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Ninth Circuit Reaffirms Exacting Pleading Standard for Duty-of-Prudence Claims Against ESOP Fiduciaries

Since the Supreme Court established the demanding pleading standards for duty-of-prudence claims against trustees of an employee stock ownership plan (“ESOP”) announced in *Fifth Third Bancorp v. Dudenhoeffer*, 573 U.S. 409 (2014), the lower courts have nearly uniformly dismissed such claims. In particular, circuit courts have largely rejected the argument that general economic principles would lead a prudent ESOP fiduciary to affirmatively disclose adverse nonpublic company information rather than continue to invest in company stock pursuant to the plan documents.

In its recent decision in *Wilson v. Craven*,¹ the Ninth Circuit joined its fellow circuits in rejecting such arguments. The decision provides important protection to ESOP fiduciaries by reaffirming the rigorous pleading standard in ESOP duty-of-prudence cases, in which plaintiffs must plead “context-specific” allegations describing an alternative action “so clearly beneficial” that a prudent fiduciary “could not conclude that it would be more likely to harm the fund than to help it.”

The Pleading Standard for Duty-of-Prudence Claims Against ESOP Fiduciaries

ESOP plans, which invest in a company’s own stock, are typically governed by fiduciaries who are company insiders. When ESOP fiduciaries learn that their company’s stock is overpriced based on nonpublic adverse information, they face several competing considerations. On the one hand, they are statutorily required to obey plan documents that instruct fiduciaries to invest in company stock, and legally prohibited from trading company stock based on material nonpublic information. On the other hand, they are statutorily required to manage the plan with “prudence,” which ordinarily would counsel against imprudent investment and in favor of divesting imprudent holdings.

In *Fifth Third Bancorp v. Dudenhoeffer*, the Supreme Court addressed this potential inherent tension by establishing the following pleading standard applicable to ESOP duty-of-prudence claims: “To 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 The Supreme Court explained that this was a context-specific inquiry, and instructed lower courts to consider whether the complaint had plausibly alleged that a prudent fiduciary “could not have concluded that stopping purchases . . . or publicly disclosing negative information would do more harm than good to the fund.”³

The Ninth Circuit’s Decision in *Wilson*

The plaintiff in *Wilson* purported to represent a class of employees at Edison International, Inc., who invested in the company’s ESOP. Before the complaint was filed, the company’s subsidiary, Southern California Edison Company (“SCE”)—which supplies electricity to Southern California—had entered into a settlement with ratepayers over allocating costs associated with a power plant closure. It was subsequently revealed over several months that SCE executives had inappropriately engaged in *ex parte* communications with the public utilities commission overseeing the negotiations. These revelations prompted an investigation, endangered the settlement, and allegedly drove a 15% decline in Edison’s stock price.

Plaintiff alleged that the ESOP fiduciaries knew about the *ex parte* communications before they were publicly disclosed but failed to take appropriate action to protect plan participants. Specifically, plaintiff alleged that a prudent fiduciary would have affirmatively revealed the existence of the *ex parte* communications sooner, both because “the longer the corrective disclosure [was] delayed, the greater the negative price impact would be once disclosure finally occurred,” and because “the longer Edison’s fraud went on, the more damage would be done to [Edison’s] reputation when the truth emerged.”⁴ The district court dismissed the complaint and plaintiff appealed.

On April 14, 2021, a unanimous Ninth Circuit panel affirmed the dismissal. The court rejected plaintiff’s argument that delaying disclosure increased eventual negative price impact and reputational harm, explaining that “if all that is required to plead a duty-of-prudence claim is recitation of general economic principles that apply in every ERISA action, every claim, regardless of merit, would go forward.”⁵ The court held that the complaint failed to satisfy the *Fifth Third* pleading standard because plaintiff failed to identify “context-specific allegations explaining why an earlier disclosure was so clearly beneficial that a prudent fiduciary could not have concluded that it would be more likely to harm the fund than help it.”⁶

Importantly, the panel distinguished the Second Circuit’s decision in *Jander v. Retirement Plans Committee of IBM*—the only appellate decision after *Fifth Third* reversing dismissal of a duty-of-prudence claim in the ESOP context—on two grounds.

First, unlike in a “normal case,” it was alleged that the fiduciaries in *Jander* “knew” throughout the class period that disclosure of negative information was “inevitable,” and thus were forced to weigh the benefits of early disclosure against those of later disclosure. In *Wilson*, by contrast, disclosure of the *ex parte* communications did not become “inevitable” until *after* the company’s stock price peaked; thus, it was likely too late for a corrective disclosure to mitigate the eventual price correction. Second, unlike in *Jander*, where it was “clear no further investigation was needed to permit a comprehensive corrective disclosure,” in *Wilson* investigations into the alleged wrongdoing were ongoing during the class period. Plaintiff failed to show that a “prudent fiduciary could not have concluded that deferring a disclosure until after the completion of investigations . . . would cause more harm than good.”⁷

Implications of the *Wilson* Decision

The Ninth Circuit’s decision in *Wilson* is an encouraging development for companies that offer ESOPs and for the fiduciaries that manage such plans. The decision builds on the foundation laid by other appellate courts and confirms that generalized allegations that earlier disclosure would have caused less harm to a company’s stock price are categorically insufficient to show that a prudent fiduciary could not conclude that disclosing negative information would be more likely to harm a fund than to help it. The decision also underscores the extent to which *Jander* is an outlier case, distinguishing it from “the normal case” due to its unusual facts. By reaffirming the daunting, context-specific pleading standard established by the Supreme Court in *Fifth Third*, the *Wilson* decision further adds to the growing wealth of authority giving broad deference to ESOP fiduciaries who are company insiders when navigating the tension between their obligation to invest in company stock and their duty of prudence to plan participants.

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¹ No. 18-56139 (9th Cir. Apr. 19, 2021).

² *Fifth Third*, 573 U.S. at 428.

³ *Id.* at 430.

⁴ *Wilson*, slip op. at 14.

⁵ *Id.* at 15.

⁶ *Id.* at 16.

⁷ *Id.* at 18–20.