 18-1165 (2020) (per curiam).

[2] 573 U.S. 409 (2014).

[3] Id. at 428.

[4] Id. at 424.

[5] Retirement Plans Committee of IBM v. Jander , No. 18-1165 (2020) (per curiam).

[6] Retirement Plans Committee of IBM v. Jander, No. 18-1165 (2020) (Kagan, J., concurring).

[7] Id.

[8] Id.

[9] Retirement Plans Committee of IBM v. Jander, No. 18-1165 (2020) (Gorsuch, J., concurring).

[10] Id.