
LEGAL UPDATE

Application of Dudenhoeffler in Private Company Setting

Marcia S. Wagner, Esq.

Some time in 2020, when it decides the *IBM* case, the Supreme Court will elaborate upon the pleading standards in cases alleging breaches of fiduciary duty with respect to allegations of breach of the fiduciary duty of prudence with respect to publicly held stock. That case established a high bar for plaintiffs to satisfy, and to date, in most instances, plaintiffs' cases have been dismissed at the motion to dismiss stage. However, investment advisors should be aware that the law is unsettled with respect to the application of *Dudenhoeffler* in the private company setting.

The issue was recently addressed by the District Court for the Middle District of Florida in *Woznicki v. Raydon Corp.*, in which the District Court held that *Dudenhoeffler* only applies to publicly held companies. It indicated that the concerns expressed in *Dudenhoeffler* do not apply to closely-held corporations. There is no liquid market for the stock of closely held corporations, and the securities laws regarding inside information and corporate disclosure do not generally apply. Simply put, the concerns and rationales that led the Supreme Court to call for a heightened pleading standard in *Dudenhoeffler* are inapplicable in the case of privately held corporations.

The District Court's decision followed that of the only Circuit Court of Appeals to address the issue, the Court of Appeals for the Seventh Circuit in *Allen v. GreatBanc Trust Co.*, 835 F.3d 670 (7th Cir. 2016). The Seventh Circuit rejected the holding of the District Court that in order for the complaint to survive plaintiffs need to allege "special circumstances regarding, for example, a specific risk a fiduciary failed properly to assess." The Court explained that the Supreme Court's holding in *Dudenhoeffler* was limited to publicly traded stock and relies on the integrity of the prices produced by liquid markets. In contrast, private stock has no market price and there is no market price to explain away, and no reason to apply any "special circumstances" rule. Additionally, another part of the Supreme Court's rationale

in *Dudenhoeffler*, namely, the need to protect fiduciaries from violating insider trading law by relying upon non-public information for stock valuation, had no application in the private stock context. Therefore, it was sufficient for pleading purposes simply to allege that *GreatBanc* failed to conduct an independent investigation of the value of stock and instead relied upon an interested party's number.

An opposite conclusion was reached by Federal District Courts in *Hill v. Hills Bros. Construction Company*, 2016 WL 1252983 (N.D. Miss. 2016) and *Vespa v. Singler-Ernster, Inc.* (N.D. Cal. 2016). The issue in those cases was whether plaintiff, in a case involving a privately held company, had to plead an alternative course of action that would not cause more harm than good. The District Court indicated that neither in *Dudenhoeffler* or the only other Supreme Court case expanding upon *Dudenhoeffler*, *Amgen, Inc. v. Harris*, did the Supreme Court specify that the "alternative action" standard is to be applied to ESOPS of publicly-traded entities only. In its view, the context-specific inquiry engaged in by the Supreme Court in *Dudenhoeffler* and *Amgen* led the Supreme Court to analyze the elements and considerations unique to publicly held corporations. It also indicated that even with respect to a privately-held corporation, inside information exists, that is, information about a company's financial or market situation obtained not from public information, but from a source within the company or a source within the company that has a duty to keep the information confidential. It did not cite, but would have agreed with, the Seventh Circuit that none of the considerations which informed the Supreme Court's analysis in *Dudenhoeffler* would apply to closely held corporations. However, it then concluded that would not necessarily preclude application of the alternative action standard to a closely-held corporation. It concluded that its reading of *Dudenhoeffler* did not preclude the application of the alternative action standard. It concluded that "in order to state a claim for the breach of fiduciary duty

of prudence, the plaintiff must plausibly allege an alternative action that the defendants could have taken consistent with securities laws and that a prudent fiduciary in the same circumstance would not have viewed as more likely to harm the fund than help it.”

Takeaway—Investment advisers should be aware that outside of the Seventh Circuit, the extent to which the *Dudenhoeffer* pleading standard applies to private companies

is an open issue. The Supreme Court’s decision in the *IBM* case is unlikely to provide any additional guidance on this issue.

Marcia S. Wagner is the Managing Director of The Wagner Law Group. She can be reached at 617-357-5200 or Marcia@WagnerLawGroup.com.
