EMPLOYEE STOCK OWNERSHIP PLANS: LEGAL AND REGULATORY UPDATE

Heart of America Chapter of the ESOP Association

15th Annual Fall ESOP Conference

Doubletree by Hilton Hotel
Overland Park, Kansas

September 4, 2014

By
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TABLE OF CONTENTS

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1. **No Presumption of Prudence in Investment Decisions Concerning Employer Stock: *Fifth Third Bancorp v. Dudenhoeffer***. The Supreme Court, in *Fifth Third Bancorp v. Dudenhoeffer*, 2014 US LEXIS 4495 (U.S. 2014), considered whether, when an ESOP fiduciary's decision to buy or hold the employer's stock is challenged in court, the fiduciary is entitled to a presumption that its investment of ESOP assets in employer stock is consistent with ERISA – that is, whether a "presumption of prudence" applies with respect to investments in employer stock. The Supreme Court held that no such presumption applies. It said ESOP fiduciaries are instead subject to the same duty of prudence that applies to ERISA fiduciaries in general, except they need not diversify the plan's assets to the extent those assets are invested in employer stock.

   The case concerned a KSOP maintained by Fifth Third Bancorp, a large financial services firm. Employees were permitted to contribute a portion of their compensation, with Fifth Third matching contributions of up to four percent of an employee's compensation. The plan's assets were invested in 20 separate funds, including mutual funds and an ESOP. Participants could allocate their contributions among the funds in any way they wanted, except the company's matching contributions were always invested initially in the ESOP, after which participants could choose to move them to another fund.

   Former employees and ESOP participants filed what they claimed was a class action asserting that the company and various of its officers were fiduciaries of the plan and violated their duties of loyalty and prudence. The Supreme Court considered only the duty of prudence claims, and not the duty of loyalty claims.

   The plaintiffs argued that by July 2007 the fiduciaries knew or should have known that the company's stock was overvalued and excessively risky for two separate reasons. The first was that publicly available information, such as newspaper articles, provided early warning signs that subprime lending, which formed a large part of the company's business, would soon leave creditors "high and dry" as the housing market collapsed and subprime borrowers became unable to pay off their mortgages. The second reason the plaintiffs argued the fiduciaries should have known the company's stock was overvalued and excessively risky was because of nonpublic information. The plaintiffs claimed the fiduciaries who were insiders knew the company's officers had deceived the market by making material misstatements about the company's financial prospects. The plaintiffs said those misstatements led the market to overvalue the company's stock, so the plan was paying more for the stock than it was worth.

The plaintiffs argued that a prudent fiduciary would have responded to this public and nonpublic information in one or more of the following ways: (1) selling the employer stock owned by the ESOP before the value of those shares declined, (2) refraining from purchasing more employer stock, (3) "canceling" the plan's ESOP option, and (4) disclosing the inside information so the market would adjust its valuation of the company's stock downward, with the result that the ESOP would no longer be overpaying for that stock.

The company's stock price allegedly fell by 74 percent between July 2007 and September 2009, when the lawsuit was filed. The stock apparently had partially recovered to around half of its July 2007 price by the time the Supreme Court considered the case.

The Supreme Court first concluded as follows:

> [T]he law does not create a special presumption favoring ESOP fiduciaries. Rather, the same standard of prudence applies to all ERISA fiduciaries, including ESOP fiduciaries, except that an ESOP fiduciary is under no duty to diversify the ESOP's holdings.

Put another way, the Supreme Court said:

> Thus, ESOP fiduciaries, unlike ERISA fiduciaries generally, are not liable for losses that result from a failure to diversify. But aside from that distinction, because ESOP fiduciaries are ERISA fiduciaries and because [ERISA Section 404(a)(1)(B)'s] duty of prudence applies to all ERISA fiduciaries, ESOP fiduciaries are subject to the duty of prudence just as other ERISA fiduciaries are.

The court rejected the defendants' argument that a presumption of prudence was appropriate because in deciding what is prudent fiduciaries of an ESOP can consider that among an ESOP's goals are the promotion of employee ownership of employer stock. The defendants' argument was that given this nonpecuniary goal of encouraging employee ownership, an investment in employer stock would be imprudent only if the company were about to go out of business. The Supreme Court rejected the notion that nonpecuniary benefits of a qualified retirement plan, such as an ESOP, are a proper consideration when determining whether fiduciaries have acted prudently. Instead, the proper focus is on the <u>financial</u> benefits of the plan, such as retirement income, even where the plan is an ESOP.

After delivering this considerable blow to ESOP fiduciaries – by declaring there to be no presumption of prudence when ESOP fiduciaries make investment decisions relating to employer stock – the court provided guidance to courts considering claims of imprudent investment relating to employer stock that fiduciaries should find encouraging. This guidance related to what a plaintiff must allege to state a case that can go forward (that is, survive a motion to dismiss for failure to state a claim under Federal Rules of Civil Procedure § 12(b)(6)).

First, the Court was dismissive of potential claims that fiduciaries need to second guess the market's analysis of publicly available information as reflected in the stock price. The court put it is way:

> In our view, where a stock is publicly traded, allegations that a fiduciary should have recognized from publicly available information alone that the market was over- or undervaluing the stock are implausible as a general rule, at least in the absence of special circumstances.

That is, fiduciaries "may, as a general matter . . . prudently rely on the market price." So, a fiduciary usually "is not imprudent to assume that a major stock market . . . provides the best estimate of the value of the stocks traded on it that is available to him."

The Supreme Court left open the possibility that a plaintiff could plausibly allege imprudence on the basis of publicly available information by pointing to a "special circumstance" affecting the reliability of the market price as a fair assessment of the stock's value that would make reliance on the market's valuation of employer stock imprudent. Though acknowledging the possibility of such special circumstances, the Court gave no examples of when this might occur. One has the sense the Court was skeptical this would often occur.

The Court then offered guidance on claims that fiduciaries have behaved imprudently by failing to act on the basis of nonpublic information available to them because they were insiders. The Court said to state a claim for breach of the duty of prudence based on 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." The Supreme Court said the following three points should help in making this determination:

1. ERISA's duty of prudence does not require a fiduciary to break the law. So, the duty of prudence cannot require an ESOP fiduciary to perform an action – such as divesting a plan's holdings of the employer's stock on the basis of inside information – that would violate the securities laws.

2. Where plaintiffs claim that fiduciaries should, on the basis of inside information, have refrained from making additional stock purchases, or disclosed that inside information to the public so the stock would no longer be overvalued, courts should consider whether doing so could "conflict with the complex insider trading and corporate disclosure requirements imposed by the federal securities laws or with the objectives of those laws." The Supreme Court did not seem ready to address these points further, noting that the SEC had not advised it of its views, which the Supreme Court noted "may well be relevant."

3. Courts considering prudence claims based on a fiduciary's inside information should consider whether a prudent fiduciary might have "concluded that stopping purchases – which the market might take as a sign that insider fiduciaries viewed the employer's stock as a bad investment – or publicly disclosing negative information would do more harm than good to the fund by causing a drop in the stock price and a concomitant drop in the value of the stock already held by the fund."

2. **Sierra Aluminum Company Settlement: *Perez v. GreatBanc Trust Co***. GreatBanc Trust Company entered into a settlement agreement with the Department of Labor in connection with fiduciary claims made by the DOL relating to the purchase by Sierra Aluminum Company's ESOP of Sierra Aluminum Company stock. The settlement was approved by the federal district court for the Central District of California on June 2, 2014 (Case No. 5:12-CV-01648).

The settlement was notable because not only did it involve a payment by GreatBanc and its insurers of over $4.7 million to the Sierra ESOP, and a payment to the DOL of a Section 502(a) payment in the amount of over $477,000, the settlement also established a lengthy set of procedures that GreatBanc agreed to follow whenever serving as a trustee or other fiduciary of an ESOP (subject to Title I of ERISA) in connection with transactions in which the ESOP is purchasing or selling, is contemplating purchasing or selling, or receives an offer to purchase or sell, employer securities that are <u>not publicly traded</u>.

The DOL alleged that GreatBanc failed to adequately inquire into an appraisal that presented unrealistic and aggressively optimistic projections of Sierra's future earnings and profitability. The DOL asserted that GreatBanc failed to investigate the creditability of the assumptions, factual bases, and adjustments to financial statements that went into the appraisal. And the DOL alleged that GreatBanc asked for a revised valuation opinion in order to reconcile the ESOP's higher purchase price with the lower fair market value of the company stock.

As to the payment of over $4.7 million to the Sierra ESOP, the settlement agreement calls for GreatBanc's insurers to pay $3.25 million of that amount, and for GreatBanc to pay the balance together with the Section 502(l) payment over a three-year period. Although Sierra and GreatBanc had an indemnification agreement under which Sierra may have been required to pay GreatBanc's attorney's fees, costs, and expenses incurred in connection with the DOL's lawsuit and underlying investigation, as part of the settlement GreatBanc agreed not to seek or accept indemnification from the company or to use any assets of the company or the company's ESOP for any payments to be made under the settlement agreement or for any expenses, including attorney's fees, associated with the negotiation, consideration, documentation, or implementation of a settlement incurred after a particular date (which was May 20, 2014).

The procedures, which the settlement agreement refers to as "process requirements" and to which GreatBanc agreed, are set forth in Appendix A to this outline. Among the many interesting and notable requirements are the following:

1. <u>Valuation Advisor Having No Conflict</u>. GreatBanc has agreed not to use a valuation advisor for a transaction that has previously performed work – including but not limited to a preliminary valuation – for or on behalf of the ESOP sponsor, any counterparty to the ESOP involved in the transaction, or any entity that is structuring the transaction (such as an investment bank) for any party other than the ESOP or its trustee.

2. <u>Reasonableness of Projections</u>. Either the valuation advisor, in its valuation report, or GreatBanc must provide a written opinion as to the reasonableness of projections considered in connection with the proposed transaction, explaining why and to what extent the projections are or are not reasonable. This analysis must, at a minimum, consider how the projections compare to, and whether they are reasonable in light of, the sponsor's five-year historical averages and/or medians and five-year historical averages and/or medians of a group of comparable public companies (if any exist) for various financial metrics, unless five-year data are unavailable in which case the analyses are to use averages extending as far back as possible.

3. <u>Plan Demographics and Duration of Loan: Possible Effect on Repurchase Obligation and Propriety of Purchase</u>. The valuation report, or GreatBanc, must consider how the plan document provisions concerning stock distributions, the duration of the ESOP's loan, and the age and tenure of the ESOP participants, may affect the plan sponsor's prospective repurchase obligation, the prudence of the stock purchase, or the fair market value of the stock.

4. <u>Debt Service and Fairness Determination</u>. The valuation report or GreatBanc must not only analyze whether the plan sponsor will be able to service the debt in connection with any leveraged transaction, but also whether the transaction is "fair" to the ESOP from a financial point of view and "fair" to the ESOP relative to all of the parties to the proposed transaction. Further, the valuation report or GreatBanc must analyze the financial impact of the proposed transaction on the sponsor.

5. <u>Strong Preference for Audited Financials</u>. GreatBanc is required to ask that the plan sponsor provide it and the its valuation advisor with audited unqualified financial statements prepared by a CPA for the preceding five fiscals years, unless financial statements extending back five years are unavailable, in which case GreatBanc will request audited unqualified financial statements extending back as far as possible. Special rules place a burden on GreatBanc or its valuation advisor in relying on unaudited or qualified financial statements, in particular in determining whether it is prudent to rely on such statements. If it is not prudent to rely on unaudited or qualified financial statements, GreatBanc must not proceed with the transaction.

6. <u>Trustee Report on Valuation Report</u>. GreatBanc must document in writing its analysis of the final valuation report, addressing each of 16 different topics, providing its conclusions and written explanations concerning the bases for its conclusions with respect to each of those topics. These 16 topics generally concern the reasonableness and propriety of both the financial information and other data

considered in the valuation report, and the techniques, such as marketability discounts and minority interests and control premiums, applied in reaching the conclusion as to fair market value.

7. Recording the Views of Individuals at the Trustee. Rather strikingly, GreatBanc agreed to document in writing the identities of its personnel primarily responsible for the proposed transaction, including those who participated in decisions on whether to proceed or the price of the transaction, and set forth any material points as to which the personnel disagreed and why, and whether any personnel concluded or expressed the belief prior to approval of the transaction that the valuation report's conclusions were inconsistent with the data and analysis therein or that the valuation report was internally inconsistent in material aspects. Generally, if the individuals responsible for performing this analysis believe the valuation report's conclusions are not consistent with the data and analysis or that the valuation report is internally inconsistent in material respects, GreatBanc must not proceed with the transaction. GreatBanc agreed to keep for at least six years notes and records documenting (a) who was on its Fiduciary Committee, (b) whether or not an individual voted on the transaction, (c) other personnel who made material decisions, and (d) the vote (yes or no) of each member of the Fiduciary Committee who voted on the proposed transaction, with a signed certification by each of the voting members and any other trustee personnel who made any material decision in connection with the transaction that they have read the valuation report, identified its underlying assumptions, and considered the reasonableness of the valuation report's assumptions and conclusions. GreatBanc agreed to keep for at least six years all notes and records created by it in connection with its consideration of the proposed transaction, and all electronic or other written communications with service providers (including any valuation advisor), the ESOP sponsor, any non-ESOP counterparties, and any advisors retained by the ESOP sponsor or non-ESOP counterparties.

8. Clawback. GreatBanc agreed that in evaluating proposed stock transactions, it will consider whether it is appropriate to request a clawback arrangement or other purchase price adjustment (or adjustments) to protect the ESOP against the possibility of adverse consequences in the event of significant corporate events or changes in circumstances.

The processes to which GreatBanc has agreed may represent a template for what the DOL will look for in terms of due diligence in connection with sales and purchases of nonpublicly-traded stock. Although there is no statutory or regulatory authority plainly supporting the obligation of an ESOP trustee or other fiduciary to take the steps to which GreatBanc has agreed, the DOL is pointing the industry toward the agreement and holding it up as an exemplar. Phyllis Borzi, the Assistant Secretary of Labor for the Employee Benefits Security Administration ("EBSA"), said about the agreement "[o]thers in the industry would do well to take notice of the protections put in place by this agreement."

3. **Evaluating Tender Offers, Statute of Limitations for Fiduciary Claims: *Fish v. GreatBanc Trust Co.*** In *Fish v. GreatBanc Trust Co.*, 2014 U.S. App. LEXIS 9043 (7th

Cir. 2014), the Seventh Circuit Court of Appeals considered the application of the statute of limitations for claims of fiduciary breach and prohibited transactions under ERISA. The general limitation period for fiduciary breach claims is six years from the date of the last action constituting a part of the breach or violation. This six year limit can be extended in cases of fraud or concealment. There is, however, an exception to the six year rule. There is a shorter three-year period that applies, measured from the time a plaintiff gains "actual knowledge of the breach or violation." ERISA Section 413.

The court not only dealt with statute of limitations issues, but also had a fair amount to say about the proper process for ESOP fiduciaries to follow when considering how to respond to a tender offer for the employer's stock. Because the court was ruling on an appeal from a grant of summary judgment, it was required to treat the factual allegations made by the plaintiffs in the light most favorable to the plaintiffs. As a consequence, one should not take from the Seventh Circuit's opinion's any substantive conclusions about what the fiduciaries may or may not have done. In describing the facts below, we will adopt the approach taken by the court, so the description will set forth the facts largely as alleged by the plaintiffs, which may or may not be accurate.

The plaintiffs were employees of the Antioch Company ("Antioch") who had participated in the company's ESOP. Their claims arose from a buy-out transaction at the end of 2003, in which the company borrowed money to buy all of the company's stock except stock owned by the ESOP. The company ultimately declared bankruptcy, and the ESOP's assets became worthless. The plaintiffs sued GreatBanc (and others), alleging a breach of fiduciary duties in connection with the buy-out.

The direct issue before the court was whether the three year statute of limitations, rather than the six year limit, applied because the plaintiffs had "actual knowledge" of the breach at the time of the buy-out or shortly thereafter. The defendants argued that proxy documents provided to the plaintiffs at the time of the buy-out transaction, and the plaintiffs' knowledge of the Company's financial affairs after the transaction, gave them actual knowledge of the alleged violations more than three years before they filed suit. The court concluded that this was not the case. The court reached this conclusion because a good part of the claim related to whether GreatBanc had followed a good process in evaluating the buy-out, yet the information the plaintiffs had did not disclose the details of the process GreatBanc followed.

In determining whether the plaintiffs had actual knowledge of the alleged breaches of fiduciary duty more than three years before the suit was filed, the court also had a fair amount to say about the proper process for analyzing the tender offer. Before saying more about this, it will be helpful to say more about the facts, as alleged by the plaintiffs, which were as follows:

Before the buy-out transaction, the ESOP owned 43 percent of the company's common stock. The remainder was held primarily by members of a family (the "Morgans") which had founded and still controlled the company. The Morgans decided to pursue a major transaction that would accomplish several goals: (a) allow the Morgan family and other shareholders to cash out their company stockholdings at a favorable price, (b) leave the

Morgan family in control of the company as fiduciaries of the ESOP, and (c) gain tax advantages by converting the company to an S-Corporation with just one shareholder (the ESOP).

The proposed transaction was structured so the company would make a tender offer of $850 per share for all the shares of its stock. The expectation was that the Morgan family and all other shareholders would sell all their stock, but an express condition of the transaction was that the ESOP was required to decline the tender offer so it would be left as the sole shareholder. To pay all the non-ESOP shareholders $850 per share, the company, which the court referred to as a "relatively small employee-owned company," would have to pay more than $150 million in cash, much of it newly borrowed.

The plaintiffs asserted that causing the ESOP to decline the tender offer and the company to satisfy the conditions for redemption of all common shares (excepting the ESOP shares), which resulted in the ESOP becoming the 100% owner of company shares (subject to dilution from certain warrants and stock appreciation rights) constituted a prohibited transaction. Presumably the theory was that the economic substance of the transaction was one in which the ESOP would "buy" the company stock indirectly from the Morgan family and other shareholders, though this seems a stretch.

Some of the sellers were themselves plan fiduciaries (and therefore parties in interest), and the plaintiffs sued not only GreatBanc, but these individuals as well. The court noted that there is a prohibited transaction exemption for purchases of certain company stock, where, among other requirements, the plan does not pay more than fair market value, as determined in good faith by the fiduciary. ERISA Section 408(e).

The company and the individual Morgan defendants agreed to retain GreatBanc Trust to become the ESOP's trustee on a temporary basis for purposes of evaluating the proposed tender offer and making an independent decision about whether to agree to it (which, oddly enough, meant agreeing <u>not</u> to tender the plan's shares). GreatBanc remained the trustee until the buy-out transaction closed.

The plaintiffs argued that the defendants breached their fiduciary duties to use a sound process to evaluate the fairness of the proposed buy-out. GreatBanc, in serving temporarily as a trustee independent of the company and the Morgan family to evaluate the fairness of the transaction, would negotiate with the defendants on behalf of plan participants and keep them informed, and ultimately decide whether to approve or reject the buy-out transaction. The intention was that the individual defendants retain control of the company by returning to their fiduciary positions with respect to the ESOP after the buy-out.

For help in evaluating the transaction, GreatBanc hired Duff & Phelps to provide financial advice. GreatBanc had been retained in August 2003. Duff & Phelps, in early October 2003, was said to have described the proposed transaction as "the most aggressive deal structure in the history of ESOPs." This allegedly led the Morgans and other company management to contemplate firing GreatBanc and Duff & Phelps. GreatBanc then began negotiating modifications to the proposed transaction.

In late October, the company agreed to GreatBanc's request for a so called Put Protection Price (or "PPP") for employees who "cashed out" in the three years following the transaction. The PPP was a mechanism to protect ESOP participants against a short-term drop in stock value, such as in the wake of a highly-leveraged transaction. The PPP imposed a floor price for 2004 cash outs and set a fixed amount to add to the appraised fair market value of company stock for cash outs in 2005 and 2006. The PPP allegedly created significant additional liability and risk for the Company and the ESOP, since the company was contractually obligated to pay the agreed-upon price premium. The PPP was binding no matter how many employees decided to cash out and no matter what the appraised fair market value of the company stock might be at the time.

In November 2003, the company also adopted a new ESOP distribution policy that further increased the incentive for participants to "cash out," with the benefit of the PPP, after the buy-out. Specifically, a participant who retired early under the old distribution policy had to wait five years for payments to begin, as permitted under Internal Revenue Code ("**IRC**") Section 409(o). Under the new distribution policy, though, payment would begin immediately and the full value would be paid within five years. This change was alleged to further increase the company's potential repurchase liability after the transaction.

These two developments – the negotiation of the Put Protection Price and the new, more lenient, distribution policy, were at the heart of the plaintiffs' complaints.

As they began their work, GreatBanc and Duff & Phelps asked the company to provide repurchase liability projections for 25 years following the proposed transaction. These projections were to compare the company's then-current repurchase obligations to the obligations expected after the buy-out. The company provided GreatBanc, in this regard, with one page from a report that the company's chief financial officer had prepared to assess the company's liability before and after the proposed transaction. The court said the record did not indicate whether GreatBanc or Duff & Phelps ever reviewed or even requested the full report. The argument was that without the full report GreatBanc and Duff & Phelps would have been unable to verify the key assumptions underlying the report's conclusions. They instead allegedly took the company at its word. These key assumptions, which included the projected retirement age of participants, were made in July 2003, before the addition of the PPP and the new distribution policy. According to plaintiffs, GreatBanc's final approval of the buy-out was therefore based on obsolete and incomplete information.

Prior to the final version of the PPP agreement and adoption of the new distribution policy, Duff and Phelps provided GreatBanc with a 22-page report summarizing the proposed transaction, and a 79-page preliminary report reviewing its impact. These were supplemented in December 2003 by a 4-page update to the original review and a final 5-page fairness letter. These documents allegedly gave no indication that GreatBanc or Duff & Phelps considered the potential negative impact of the PPP or the new distribution policy in their fairness analysis. It is these omissions that lie at the core of the plaintiffs' claims.

As to the statute of limitations question – whether the plaintiffs had "actual knowledge" of fiduciary breaches or prohibited transactions more than three years before they filed suit –

the court noted that the company had sent a proxy statement regarding the tender offer to all plan participants and shareholders in November 2003, a month before the transaction closed. That proxy statement described the transaction and provided a fairness analysis for non-plan participants, who had to act independently to tender their shares. The cover letter told ESOP participants that GreatBanc had been hired for the sole purpose of ensuring that the transaction was fair, prudent, and in the best interest of the plan and its participants. The defendants argued that these disclosures in the proxy materials showed the plaintiffs had early "actual knowledge" of the alleged breaches. The cover letter for the proxy materials said GreatBanc had determined that "it is prudent and in the best interests of the ESOP participants and beneficiaries not to sell the ESOP's shares of [the company's] common stock in the Tender Offer." The proxy materials said "a condition of the Closing is [GreatBanc Trust's] receipt of an opinion from Duff & Phelps that the Transaction, as a whole, is fair to the ESOP from a financial point of view." The proxy letter said GreatBanc had received a preliminary opinion from Duff & Phelps to this effect.

The proxy materials also included a one-page section entitled "Risks Related to the Transaction," which noted potential dangers of the highly-levered transaction. These included risks that the tax benefits were overestimated or the purchased shares were overvalued. They also noted that the ESOP repurchase obligations could be higher than expected if the fair market value of the stock "increases substantially." But, the proxy materials said, "the company has projected the potential of repurchase liability through the year 2013 under a set of assumptions that the company believes to be reasonable." The proxy materials also concluded that the repurchase obligations could be unexpectedly higher and could leave the company "insolvent."

Because the proxy materials did not, however, disclose the processes GreatBanc and Duff & Phelps used to exercise due diligence and to conduct a fairness analysis, the court concluded that the plaintiffs did not have actual knowledge of the alleged fiduciary breaches and prohibited transaction when they received the proxy materials, nor when they noticed that many plan participants were leaving the company and choosing to cash out their benefits from the ESOP.

The transaction closed on December 16, 2003. Plan participants began cashing out in the summer of 2004. Specifically, in 2004, 70 employees under the age of 50 resigned or cashed out, taking advantage of a high stock value and the new distribution policy. These resignations allegedly depleted the company's remaining cash reserves, and tax savings could not fully offset declining sales. The plaintiffs alleged that these events set off a downward cycle, as liabilities increased and revenues decreased. The company declared bankruptcy in 2008, at which point the company's shares and the interest of participants in the ESOP were worthless. The total loss to plan participants was allegedly roughly $60 million.

The plaintiffs alleged that the company failed because the buy-out transaction was far too generous to the Morgan family and other shareholders, and because the transaction included ill-advised promises to participants about their ability to receive comparable stock prices and cash if they retired or left the Company within a few years. The plaintiffs argued that the Company was vulnerable to a "stampede" by participants wishing to cash out because it was saddled with excessive debt incurred to pay the Morgan family in the buy-out.

The plaintiffs asserted that GreatBanc violated its fiduciary duties by failing to take reasonable steps to evaluate the fairness of the proposed buy-out before agreeing to the transaction. They also contended that the other defendants failed to monitor GreatBanc sufficiently, failed to disclose material information to GreatBanc, and acted under a conflict of interest whereby they would benefit from the transaction regardless of its effect on employees in the plan.

The plaintiffs' claims focused on the fairness analysis performed by GreatBanc, and the individual defendants' actions before the 2003 transaction. The plaintiffs argued that all defendants breached their fiduciary duty of prudence, and engaged in a prohibited transaction without adequate consideration, making inapplicable the prohibited transaction exemption in ERISA Section 408(e).

Although the court made clear it was not deciding the merits of the fiduciary prudence and prohibited transaction claims, it did discuss the nature of these allegations to the extent necessary to make its determination of what information the plaintiffs would have needed to receive to have gained "actual knowledge" of the breach or prohibited transaction.

In describing how it analyzes whether a fiduciary has acted prudently, the Seventh Circuit cited with approval a case it had decided almost 20 years previously, *Eyler v. Comm'r of Internal Revenue*, 88 F.3d 445 (7th Cir. 1996). The court said whether a fiduciary has acted prudently requires consideration of both (a) the substantive reasonableness of the fiduciary's actions, and (b) the procedures by which the fiduciary made its decision. The court put it this way in *Eyler*:

> In reviewing the act of ESOP fiduciaries under the objective prudent person standard, courts examine both the process used by the fiduciaries to reach their decision as well as an evaluation of the merits.

The court said this is true when determining whether an act was prudent under the general fiduciary standard, and also whether an otherwise prohibited transaction is saved under the "adequate consideration" exemption in ERISA Section 408(b).

The Seventh Circuit cited its earlier decision in *Keach v. U.S. Trust Co.*, 419 F.3d 626 (7th Cir. 2005), as well as a proposed Department of Labor Regulation (Prop. DOL Reg. Section 2510.3-18(b)), for the view that for a transaction to be considered supported by adequate consideration, two requirements must be met: a substantive requirement that the value assigned reflect the fair market value of the asset, and a procedural requirement that the fiduciary actually determine the value assigned in good faith. As to GreatBanc's <u>process</u> in determining the fair market value of the company stock, the court said Duff & Phelps' financial advice was "highly relevant," but, citing the Fifth Circuit's venerable decision in *Donovan v. Cunningham*, 716 F.2d 1455, 1474 (5th Cir. 1983), cautioned that "an independent appraisal is not a magic wand that fiduciaries may simply wave over a transaction to ensure that their responsibilities are fulfilled." That is, the court said (as it had in *Keach*), "an independent assessment from a financial advisor . . . is not a complete defense against a charge of imprudence." The court suggested that GreatBanc needed to perform sufficient due diligence, which would necessarily include reasonable investigation into Duff & Phelps' process and independent scrutiny of materials from the company. In examining a fiduciary's process, "the degree to which a fiduciary makes an independent inquiry is critical." Although a "fiduciary's reliance on a financial advisor is evidence of prudence, . . . some inquiry into the advisor's qualifications and methods is still required." So, while GreatBanc could rely on a fairness analysis of an expert, it was still obligated to demonstrate that its reliance on the advice from Duff & Phelps for the particular transaction was justifiable.

The court concluded that the district court had been in error when it held the plaintiffs' claims were barred by the three-year statute of limitations, and sent the case back to the district court. It did not conclude whether GreatBanc or the other defendants acted in an impermissible fashion, and in particular whether they breached their fiduciary duties or engaged in a prohibited transaction.

4. **Valuation Firm Not Liable to Selling Shareholders: *Arvig Enter., Inc. v. Sansome Street Appraisers, Inc*.** On motions to dismiss, and therefore without addressing the merits of the contested valuation of stock of a company maintaining an ESOP, a district court held that employees who sold stock to an ESOP for a price the employees asserted was too low, and to which the ESOP had allegedly agreed in reliance on annual valuations prepared in connection with the company's ESOP that the plaintiffs claimed undervalued the company's stock, did not have a valid claim against the valuation company for negligence or malpractice. That was because the employees were not intended third party beneficiaries of the contract between the valuation firm and the company, and the valuation firm therefore did not owe the employees any duty of care. *Arvig Enter., Inc. v. Sansome Street Appraisers, Inc*., 2013 U.S. Dist. LEXIS 151435, 57 EBC 1081 (D. Minn. 2013). The court did, however, allow the company to proceed on breach of contract claims against the valuation firm, despite that firm's argument that its contract was with the ESOP, not the company, because in fact the contract on its face was with the company. The court also held that where the company retained the independent appraisal firm to provide annual valuations, but that firm in turn hired a subcontractor to actually conduct the appraisal, the firm hired by the fiduciary committee and ESOP would be liable for any negligence or malpractice caused by the subcontractor retained by it.

By way of background, the plaintiffs claimed that the Department of Labor audited the ESOP and found "egregious errors" with the annual valuations. The company allegedly incurred expenses in the amount of almost $720,000 during the DOL investigation to rectify those valuations errors, and entered into a voluntary compliance agreement with the DOL requiring that its past valuations be recalculated. The new valuations for three of the years were substantially higher than those produced by the original appraiser, allegedly due at least in part to the original appraiser's failure to account for an $18.8 million investment the company made in another company.

The DOL allegedly concluded that due to the original appraiser's alleged undervaluation, the ESOP underpaid plan participants who terminated employment, and the DOL required the company, on behalf of the ESOP, to make restorative payments to those terminated participants in the amount of over $435,000. The ESOP asserted that in reliance on the erroneous valuations it purchased and allocated to employees' accounts more shares of company stock than it would have had it known the stock's true value. The plaintiffs claimed that, as a consequence, the company, the ESOP, and the fiduciary committee would incur approximately $15 million in damages in the form of additional repurchase liability to employees terminating in the future.

The plaintiffs were shareholder-employees who claimed they suffered damages because they sold company stock to the ESOP for less than its value (approximately $5 million less, collectively) in reliance on the allegedly faulty valuations. As noted, the shareholder-employees' negligence and malpractice claims were rejected, as was their breach of contract claims, because they were not intended third party beneficiaries of the appraiser's contract with the company relating to the ESOP. The company, the ESOP, and the fiduciary also made a claim for any damages they might incur should they be liable to the shareholder-employees as a consequence of the shareholder-employees selling stock at a price below market value.

5. **Fiduciaries Do Not Breach Duty of Loyalty Merely Because Compensation is Linked to Company Stock: *In re Chesapeake Energy Corp. 2012 ERISA Class Litigation***. A district court rejected claims that ESOP fiduciaries violated their duty of loyalty based solely on an alleged tie between the price of the sponsoring employer's stock and the fiduciaries' compensation in *In re Chesapeake Energy Corp. 2012 ERISA Class Litigation*, 2013 U.S. Dist. LEXIS 147128, 57 EBC 1528 (W.D. Okla. 2013). The plaintiffs had filed a class action complaint alleging that the ESOP's fiduciaries had imprudently continued to offer company stock as an investment option and held preexisting plan investments in company stock when it was no longer prudent to do so. They also alleged a breach of the duty of loyalty based on the fiduciaries' conflict resulting from their compensation being tied, in part, to the price of company stock, therefore creating an incentive to keep the company's stock price "artificially inflated."

   In addition to the district court's dismissal of the plaintiffs' loyalty claim on a motion to dismiss, the court held with respect to the plaintiffs' prudence claims that the plaintiffs had not overcome a presumption of prudence in favor of the ESOP fiduciaries. The Supreme Court's decision in *Dudenhoeffer* makes this latter holding unimportant as precedent, because it directly conflicts with the Supreme Court's holding in *Dudenhoeffer*.

6. **Trachte Building Systems ESOP Damages**. A district court has, over the past year, ruled on the particulars of the remedies available to plaintiffs with respect to their claims against various companies and individual defendants for violation of their fiduciary duties owed to two ESOPs – the Trachte Building Systems, Inc. Employee Stock Ownership Plan and the Alliance Holdings, Inc. Employee Stock Ownership Plan – in connection with a complex leveraged buyout. The district court had held in mid-2012 that the defendants had leveraged the accounts of participants in the Alliance ESOP to purchase Trachte Building Systems, Inc. on behalf of the Trachte ESOP at a substantially inflated price.

The court issued its ruling with respect to the measure of damages in *Chesemore v. Alliance Holdings, Inc.*, 948 F.Supp.2d 928, 57 EBC 1231 (W.D. Wis. 2013), concluding that the defendants' breach of their duties to the Alliance and Trachte ESOPs caused the Trachte ESOP to overpay for the purchase of Trachte, and that the amount of the overpayment could reasonably be estimated at roughly $8.3 million. The court held that Alliance and the individual who formed and controlled Alliance, a Mr. Fenkell, used their control over the Trachte employees' accounts in the Alliance ESOP, and over the Trachte ESOP trustees, to obtain an inflated price, which ensured payment of phantom stock to Mr. Fenkell. As a consequence, the court held that Alliance and Mr. Fenkell must reinstate the plaintiffs in the Alliance ESOP and restore roughly $7.8 million to their accounts. The court also ordered Mr. Fenkell to disgorge roughly $2.9 million he received in phantom stock payments by reason of the inflated value of Alliance stock established, at least in part, by reason of the improper ESOP transaction.

The court ordered the removal of Mr. Fenkell as trustee of the Alliance ESOP. Further, the court held that independent fiduciaries who were retained to serve as independent fiduciaries of the Trachte ESOP "at the eleventh hour," to review the transaction and to direct the trustees, had breached their fiduciary duties and caused the Trachte ESOP to overpay for Trachte. As a consequence, those fiduciaries were ordered to restore roughly $6.8 million to the Trachte ESOP. But because Alliance and Mr. Fenkell were the more culpable fiduciaries, the court ordered them to indemnify the independent fiduciaries for any compensatory relief paid by them.

By way of background, the court, in an earlier mid-2012 ruling, summarized the facts in this way:

> As many majority owners of closely-held companies with ESOPs began looking for ways to sell their majority interests, defendants David B. Fenkell and the companies he formed and controls, Alliance Holdings, Inc. ("Alliance"), A.H.I., Inc. ("AHI") and AH Transitions (collectively "the Alliance Defendants"), saw an opportunity. They buy companies with an ESOP, fold these ESOPs into the Alliance ESOP, hold and expand the companies over a relatively short period of time and then flip them at a profit, benefitting Alliance generally and Fenkell in particular as he personally redeems phantom stock. All of this is perfectly legal, provided that someone is acting as fiduciary to protect the interests of the employee holdings in the ESOP. Unfortunately, Fenkell and the other Alliance Defendants took calculated steps to insure no one would be doing so when they flipped Trachte Building Systems, Inc. ("Trachte").
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> In 2002, defendant Alliance purchased Trachte in a private stock transaction for $24 million and merged accounts of plaintiffs, who were Trachte employees, with an old Trachte ESOP into the Alliance Holdings, Inc. Employee Stock Ownership Plan and Trust (the "Alliance ESOP"). Five years later, Alliance expected to sell Trachte for around $50 million. After failing to find a third-party buyer at the desired price, Alliance orchestrated a sale of Trachte to a newly-formed Trachte Building Systems Employee

> Stock Ownership Plan ("the Trachte ESOP"). Plaintiffs' accounts in the Alliance ESOP, holding approximately $8 million worth of Alliance stock, was a linchpin of the sale.
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> Alliance structured the sale as a series of interdependent actions on August 29, 2007 (collectively, "the 2007 Transaction"), each of which was conditioned on the completion of all subsequent actions. At Alliance's direction, the Alliance ESOP spun-off the Trachte employees' accounts into the new Trachte ESOP and the Alliance shares in those accounts were exchanged for Trachte shares held by AHI. Using these shares as collateral for loans, Trachte and the Trachte ESOP redeemed or purchased all of Trachte's outstanding equity from Alliance, AHI and Stephen Pagelow, Trachte's former CEO. At the close of the 2007 Transaction, the Trachte ESOP had paid $38.1 million for 100% of Trachte's equity and Trachte had taken on $36 million in debt. Fenkell and Alliance *designed* this transaction so that either plaintiffs' ESOP holdings would be used as leverage to buy Trachte on terms favorable to Alliance or those holdings would revert to holdings in the Alliance ESOP.
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> All of this might have been fine, except that Alliance also orchestrated the parties so that no independent person was looking out for the employees' interests in the Alliance or the Trachte ESOP. Only a week before the 2007 Transaction, Alliance appointed Trachte's President Jeffrey A. Seefeldt and CFO James Mastrangelo -- both beholden to Alliance -- as the sole members of Trachte's board of directors. The board then adopted a new Trachte ESOP and named as its sole trustees Seefeldt, Mastrangelo and Pamela Klute, Trachte's VP of Human Resources, (collectively, "the Trustee Defendants"). After realizing at the eleventh hour that they faced a conflict of interest and were not qualified to assess the transaction, the Trustee Defendants hired defendants Alpha Investment Consulting Group, LLC ("Alpha") and John Michael Maier to serve as "independent fiduciaries" of the Trachte ESOP, review the transaction and direct the trustees. Unfortunately, Alliance and the trustees restricted the scope of Alpha's authority and obligations and did not appoint Alpha properly as a directing trustee.
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> As a result of the Alliance Defendant's orchestration and the Trustee Defendant's negligence and conflicts of interest, questionable judgments were made in the valuation of Trachte without independent scrutiny and the Trachte ESOP paid more than fair market value. Ultimately, Trachte could not afford the debt load that it incurred as part of the 2007 Transaction. The 2007 annual valuation for the Trachte ESOP placed Trachte's equity value at $16.99 million. By 2008, the value was $0.

The court later dealt with a claim against Mr. Fenkell's wife. This claim concerned a payment of phantom stock to Mr. Fenkell that the court had previously held violated ERISA, and which the court had required that Mr. Fenkell disgorge. The plaintiffs filed suit against Mr. Fenkell's wife, arguing that the phantom stock had been transferred to her, and that she needed to return those monies. The court denied Mrs. Fenkell's motion to dismiss this claim in *Chesemore v. Alliance Holdings, Inc.*, 2013 U.S. Dist. LEXIS 148651 (W.D. Wis. 2013). The court had previously ruled that a gratuitous transferee could be required to disgorge a payment as a remedy under ERISA Section 502(a)(3), whether or not that transferee had any knowledge, actual or constructive, of the existence of a fiduciary duty and breach of that duty. The court, in concluding that knowledge of the existence of a fiduciary duty is only required if the transferee of trust proceeds purchased them for some value, had relied on the Supreme Court's decision in *Harris Trust & Sav. Bank v. Salomon Smith Barney, Inc.*, 530 U.S. 238, 120 S. Ct. 2180 (2000).

The court also clarified its earlier ruling with respect to the $7.8 million to be restored to the accounts of plaintiffs in the Alliance ESOP. It considered the question whether the allocation to participants' accounts could be made in the form of a contribution of company stock independently valued in the amount of $7.8 million plus prejudgment interest. The court held that each class member should be given the option of receiving his or her respective allotment in cash or instead in company stock. If any of the class members were to choose stock, the court established a process for the parties to jointly choose a valuation expert and independent fiduciary to manage the reinstatement process for those class members electing stock.

The court next preliminarily enjoined the Alliance ESOP from transferring any portion of Mr. Fenkell's ESOP benefits (presumably to Mr. Fenkell). The court said it had previously held that the plaintiffs had a right to offset Mr. Fenkell's benefits to pay the plan pursuant to a final judgment, once a final judgment were issued (there remained the outstanding claim against <u>Mrs</u>. Fenkell, so there was not yet a final judgment). The court concluded that taking Mr. Fenkell's ESOP account to satisfy the award against him would not violate ERISA's anti-alienation provision because of the exception under ERISA Section 206(d)(4) permitting a participant's benefits to be offset by the amount the participant is ordered or required to pay to the plan where that order or requirement arises under a civil judgment (including a consent order or decree) entered by a court in an action brought in connection with the violation (or alleged violation) of Part 4 of Title I, which includes ERISA's fiduciary duty and prohibited transaction rules.

In various proceedings in 2014, the court dealt with various settlement agreements, in part to reflect the limits of fiduciary liability insurance coverage available and the limited personal assets of various individual defendants.

7. <u>**Fiduciary Standards for Purchasing Employer Stock: *Harris v. Amgen, Inc***</u>. The Ninth Circuit Court of Appeals, in a ruling issued prior to the Supreme Court's decision in *Dudenhoeffer*, held that the presumption of prudence the Ninth Circuit has applied under standards it set forth in *Quan v. Computer Sciences Corp.*, 623 F.3d 870 (9th Cir. 2010), did not apply because the plan did not "require or encourage" the appropriate plan fiduciary to invest primarily in employer stock. Instead, although the plan permitted the establishment of an employer stock fund, the court did not consider the plan to require or even encourage the establishment of such a fund. *Harris v. Amgen, Inc.*, 738 F.3d 1026 (9th Cir. 2013). This portion of the court's analysis – concerning the prior "presumption of

prudence" – has been superseded by the Supreme Court's decision in *Dudenhoeffer*. Other aspects of the decision, noted below, may, however, retain validity.

The decision in *Harris*, which replaced an earlier opinion (at 717 F.3d 1042, which the court withdrew) ruled on a motion by the defendants to dismiss the lawsuit. This meant the court was required to assume the allegations made by the plaintiffs were true in deciding whether the case should be permitted to continue to trial. The court held that the plaintiffs' claims should not be dismissed, paving the way for the case to proceed to trial. Although the court merely assumed that the allegations made by the plaintiffs were accurate, it did note that in a separate class action pending at the same time and before the same federal district judge, that judge had concluded that investors in Amgen common stock had sufficiently alleged material misrepresentations and omissions, scienter, reliance, and resulting economic loss to state claims under Section 10(b) and 20(a) of the 1934 Securities Exchange Act. The district court certified a class based on the facts alleged in that securities law complaint, and the Ninth Circuit affirmed the district court's class certification at 660 F.3d 1170 (9th Cir. 2011), in a case called *Conn. Ret. Plans & Trust Funds v. Amgen, Inc.*

As to the plaintiffs' allegations that the fiduciaries had violated ERISA's fiduciary obligation to act prudently, by allowing the investment of plan assets in company stock, the court noted that its focus should properly be on the fiduciary's process. The court said the question was whether the fiduciaries "at the time they engaged in the challenged transactions, employed the appropriate methods to investigate the merits of the investment and to structure the investment." (*Quoting Quan*, 623 F.3d at 879 (which in turn quotes *Wright v. Oregon Metallurgical Corp.*, 360 F.3d 1090, 1097).)

In response to the defendants' contention that if the stock fund had been removed as an investment option this might have resulted in a drop in the stock price, the court surmised it was unlikely that failing to make future investments, as opposed to removing the stock fund altogether, would have had an "appreciable negative" impact on the share price. That is because of the relatively small number of Amgen shares that would have been purchased by the plan in comparison to the "enormous" number of actively traded shares. [The essence of the plaintiffs' complaint was that the fiduciaries should not have continued to provide the company common stock as an investment alternative when "they knew or should have known" that the stock was being sold at an artificially inflated price due to various alleged false or misleading statements about the company's products.]

As to removing the stock fund as an investment option altogether, the Ninth Circuit conceded that this would have sent a "negative signal to the wider investing public," and might well have caused a drop in the share price. But the court said several factors mitigated this effect. First, the court said the efficient market hypothesis ordinarily applies, and in the case of stock fraud the ultimate decline in price would therefore have been no more than the amount by which the price was artificially inflated. In addition, once the stock funds were removed as an investment option, employees would have been prevented from making additional investments while the price remained artificially inflated. Third and finally, the fiduciaries' obligations to remove the fund as an investment option would have been triggered as soon as they knew or should have known the share price was artificially inflated, rather than long after they gained this knowledge and participants would have invested at an artificially inflated price. The court said the defendants were alleged to have violated their fiduciary duties under ERISA at "more or less the same time" some of them violated their duties under the federal securities laws. If they had timely complied with their duties under ERISA, there would have been "little or no artificial increase" in the share price before the company stock funds were removed as an investment option.

As to arguments that the fiduciaries' hands were tied to some degree by their obligation to comply with securities laws, the Ninth Circuit said, as the Supreme Court did in *Dudenhoeffer*, that fiduciaries are under no obligation to violate federal securities laws. The defendants argued that the fiduciaries could not have removed the stock fund based on undisclosed alleged adverse material information because doing so would have been a potentially illegal course of action. The court said the following about this:

> The central problem in this case is that Amgen officials, many of whom are defendants here, made material misrepresentations and omissions in violation of the federal securities laws. Compliance with ERISA would not have required defendants to violate those laws; indeed, compliance with ERISA would likely have resulted in compliance with the securities laws. If defendants had revealed material information in a timely fashion to the general public (including plan participants), thereby allowing informed plan participants to decide whether to invest in the Amgen Common Stock Fund, they would have simultaneously satisfied their duties under both the securities laws and ERISA.
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> Alternatively, if defendants had made no disclosures but had simply not allowed additional investments in the Fund while the price of Amgen stock was artificially inflated, they would not thereby have violated the prohibition against insider trading, for there is no violation absent purchase or sale of stock.

In addition to prudence arguments, the plaintiffs argued that the defendants violated their duty of loyalty and care by failing to provide material information to plan participants about investments in the company stock fund. The defendants countered that they had limited obligations under ERISA to disclose information to plan participants, and that their disclosure obligations did not extend to information that is material under the federal securities laws. The defendants also argued that the plaintiffs had not alleged detrimental reliance on the defendants' omissions and misrepresentations. Finally, the defendants contended that their omissions and misrepresentations, if there were any, were not made in their fiduciary capacity. The Ninth Circuit rejected each of these claims.

As to the first contention, that the defendants owed no duty under ERISA to provide material information about the company stock to plan participants who must decide whether to invest in that stock, the court said this was not the case. Instead, quoting *Quan*, the court said:

> We have recognized [that] . . . [a] fiduciary has an obligation to convey complete and accurate information material to the beneficiary's circumstance, even when a beneficiary has not specifically asked for the information. [T]he same duty applies to "alleged material misrepresentations made by fiduciaries to participants regarding the risks attendant to fund investment." (Case names and citations omitted.)

As to what constitutes a material misrepresentation, the court again quoted its earlier opinion in *Quan* as follows:

> [A] misrepresentation is "material" if there was a substantial likelihood that it would have misled a reasonable participant in making an adequately informed decision about whether to place or maintain monies in a particular fund.

As to the defendants' contention the plaintiffs failed to show they relied on the defendants' material omissions and misrepresentations, the court borrowed from federal securities law decisions under Section 10(b) establishing that a defrauded investor need not show actual reliance on the particular omissions or representations of the defendant. Instead, an investor can rely on a rebuttable presumption of reliance based on a "fraud-on-the-market" theory.

Under this theory, the market price of shares traded on "well-developed markets" reflects all publicly available information and therefore any material misrepresentations. Because the market effectively transmits information to a potential investor in the form of the market price, the Supreme Court had held in a 2011 decision (*Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179 (2011)) that an investor effectively relies on public misstatements whenever he or she buys or sells stock at the price set by the market. The Ninth Circuit said it saw no reason why ERISA plan participants who invested in an employer stock fund the assets of which consisted solely of publicly traded common stock should not be able to rely on the fraud-on-the-market theory in the same manner as any other investor in publicly traded stock.

The defendants contended that statements made to the Securities and Exchange Commission in documents required by the federal securities laws were not made in a fiduciary capacity, and therefore could not be considered in an ERISA suit for breach of fiduciary duty. The Ninth Circuit said it had not decided this issue, and that the defendants might be correct if the documents had only been filed and distributed as required under the securities laws. In that event, the acts might well have been performed only in a corporate capacity. Here, however, the defendants had in the summary plan descriptions for the two ESOPs at issue incorporated by reference the SEC filings. The court held that the defendants' preparation and distribution of the SPDs, including their incorporation of the company's SEC filings by reference, were acts performed in their fiduciary duties.

Finally the court held that the company could not be dismissed as a defendant on the ground that it was not a plan fiduciary. Amgen argued it was not a fiduciary because it had delegated its discretionary authority. The court seemed to accept that where a company grants to another the exclusive authority to take action the company could otherwise take, the company might effectively avoid fiduciary liability (other than as to any obligation it might have to monitor and possibly replace a party to which it had delegated authority). But the court said the company was a named fiduciary under the plans under consideration (and was the "administrator" and "plan sponsor"). Further the plans indicated that where an action was to be taken by the company, the fiduciary committee "shall be authorized to act on behalf of the company." This provision authorizing the fiduciary committee to take action on behalf of the company did not, the court said, preclude fiduciary status for Amgen because the company had not given the committee the exclusive right to make decisions under the plan. Instead, the plan merely authorized the fiduciary committee to act on behalf of the company. It neither provided exclusive authority to the committee, nor precluded the company from acting on its own behalf.

8. **Fiduciary Duty to Investigate Possible Fictitious Sales, and Possible Obligation to Notify Valuation Firm About Potential Offers to Buy Employer: *Malcolm v. Trilithic, Inc*.** A district court considered ESOP-related claims brought by the ousted CEO of a closely held corporation in *Malcolm v. Trilithic, Inc.*, 2014 U.S. Dist. LEXIS 43149, 57 EBC 2862 (S.D. Ind. 2014). The former CEO alleged that the company had recorded a large false sale on its financial books, and that fiduciaries withheld material information about the company's valuation from both the appraiser who prepared the company's annual valuation and plan participants, concerning potential offers to buy the company.

The plaintiff and one of the defendants were the co-founders and major shareholders of the company. Each owned approximately 35 percent of the company's outstanding voting stock. An ESOP held about 20 percent of the voting shares, and a relatively small number of voting shares were held by various company employees.

The plaintiff had been the CEO and chairman of the three person board of directors of the company. The court was ruling on motions to dismiss, so it took the facts as alleged by the former CEO, who brought the lawsuit, as true. According to the former CEO, the company's annual audit was being completed in late May 2012 when he learned that a fictitious sale had been included on the company's books and records. He asserted that finished goods with a sale price of $175,000 were hidden in the company's machine shop, but that a purchase order created on April 5, 2012, showed a sale of those goods to a distributor owned by a friend of the other co-founder (and board member). The former CEO asserted that this fictitious sale had been recorded on the company's books merely to bolster the company's receivables account and profitability in order to present a better record to its lender (the lender provided a line of credit based on certain factors that included monthly sales receivables).

The former CEO asserted that he approached each of the members of the company's benefits committee to inquire about his suspicions. He claimed that these committee members either participated in the false sale or subsequently learned about it and failed to take appropriate responsive action. The former CEO said he was removed as an officer and director on July 24, 2012, after initiating his inquiry. He also asserted the defendants withheld information obtained from brokers and potential buyers about the company's estimated fair market value in order to affect the company's valuation.

The defendants argued that any false sales involved misconduct only in their roles of officers and directors of the company, and not in their functions as plan administrators. But the court said the plaintiff was really claiming that the defendants, acting as fiduciaries, failed to take any steps to investigate whether continuing to invest in the company's stock was a prudent decision. The plaintiff seemed to have argued that recording a false sale would render the company's monthly financial statements false and that the submission to the lender of that information would constitute a fraudulent act, all of which would place the company in default of its lending agreement. The plaintiff said this default "would impair the continuing viability of the company" and conceivably cause ESOP participants to lose their benefits under the plan, one assumes due to a failure of the company or at least a precipitous drop in the value of the company's stock.

The court dismissed the former CEO's fiduciary claims based on his assertions about alleged false sales. In doing so, the court focused on when fiduciaries have an obligation to investigate allegations of a false sale, to determine whether the ESOP's continued investment in company stock would be consistent with their duty of prudence, and perhaps to take actions to correct the fraudulent activity. The court noted that under Seventh Circuit precedent "ERISA imposes no duty on plan fiduciaries to continuously audit operational affairs." (*Citing Pugh v. Tribune Co.*, 521 F.3d 686, 700 (7^{th} Cir. 2008).) Instead, a fiduciary's duty to investigate "only arises when there is some reason to suspect that investing in company stock may be imprudent – that is, there must be something akin to a 'red flag' of misconduct." The plaintiff alleged that the defendants' own knowledge of their involvement in the false sale and the effect it would have on the company's relationship with its lender, together with his reports to them of his concerns after discovering the allegedly fraudulent activity, triggered their duty to investigate whether the continuation of investing in the company's stock was prudent. The court dismissed the claim because it said there was no allegation in the complaint that the fraudulent sale had any negative impact on the plan's investment in the company such that it would amount to a "red flag" signaling the imprudence of continuing to invest in the company's stock.

The court did, however, refuse to dismiss at this early stage the former CEO's assertion that the defendants had breached their fiduciary duties by withholding material information about the company's valuation from both the appraiser who prepared the annual valuation and plan participants. The plaintiff alleged that two of the defendants withheld information from the appraiser concerning fair market value obtained from brokers and potential buyers, which the plaintiff asserted resulted in the plan being valued at one-third of its true fair market value. The plaintiff asserted that this improper valuation caused payments made to plan participants to be depressed, and that withholding this information from plan participants left them without accurate information as to the true value of their shares.

The defendants argued that they were not required to inform the valuation company about inquiries from potential buyers of the company. The court said it is possible facts could be developed establishing that the information allegedly withheld would have been immaterial to the valuation firm in reaching its fair market value, but at this early stage in the litigation, the former CEO had adequately alleged that the information would have impacted the valuation company's opinion of the value of the company's common stock held by the plan, and therefore refused to dismiss the claim.

9. **Control Premium: *Perez v. First Bankers Trust Services, Inc***. A district court refused to dismiss the Department of Labor's claims concerning an ESOP's alleged improper payment of a control premium in *Perez v. First Banks Trust Services, Inc.*, 2014 U.S. Dist. LEXIS 19300 (S.D.N.Y. 2014). Because the court was considering a motion to dismiss the lawsuit, it assumed the allegations made by the DOL were true.

The DOL alleged as follows: An individual who was the CEO and chairman of a company decided to retire and sell his 87 percent interest in the company. The CEO and other shareholders sold 100 percent of the company's stock to an ESOP. The ESOP paid a 25 percent control premium. The plan paid $15.5 million for the company's stock, funded by a loan in that amount from the company to the ESOP. Importantly, as part of the financing of the loan, the CEO and other selling shareholders made subordinated loans to the company in the amount of $6.5 million, which were to be repaid over the course of 10 annual installments. This was important because the trustee of the ESOP, First Bankers Trust Services, Inc., the CEO, and the company signed a Limitation Agreement, which included covenants that "significantly limited the ESOP's post-transaction ability to exercise control" over the company. In particular, the Limitation Agreement provided that so long as the subordinated loan in favor of the CEO were outstanding, the trustee would vote all shares of common stock held by the ESOP to cause a majority of the members of the board of directors to be designated by the CEO. Similarly, the agreement required the company to cause the board of directors to be such that a majority of its members were designated by the CEO.

Since the subordinated note in favor of the CEO would not be paid in full for 10 years, the CEO would continue to control the company for 10 years even though the ESOP had paid a control premium as part of the ESOP transaction. The DOL asserted this was improper. The DOL alleged that although the CEO was not given the power under the ESOP's plan documents to appoint and remove the trustee, he in fact did so, which made him a functional fiduciary. The court agreed that these allegations were sufficient to give rise to a plausible inference that the CEO did, in fact, act as a functional fiduciary with respect to the ESOP transaction.

The DOL asserted that the CEO violated his fiduciary duties of loyalty and prudence by (1) failing to monitor and oversee First Bankers to insure that it fulfilled its fiduciary duties to the ESOP, (2) failed to remove First Bankers, (3) failed to prevent the ESOP from purchasing shares at a price he knew or should have known to be inflated (because the ESOP was paying a control premium and would not in fact have control for 10 years), and (4) failed to otherwise act prudently and solely in the interest of participants and beneficiaries.

The DOL also made prohibited transaction claims. It asserted that the CEO was a fiduciary who caused – or alternatively, a party in interest who knowingly participated in – a nonexempt prohibited transaction by allowing First Bankers to cause the ESOP to overpay for the stock. Finally, the DOL alleged that the CEO was liable as First Bankers' co-fiduciary for participating in and contributing to First Bankers' breaches of its fiduciary duties.

The DOL also made claims against First Bankers, but they were not the subject of the court's ruling on the CEO's motion to dismiss the lawsuit.

In addition to concluding that the Department of Labor had alleged facts that supported a plausible inference that the CEO was a functional fiduciary, the court held that the DOL had made sufficient allegations that the CEO breached his fiduciary duties of loyalty and prudence by failing to monitor and oversee First Bankers and by failing to remove First Bankers as the ESOP trustee or take other action in response to First Bankers' alleged failures to fulfill its own fiduciary duties to the ESOP. In doing so, the court rejected the CEO's arguments that it would be improper to charge him with a duty to monitor "at the very inception of the Plan" First Bankers' determination of the fairness of the initial sales of shares by him and the other selling shareholders to the ESOP. The court said the proper scope of the CEO's duty to monitor First Bankers concerned factual issues that could not be resolved on a motion to dismiss.

The court also rejected the CEO's argument that requiring him to monitor First Bankers, an independent trustee, would interfere with First Bankers' independent status. The court observed that the CFO could have avoided any conflict by shifting responsibility for the selection and appointment of the trustee to another member of the company's committee investigating the formation of the ESOP or to some other individual without a financial interest in the outcome of the ESOP transaction, and that the CEO could not rely on "a conflict created by his own alleged actions to avoid the fiduciary responsibilities flowing from those actions."

The court also concluded that the DOL had made allegations sufficient to proceed on its prohibited transaction claims because the DOL plausibly alleged that the CEO acted as a fiduciary with respect to the ESOP transaction, and that he caused the ESOP to engage in a prohibited transaction by allowing the sale to the ESOP to occur with the knowledge that the ESOP was overpaying for the company's stock. The CEO would have known of this overpayment because he knew the stock valuation that served as the basis for the price included a control premium, and he knew of the Limitation Agreement that would prevent the ESOP from actually obtaining control of the Company for 10 years. In addition, the court allowed the DOL's allegation that the CEO caused the ESOP to pay more than adequate consideration to proceed.

Finally, the court allowed the DOL to proceed with its claim that the CEO was liable as a co-fiduciary with First Bankers, as a functional fiduciary who breached his duty to monitor First Bankers, and who caused the ESOP to engage in a prohibited transaction that permitted First Bankers to cause the purchase of the stock by the ESOP, knowing the ESOP was overpaying him for his stock.

10. **Former Fiduciary Cannot Seek Removal of Current Trustees: *Pioneer Centres Holding Co. Employee Stock Ownership Plan and Trust v. Alerus Financial, NA***. In the context of a very interesting lawsuit, a federal district court ruled that a former fiduciary, who is being sued by current ESOP trustees, did not have standing to seek an order removing the current trustees. The former fiduciary argued that the current trustees should be removed because if it breached its fiduciary obligations, the current trustees violated their co-fiduciary responsibilities as well. *Pioneer Centres Holding Co. Employee Stock Ownership Plan and Trust v. Alerus Financial, NA,* 2014 U.S. Dist. LEXIS 1984, 57 EBC 2405 (D. Colo. 2014).

In *Pioneer Centres*, an ESOP and its trustees sued an organization that had acted as an independent fiduciary to the ESOP for the purpose of determining whether the plan should acquire sole ownership of the employer. The majority shareholder of the company wanted the ESOP to acquire all his stock, which would have resulted in the ESOP owning the company. Because of perceived conflicts of interest involving the owner, who served as one of three trustees, as well as conflicts involving the other two trustees, Alerus was appointed as "transactional trustee" for the purpose of reviewing, analyzing, and making a determination as to whether the ESOP should approve, consent to, and/or otherwise engage in the proposed acquisition.

The unhappiness arose because the ESOP did not enter into the proposed transaction. According to the trustees, this was due to Alerus' unjustified insistence that the owner give "unconditional and detailed representations and warranties regarding" the company and its businesses. The failed transaction was, it appears, proposed to occur in 2007 or shortly thereafter. In December 2011, the company sold substantially all of its assets to a third party purchaser at a substantially higher price than that proposed for the acquisition by the ESOP. The ESOP trustees sued Alerus, claiming it breached its fiduciary duties to the ESOP by continuing to demand that the majority shareholder make unnecessary representations and warranties in connection with the ESOP's potential purchase of the majority shareholder's shares. The trustees claimed damages in the form of a lost opportunity, asserting that the ESOP could have purchased the majority shareholder's stock at a substantial discount, as compared to the price later paid by the third party for the company's assets.

In its decision, the court did not rule on the merits of the case. In particular, it did not rule on whether Alerus breached its duty, whether the trustees were co-fiduciaries in connection with the purposed transaction, or whether the trustees breached their own duties to the ESOP. The court instead considered only Alerus' request that the trustees be removed. Alerus argued that if it breached its fiduciary duty by refusing to acquiesce to the majority shareholder's terms, the trustees, as co-fiduciaries, were required under ERISA to take reasonable action to remedy that breach, but did not do so, instead selling to another buyer.

The court rejected Alerus' argument, saying it did not, as a former fiduciary, as opposed to current fiduciary, have standing to seek removal of the trustees and the appointment of a trustee ad litem. The court held instead that a lawsuit seeking removal of a fiduciary may be brought only by the Department of Labor, a participant, a beneficiary, or a current fiduciary, but not by a former fiduciary.

11. **Indemnification Agreements and Arbitration: *Schafer v. Multiband Corp***. In an interesting opinion (though not recommended by the court for publication), the Sixth Circuit Court of Appeals refused to vacate an arbitrator's decision that an indemnification agreement in favor of ESOP fiduciaries was invalid. *Schafer v. Multiband Corp.*, 551 Fed. Appx. 814 (6th Cir. 2014) (unpub.). The case involved a putative indemnification obligation of a company, Multiband Corp., that had purchased a holding company that maintained an ESOP. The holding company had been formed when four entities, some of which had themselves maintained ESOPs, exchanged their ownership interests for shares of stock in the holding company, and the holding company became the parent company of all four entities. The holding company then formed its own ESOP.

The dispute concerned two directors of the holding company who were also trustees of some of the ESOPs. The Department of Labor asserted that the trustees had breached their fiduciary duties by allowing various ESOPs to purchase company stock at inflated prices.

The DOL offered to settle the lawsuit for $42 million. Pursuant to the terms of indemnification agreements, the two trustees requested that Multiband which was the company that had purchased the holding company, indemnify them. Multiband refused. The DOL later filed suit against the trustees, and without admitting liability, the trustees agreed to pay $1.45 million each. The trustees again requested indemnification from Multiband, and Multiband refused to pay.

The two trustees filed an arbitration complaint against Multiband for its refusal to indemnify them (arbitration was required under the terms of the indemnification agreements). Multiband asserted that the agreements were void as against public policy under Section 410(a) of ERISA, which is the provision prohibiting exculpatory provisions. The arbitrator ruled in favor of Multiband and against the two former trustees, saying the indemnification agreements were invalid. Apparently the arbitrator, though acknowledging the permissibility of the purchase of fiduciary liability insurance, concluded that, at least in the context of ESOPs, indemnification agreements are not permitted.

The Sixth Circuit said the arbitrator's holding was inconsistent with Sixth Circuit precedent, and that the "arbitrator's decision would doubtless be reversed if it were a court decision under the precedent of this court, because the arbitrator's reading of the relevant section of ERISA is contrary to our precedent." The court noted that the arbitrator had, however, cited some court decisions outside the Sixth Circuit where indemnity agreements had been invalidated "because they would have some sort of financial impact on the plan itself," *citing Johnson v. Couturier*, 572 F.3d 1067, 1080 (9th Cir. 2009); *Donovan v. Cunningham*, 541 F. Supp. 276, 289 (S.D. Tex. 1982) rev'd in part on other grounds, 716 F.2d 1455 (5th Cir. 1983); and *Fernandez v. K-M Indus. Holding Co.*, 646 F.Supp.2d 1150 (N.D. Cal. 2009) (all voiding agreements to indemnify ESOP fiduciaries as functionally equivalent to the plan's indemnifying itself). But the court observed that the arbitrator made no finding that the indemnity in the instant case could adversely affect the interest of the victims of the trust violation. In fact, the company from which indemnification was sought was a purchaser of the holding company and effectively, as the court characterized it, "a third party stranger to the ESOP." The arbitrator's analysis was apparently not that the indemnity could adversely affect the interest of plan participants, but instead simply that reimbursement not clearly identified as "insurance" is not permitted under ERISA.

Even though the Sixth Circuit was clear that it thought the arbitrator's decision was wrong, the court refused to vacate the arbitrator's decision. It described the very narrow standards under which an arbitrator's decision can be vacated under the Federal Arbitration Act ("FAA"). As the court put it:

> When courts are called on to review an arbitrator's decision, the review is very narrow; it is one of the narrowest standards of judicial review in all of American jurisprudence.

The court observed that it is not firmly settled whether a court can vacate an arbitrator's award when the arbitrator's decision is so clearly contrary to established law that it was in "manifest disregard" of the law. But even assuming that manifest disregard of the law is a basis for vacating an arbitrator's decision, the Sixth Circuit said "manifest disregard of the law" requires more than the arbitrator making an error of law. Where an arbitrator relies on a "colorable meaning" of the words of the statute, as the Sixth Circuit said the arbitrator did in interpreting ERISA in the case at hand, court precedent to the contrary is not necessarily determinative. Court holdings bind courts and agencies whose decisions are appealable to those courts, but an arbitrator, though he or she cannot reject the law, can disagree with a court's precedent without being considered to disregard the law.

12. **DOL Settlement: Overpayment for Stock and Indemnification by ESOP-Owned Company (People Care Holdings, Inc.)**. The Department of Labor announced on January 22, 2014, a $10 million settlement agreement with People Care Holdings, Inc. and former owners who sold the company to their employees through creation of an ESOP. The DOL claimed that the company and two former owners breached their fiduciary duties by permitting the ESOP to purchase the company's stock from the former owners for more than its fair market value. Specifically, the DOL claimed that the company and former owners breached their fiduciary duties by failing to correct unrealistically optimistic projections of the company's future earnings and profitability, even after the company lost a key municipal contract. (The company is a home-care agency that provides caregiving services, such as meal preparation, laundry, shopping, housekeeping, companionship and medical assistance, with facilities in New York and New Jersey. Its ESOP had approximately 4,655 participants.)

    The DOL also claimed that the stock purchase agreement included an indemnification agreement that was invalid because it would require the company, which was entirely owned by the ESOP, to pay costs incurred by the selling shareholders in connection with any investigation or litigation.

    Under the terms of the settlement agreement, the two former owners agreed to pay just over $9 million to the ESOP and a civil penalty of just over $900,000.

13. **Allegations that ESOP Overpaid for Stock: *Perez v. PBI Bank, Inc***. The Department of Labor filed a lawsuit against PBI Bank, Inc., as trustee of an ESOP in *Perez v. PBI Bank*,

Inc., 3:13-CV-1400 (N.D. Ind. Dec. 26, 2013). The DOL alleged that PBI Bank violated ERISA by its (a) imprudent and disloyal purchase of company stock for roughly $40 million, a price "far in excess" of the stock's fair market value, and (b) approving financing for the transaction at an excessive rate of interest.

Specifically, the DOL made the following allegations:

1. The bank knew or should have known that the valuation it had obtained for the stock was unreliable, in part because it was based on the premise that the ESOP was buying 100 percent of the company's outstanding equity and a controlling interest in the company and its subsidiary, while in fact the bank knew the ESOP was not obtaining control. That is because at the time of the purchase transaction the bank also entered into a stock voting agreement on behalf of the ESOP "entrenching" the selling shareholders (four members of a family) and other parties in interest (company executives) in control of the company's board of directors for years to come.

2. The bank knew or should have known that although the ESOP was paying for 100 percent of the company's outstanding equity, the plan would not actually receive a 100 percent interest in the growth and potential earnings of the company. That is because the selling shareholders had, prior to the ESOP's purchase, retained for themselves a substantial part of the company's future profits through an "earn-out agreement." The bank allegedly knew that the valuation upon which it relied failed to analyze the likely large negative impact of the earn-out agreement and the stock voting agreement on the value of the stock the bank caused the ESOP to purchase.

3. The bank knew that although the ESOP was buying a 100 percent interest in the company and subsidiary, at the time of the purchase the company's management had reserved for themselves 20 percent of the company's stock through various options agreements and the valuation inappropriately undervalued that 20 percent potential dilution by reducing the value of the stock the ESOP was purchasing by only 1.94 percent.

4. The ESOP was financed by a back-to-back loan. The selling shareholders loaned monies to the company and the company then loaned those monies to the ESOP. The DOL asserted that the selling shareholders were parties in interest to the ESOP, and that to enjoy an exemption from ERISA's prohibited transaction rules, these indirect loans from parties in interest to the ESOP would need to be at a reasonable rate of interest. The DOL alleged that the loan was at a rate of 12 percent, which was "far in excess of a reasonable rate of interest at the time" (September 2007).

5. Although all the draft valuations provided to the bank prior to the ESOP stock purchase included a five percent discount for lack of marketability (because the stock was not publicly tradable), the bank unreasonably relied upon a purchase valuation that included no discount for lack of marketability whatsoever.

As a consequence of the allegations above, the DOL asserted that the bank caused the ESOP to "vastly overpay" for the stock and unnecessarily give up future profits and control of the company and its subsidiary, in violation of the bank's duties of loyalty and prudence and the bank's duty not to cause the ESOP to engage in prohibited transactions.

14. **DOL Settlement: Alleged Overpayment for Stock (Parrot Cellular)**. The Department of Labor announced on October 22, 2013, that it had obtained a consent order requiring fiduciaries of the Parrot Cellular ESOP to pay almost $4.2 million to the plan. The DOL had filed suit alleging that fiduciaries caused or permitted the ESOP to purchase Parrot Cellular stock for more than fair market value. The DOL filed suit against (a) the principal owner of a company called the Entrepreneurial Ventures Inc., which operated Parrot Cellular Telephone retail stores and was the sponsor of the plan, (b) two executives of Entrepreneurial Ventures who served as ESOP trustees, and (c) Consulting Fiduciaries Inc., which served as an independent fiduciary for the ESOP during its stock purchase. The independent fiduciary, Consulting Fiduciaries, agreed to pay $2 million to the ESOP. The three individuals connected with the plan sponsor agreed collectively to pay $1.5 million to the ESOP, and the principal owner agreed to pay an additional roughly $680,000 to the ESOP.

15. **S-Corporation Distributions Not Annual Additions: PLR 201424030**. In Private Letter Ruling ("PLR") 201424030, the IRS ruled that S-corporation distributions (as described in IRS Section 1368(a)) in an amount not exceeding the company's accumulated adjustment account (as described in Section 1368(e)(1) of the Internal Revenue Code) would be treated as distributions of earnings to the company's shareholders, and not as contributions or other additions that need to be counted under the IRC Section 415(c)(1) limitation on annual additions to the accounts of participants in the company's ESOP. The ESOP owned 100 per cent of the company's stock.

The PLR was based only on the facts and circumstances presented to the IRS, but a few of facts recited in the PLR, as well as the fact that the company, which was described as "relatively small," bothered to seek a ruling, suggest that the distributions were substantial relative to the size of the company. Based on the particular facts and circumstances presented to the IRS, the Service ruled that it would not recharacterize the distributions as annual additions under the Commissioner's authority set forth in Treasury Regulation Section 1.415(c)-1(b)(4).

16. **Leveraged ESOP Improperly Using Principal-Only Method to Release Shares: TAM 201425019**. In Technical Advice Memorandum 201425019, the IRS addressed prohibited transaction issues relating to a leveraged ESOP. The ESOP had released pledged shares using the principal-only method, even though the relevant pledge agreement and one plan provision provided for releasing shares based on the principal and interest method (and, confusingly, a different plan provision permitted release using the principal-only method if the requirements of IRS regulations were satisfied).

The employer had established an ESOP effective July 1, 1999, with the plan borrowing funds from the employer in a back-to-back loan to enable the plan to purchase shares of the employer. Under its original terms, the loan was to be repaid over a period of five years, by June 30, 2004. The maturity date of the note was, however, extended, first to October 31, 2004, and later to June 30, 2009.

In 2005, the Department of Labor conducted a review of the plan and found that the principal-only method was used to release shares from 1999 through 2004. The DOL concluded that the failure to use the principal and interest method called for in the ESOP pledge agreement violated ERISA's fiduciary duty provisions and constituted a prohibited transaction. The DOL also noted that even if the principal-only method had been permitted under the relevant provisions of the plan document and pledge agreement, the loan did not follow the statutory requirements needed to permit principal-only releases.

In response, the company agreed to recalculate the release of shares from 1999 through 2004 using the principal and interest method, instead of the principal-only method. This recalculation resulted in a net release of additional shares to correct the failure. The employer agreed to credit those additional shares to participant accounts as of December 31, 2005, and to use the principal and interest method to calculate the release of shares from 2005 until the loan would be repaid in full. The DOL agreed, in response, to this action by the company to take no further action. The company allocated the additional shares to the participant accounts on October 10, 2006, based on a participant's pro rata share of the stock credited to his or her account for each respective year.

In the Technical Advice Memorandum, the IRS addressed three issues. The first was whether there was a prohibited transaction where the loan documents required pledged shares to be released using the principal and interest method permissible under Treasury regulations, even though in operation the plan used the principal-only method. That is, the IRS considered whether Treasury regulations dealing with the prohibited transaction exemption for ESOP loans were satisfied where the plan and loan provisions specified a permissible release method (principal and interest), but that method was not followed. Not surprisingly, the IRS concluded in the TAM that the release rules in the regulations have "both an operational and documentary component," apparently meaning that both the relevant plan documents and the operation of the plan must meet the requirements of the regulations to avoid a prohibited transaction.

Although the IRS, in describing why it considered a prohibited transaction to have occurred, said the prohibited transaction release requirements have "both an operational and documentary component," the Service did not seem to focus particular attention on the terms of the plan documents. It instead noted that the release of shares had been under a principal-only method, and that one of the requirements for the ability to use that method is that the loan provide for annual payments of principal and interest at a cumulative rate not less rapid at any time than level annual payments of those amounts for 10 years. In the case at hand, however, the required monthly payments were inadequate to meet this requirement. The amount of the required monthly principal payments under the loan were such that they would either have required 15 years, not 10, to pay off the loan in its entirety, or would have resulted in a balloon payment, thereby violating the level annual payment requirement for principal-only releases. So, the IRS said even if the language in the plan and pledge agreement had provided for a principal-only release, the loan violated the regulation in operation and therefore there was a prohibited transaction.

The second issue addressed by the TAM concerned the period with respect to which the 15 percent prohibited transaction excise tax was due. Under the Tax Code, this is the "taxable period." It begins with the date on which the prohibited transaction occurs and ends on the earliest of (1) the date of the mailing by the IRS of a statutory notice of deficiency, (2) the date on which the first tier excise tax is assessed, or (3) the date on which correction of the prohibited transaction is completed. IRC § 4975(f)(2). The TAM discussed what was required in the way of correction, and when correction was considered to have occurred. The IRS noted that in the case of a prohibited transaction that is a loan, an additional prohibited transaction is deemed to occur on the first day of each taxable year in the taxable period after the taxable year in which the loan was made. *See* Treas. Reg. § 53.4941(e)-1(e)(1) (this Foundation Excise Tax Regulation applies by reason of Section 141.4975-13 of the Temporary Pension Excise Tax Regulations and IRC § 4975(f)(2), (4), (5), and (6)); Rev. Rul. 2002-43; *Rutland v. Comm'r*, 89 TC 1137, 1151 (1987); and *Medina v. Comm'r*, 112 TC 51, 55 (1999).

The taxable period for the prohibited transaction began on the date of the loan, which was July 1, 1999, and ended on the date of correction, since the IRS had both mailed a notice of deficiency and assessed the excise tax later than the date it was corrected. Although the prohibited transaction began on July 1, 1999, the excise tax did not apply that early. Instead, because the first open taxable year was 2003, the TAM considered the first date of the taxable period to be January 1, 2003. As to the correction date, the IRS concluded that correction occurred on October 10, 2006, the date the employer allocated the additional shares that should have been allocated to participants' accounts under the terms of the loan, rather than December 31, 2005, the date <u>as of which</u> the additional shares were allocated. The TAM concluded that it is the employer that must the 15 percent excise tax.

The third and final issue addressed in the Technical Advice Memorandum was whether in determining the "amount involved," and therefore the amount of the excise tax the employer owed, the employer could use the actual interest rate under the loan, rather than the higher prime rate. The TAM concluded that the lower, and more favorable to the employer, actual interest rate on the loan could be used. The TAM observed that under Revenue Ruling 2002-43, where a loan is a prohibited transaction, the excise tax is determined using the interest rate that is the greater of the interest on the loan or the fair market value of interest for the loan at that time. *See also Medina v. Comm'r*, 112 TC 51 at 56-57 (1999). In determining a fair market interest rate, the IRS said courts have looked to the prime interest rate in setting an appropriate benchmark rate. But because the employer was itself able to borrow the monies it in turn lent to the ESOP in the back-to-back loan at a lower rate (which the TAM described as "slightly below" the prime rate), this actual interest rate represented a fair market rate, and therefore should be used in calculating the amount involved in determining the excise tax on the loan.

17. **<u>S Corporation: Counting Restricted Stock as Shares: *Austin v. Comm'r*</u>**. In *Austin v. Comm'r*, 141 T.C. 18 (T.C. 2013), the Tax Court considered a dispute involving an S corporation ESOP, prior to the effective date of the synthetic equity provisions of Tax Code Section 409(p). In *Austin*, two owners of a business attempted to do precisely what Section 409(p) was put in place to stop. The two owners contributed their unrestricted ownership interest in their original business to a new S corporation, in exchange for 47.5 percent each

of the shares of the S corporation's common stock. At the same time, the new S corporation issued to an ESOP for the company's employees five percent of the company's common stock (in exchange for a note). So, ostensibly, each of the two owners held a 47.5 percent interest in the S corporation and the ESOP owned five percent.

In a special twist, however, the individual owner's shares were restricted stock. If either of those employees were terminated "for cause" within four years, he would receive for his shares less than the fair market value of that stock. In fact, he would receive at most 50 percent of the fair market value of the stock, with the possibility of receiving nothing, all as determined under a formula.

The individual owners argued that the stock was "substantially nonvested" within the meaning of IRC Section 83 during this four-year period. If so, Treasury Regulations under IRC Section 1361 (§1.1361-1(b)(3)) would provide for not treating the substantially nonvested stock as outstanding stock of the S corporation, in which case the holders of the stock would not be treated as shareholders. In that case, 100 percent of the outstanding company stock would be owned by the ESOP during the four-year period (from 2000 to 2003), and 100 percent of the company's income would be allocable to it. Consistent with this position, the two individuals holding the restricted stock reported no income or other flow-through items from the S corporation on their individual income tax returns for the four-year period. And the ESOP, as a tax-exempt entity, also reported no taxable income over this period of time.

The Tax Court dealt with just one of the IRS' challenges to this arrangement. The IRS asserted that the restricted stock was actually not subject to a substantial risk of forfeiture, and was therefore "substantially vested" under the Section 83 rules. If so, this meant the restricted stock would not be disregarded in determining the outstanding stock of the S corporation.

The Tax Court pointed out that under Treasury regulations the requirement that stock be forfeited "if the employee is discharged for cause . . . will not be considered to result in a substantial risk of forfeiture." Treas. Reg. § 1.83-3(c)(2). But the court said the Treasury regulations' reference to being discharged "for cause" was different from the meaning of the term "termination with cause" in the relevant employment agreement and restricted stock agreement.

Helpfully, the Tax Court reviewed the history of the "for cause" provision in the regulations and concluded that, as used in the regulation, the term "discharge for cause" refers to termination "for serious misconduct that is roughly comparable – in its severity and any unlikelihood of its occurrence – to criminal misconduct." The Tax Court continued by saying the history of the regulation strongly suggests that discharge "for cause," refers to a "narrow and serious form of employee misconduct that is very unlikely to occur and is thus properly regarded as too remote – as a matter of law – to create a 'substantial risk of forfeiture.'"

The employment and restricted stock agreements defined three categories of employment action justifying "termination with cause." One was discharge for "[d]ishonesty, fraud, embezzlement, alcohol or substance abuse." The parties agreed that this would be a discharge for cause within the meaning of the Treasury regulation, so this was of no help to the S corporation owners in their argument that there was a substantial risk of forfeiture relating to their stock. Importantly, though, the employment agreement and restricted stock agreement also stated that a termination for a refusal to perform faithfully "the usual and customary duties of [the employee's] employment" would also be treated as a termination with cause. The court concluded that this provision was essentially intended to apply should the employee voluntarily terminate employment. This was important because an agreement conditioned on an employee continuing to provide substantial services as an employee for a time will typically constitute a substantial risk of forfeiture that will cause any property conditioned on that employment to be considered substantially nonvested. Because the employees would lose some or all of the value of their stock if they were to voluntarily terminate during the four year period, the shares were subject to substantial risk of forfeiture, and were disregarded in determining whether the ESOP owned 100 percent of the company. This meant the ESOP was considered to own 100 percent of the company during these years.

18. **S Corporation ESOP: First Nonallocation Year in Year When No Prohibited Allocation, Statute of Limitations: *Law Office of Jon H. Eggertsen P.C. v. Comm'r***. The Tax Court rejected an S corporation's arguments that the 50 percent excise tax that applies under IRC Section 4979A in the event of a violation of the Section 409(p) rules can occur prior to 2005, when those rules became effective (this would have helped the S corporation argue that the IRS was too slow in imposing the excise tax under the statute of limitations). The court also rejected the S corporation's argument that for the excise tax to apply there must be an allocation in violation of Section 409(p) in the "first nonallocation year." *Law Office of John H. Eggertsen P.C. v. Comm'r*, 142 T.C. No. 4, 57 EBC 2689 (T.C. 2014).

An individual, John H. Eggertsen, purchased all the shares of a company called J & R's Little Harvest, Inc. on January 1, 1998. A year later, on January 1, 1999, J & R's Little Harvest established an ESOP, and in December 1999, Mr. Eggertsen transferred all his shares of stock to the ESOP. Remarkably, the company's name, J & R's Little Harvest, was later changed to the name "Law Office of John H. Eggertsen P.C."!

The IRS argued that there was a nonallocation year with respect to the ESOP in 2005, at a time when the ESOP owned 100 percent of the S corporation's stock and had only three participants. The excise tax applies when there is a "nonallocation year described in [IRC Section 4979A(e)(2)(C)]," which is the <u>first</u> nonallocation year with respect to an ESOP. The S corporation argued that this first nonallocation year occurred in 1999, when 100 percent of the ESOP stock was allocated to the account of Mr. Eggertsen. The Tax Court rejected this argument, which was presumably made to strengthen the S corporation's statute of limitations argument that the IRS was too late in imposing the excise tax. The court concluded that the first nonallocation year could not occur prior to 2005, when the excise tax provision was added to the Tax Code.

The S corporation also argued that there could be no nonallocation year triggering the imposition of the excise tax unless there were an allocation of employer securities in that year. Citing the Conference Report for the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), the Tax Court said the excise tax applicable in the case of the first nonallocation year applies whether or not there is a prohibited allocation in that year. It quoted the Conference Report, as follows:

> A special rule applies in the case of the first non-allocation year, regardless of whether there is a prohibited allocation. In that year, the excise tax also applies to the fair market value of the deemed-owned shares of any disqualified person held by the ESOP, even though those shares are not allocated to the disqualified person in that year.

H.R. Conf. Rept. No. 107-84, at 276 (2001), 2001-3 C.B. 123, 399.

Although the Tax Court held that the first nonallocation year with respect to the ESOP was 2005, it did conclude that the IRS was barred by the statute of limitations in collecting the excise tax. That is because the employer had filed a Form 1120S and the ESOP had filed its 2005 annual return (Form 5500) more than three years before the IRS issued its notice of the assessment of the excise tax, and these filings gave the IRS notice of the ownership on which the liability was based. In particular, taken together, the 2005 Form 1120S and the 2005 Form 5500 informed the IRS that the ESOP held all the stock of the S corporation, and that one, two, or all three of the three plan participants in the ESOP during 2005 were deemed to own part or all of that stock. The Tax Court said the IRS must then have known that (1) during 2005 one or more of the participants owned at least 10 percent of the stock of the S corporation (if each of them owned less than 10 percent, their total holdings would have been less than 30 percent, yet they owned in the aggregate 100 percent), and (2) during 2005 one or more disqualified persons owned at least 50 percent of the stock of the S corporation.

19. **Six Year Deadline for Fiduciary Claims is Not Subject to Tolling Agreement: *Harris v. Bruister***. A district court considered fiduciary claims brought by the Department of Labor in connection with a sale by the sole shareholder of a company of 100 percent of the company's stock to the company's ESOP in *Harris v. Bruister*, 2013 U.S. Dist. LEXIS 178816 (S.D. Miss. 2013). This transfer of ownership was completed through five separate transactions. Two of these occurred more than six years prior to the Department of Labor filing suit. The district court held that these claims were barred by the requirement under Section 413(1) of ERISA that fiduciary claims be brought within six years after (a) the date of the last action which constituted a part of the breach or violation, or (b) in the case of an omission, the latest date on which the fiduciary could have cured the breach or violation. The Department of Labor had argued that it could file suit beyond this six-year period because the defendants had signed tolling agreements. The court held, however, that the six-year limitations period in ERISA 413(1) is a statute of repose which cannot be extended by consent of the defendants in a tolling agreement. The court also dealt with the presumption of prudence, but the case was decided prior to the Supreme Court's decision in *Dudenhoeffer*.

20. **S Corporation ESOP Violates Section 409(p): *Ries Enter., Inc. v. Comm'r***. The Tax Court concluded that a company was liable for $161,200 in excise taxes because its ESOP

violated IRC Code Section 409(p) in *Ries Enter., Inc. v. Comm'r*, T.C. Memo 2014-14, 2014 Tax Ct. Memo LEXIS 17 (T.C. 2014). The Section 409(p) violation occurred in 2002, at which time the ESOP owned 80 percent of the company's common stock. The company's sole employee (and the plan's sole participant), together with his wife, owned the remaining 20 percent.

The ESOP was leveraged, and in 2002 the ESOP made or was credited with making a payment toward the loan. As a consequence, the ESOP released from its suspense account some shares of company stock, all of which were allocated to the sole plan participant.

The company argued that it was not liable for the excise tax because the plan was not an ESOP. The company's bootstrapping argument was that it could not be an ESOP because the plan must meet the requirements of Section 409(p) to be an ESOP, and the plan had in fact failed to meet those requirements! Part of the argument was that the plan document did not include, by its terms, the Section 409(p) prohibition, but in fact that was not the case. The Tax Court concluded, to the contrary, that the plan did expressly include the restriction required by Section 409(p)(1).

Interestingly, the Tax Court held that the Company did not actually meet the definition of an S corporation. That was because the company had more than one class of stock and therefore was not eligible to be an S corporation. But because the company had elected to be treated as an S corporation, and because the IRS presumably relied on this representation (given that the company reported on its 2002 Form 1120S that it owed no income tax by reason of it having elected to be treated as a pass through entity under Subchapter S), the company was not allowed to assert at this time that it was not an S corporation in 2002. It was not allowed to do so because the statute of limitations on assessment had passed – so the IRS could not at this late date adjust the company's income tax liability for 2002 – and under the "duty of consistency" principle when a taxpayer represents a fact to the IRS for one year, and the IRS relies on that representation for that year, the taxpayer cannot change that representation for a later year that is after the statute of limitations on assessment bars adjustment for the initial year.

Once it was established that the plan was an ESOP, the court easily concluded that Section 409(p) had been violated. That is because for purposes of determining whether there is a nonallocation year, the sole participant in the plan was, under deemed-ownership rules, treated as owning 100 percent of the S corporation's outstanding stock, and there had been an allocation to him during 2002 when the shares were released upon the ESOP making a loan payment.