

RETIREMENT SERVICES

# CASE IMPERILS RIGHTS OF ERISA FIDUCIARIES

By Nancy G. Ross and John A. Litwinski

**U**nder a troubling decision recently handed down by a federal court in California, fiduciaries of certain employee stock ownership plans (ESOP) are not entitled to have litigation defense costs advanced by the plan sponsor, notwithstanding prior agreements between the fiduciary and plan sponsor that specifically provide for the advancement of defense costs. This ruling, if upheld by the court of appeals, is likely to create uncertainty and disincentives for institutional trustees and other entities and individuals who serve as fiduciaries of ESOPs and other employee benefit plans more generally.

Certain steps can be taken to reduce a fiduciary's potential exposure to substantial defense costs, including making sure that sufficient insurance coverage is in place to cover the cost of attorney's fees during potentially lengthy litigation. Furthermore, plan fiduciaries should consider whether the compensation they are receiving for taking on such a role is sufficient in light of the potentially astronomical cost of having to pay litigation expenses out of pocket.



ESOPs are employee benefit plans that among other things make it easier for employees to take an ownership interest in their employer. Several features distinguish ESOPs from other types of employee benefit plans. For instance, only an ESOP is required by law to invest primarily in the securities of the sponsoring employer. An ESOP is also unique among tax-qualified employee benefit plans in its ability to borrow money.<sup>1</sup> ESOPs are in part regulated under the Employee Retirement Income Security Act of 1974 (ERISA), a federal law governing most types of employee benefit plans, as well as under federal tax law.<sup>2</sup>

Often, an ESOP is established to acquire the stock of a closely held company from an owner who is retiring. Another common use of ESOPs is to establish a means of more closely aligning the interests of employees with their employers. Other companies have used ESOPs as a technique of corporate finance, such as to make an acquisition, spin off a division, or take a company private. In a small number of cases, ESOPs have been used to buy out failing firms that would otherwise close.<sup>3</sup>

*Johnson v. Couturier* involved a slightly different fact pattern.<sup>4</sup> The defendants in *Couturier* were officers and directors of the conveniently named The Employee Ownership Holding Company, Inc. (TEOHC) and its predecessor, a sheet metal manufacturer called the Noll Manufacturing Company. In 1977 the company established an ESOP that initially held only a small amount of company stock. By 2001, however, the ESOP owned 100 percent of the company's shares of stock.

While it owned all of the company's *shares*, the ESOP did not own all of the company's *equity*. This is because the company had contractual obligations to pay its longtime president, Clair Couturier, certain deferred compensation including stock options. Much of this compensation had been approved by TEOHC's independent board in 2001. In 2004, after an independent valuation, TEOHC decided to buy out all of Couturier's interests in the company for \$34.8 million.

Several current and former participants in the ESOP were upset by what they viewed as the excessive nature of Couturier's compensation. They filed suit against Couturier and others in 2005, claiming that the defendants breached their fiduciary duties by allowing Couturier to receive grossly disproportionate compensation in violation of both ERISA and state law.

Prior to the lawsuit, TEOHC had entered into indemnification agreements with the defendants. In

particular, these agreements provided that the company (not the ESOP) would advance attorney's fees to the defendants in the event of litigation. TEOHC's bylaws and articles of incorporation also provided for the indemnification of company officers and directors. In addition to these indemnification provisions, the defendants were covered under insurance policies funded by the company. Critically, however, those policies paid for only the first \$5 million in attorney's fees to defend a lawsuit.

As it turned out, the litigation dragged on for years and the cost of defending the lawsuit ballooned. In addition to the claims brought by the defendants, the Department of Labor (DOL) took an interest in the case, filing a friend-of-the-court brief that generally sided with the plaintiffs. By 2008, the defendants had burned through the \$5 million in insurance funds defending the lawsuit. They then turned to TEOHC to advance their attorney's fees so that they could continue their defense.

By this time, however, TEOHC was unwilling to advance the fees. Two of the defendants then invoked a clause in their indemnification agreements that forced the company to arbitrate the issue of attorney's fee advancement. In September 2008 the arbitrator agreed with the defendants and ordered TEOHC to pay the defendants' past-due legal bills and advance their future attorney's fees.

The plaintiffs immediately filed a motion in federal court, the site of the underlying lawsuit, seeking to prevent TEOHC from advancing any of the defendants' legal expenses incurred in defending the lawsuit prior to the conclusion of the case. The court agreed.

The court appeared to be moved by what it viewed as the problematic underlying facts in the case. The court suggested that the level of Couturier's compensation, when compared with the overall value of the company, would be strong evidence of either willful misconduct or at least lack of prudence by the individual defendants in their capacities as plan fiduciaries. The court also found it unlikely that, in the event of an adverse judgment against them, the defendants would be in a position to repay the attorney's fees that had been advanced.

In reaching its decision, the court made a number of findings that have significant consequences for the ESOP industry as a whole. Of obvious import was the court's holding that a company whose stock is wholly owned by an ESOP cannot advance attorney's fees to a fiduciary—regardless of contractual agreements to the contrary. Equally significant was the court's novel finding that ESOP participants have

an “equitable interest” in a company’s underlying assets.

The court found that because the plaintiffs were owed a fiduciary duty under ERISA with regard to the disposition of company funds, they have an equitable interest in those funds as ESOP participants, regardless of whether the funds are considered plan assets under applicable regulations. This is contrary to the position of the courts and the DOL in the past, which held that company stock held in an ESOP does not constitute a plan asset. The court’s decision is now on appeal before the United States Court of Appeals for the Ninth Circuit.

The DOL recently filed a friend-of-the-court brief with the Ninth Circuit, arguing that the court’s opinion should be upheld. The DOL argued that because the ESOP owns all of TEOHC’s shares, allowing TEOHC to advance attorney’s fees would relieve the defendants of liability for the consequences of their alleged wrongdoing and deprive the ESOP of its ability to recover its losses. The DOL argued that because an ESOP itself cannot advance attorney’s fees to a fiduciary, a company that is wholly owned by an ESOP likewise should not be allowed to advance attorney’s fees.

The DOL also took aim at the indemnification agreements between TEOHC and the defendants. The DOL argued that the agreements were so broadly worded that they would illegally permit the indemnification of litigation expenses and judgment amounts even *after* the fiduciaries were found to have violated their duties under ERISA.

While indemnification post-judgment is not at issue in *Couturier*, fiduciaries should take note of the DOL’s concern about overly broad indemnification agreements. The DOL appears to be arguing that because the agreement is too broad, the *entire* indemnification provision should be tossed out—even though, from the defendants’ perspective, the part of the agreement that allows for the advancement of attorney’s fees prior to judgment is perfectly appropriate.

If adopted by the courts, the DOL’s position could threaten many indemnification provisions that, whether by design or circumstance, were drafted with the aim of protecting fiduciaries as broadly as possible. Rather than shielding fiduciaries, the alleged overbreadth of a provision could be used as a sword to sever even that indemnification that might otherwise be appropriate.

Concerned by the effect of the court’s opinion on the industry, a consortium of professional ESOP fiduciaries recently filed a friend-of-the-court brief

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with the Ninth Circuit, arguing that the court’s opinion should be overturned. The ESOP fiduciaries advanced a number of arguments, including that the DOL’s own authorities have for decades allowed for the advancement of attorney’s fees under circumstances like those in *Couturier*. The ESOP consortium also argued that as a matter of public policy, preventing companies from advancing attorney’s fees to fiduciaries in the event of litigation would create a severe disincentive for anyone considering serving as a fiduciary, and thus have a chilling effect on our nation’s retirement system.

The ESOP consortium also argued that contrary to the court’s holding, ESOP participants do not have an equitable interest in a company’s underlying assets. Specifically, DOL regulations since 1986 have held that an ESOP does not own the underlying assets of a company, even if it owns all of the company’s stock.<sup>5</sup> The DOL regulations acknowledge that it would be extremely difficult for officers and directors to manage all of the assets of a company—potentially everything down to the mailroom supplies—in accordance with the exacting fiduciary responsibility rules of ERISA. To impose such a strict requirement, the DOL regulations reason, could disrupt the normal functioning of any business that was wholly owned by an ESOP.

Another issue is that fiduciaries have relied for decades upon various legal authorities who hold that the advancement of fees is permissible under ERISA because it does not impermissibly relieve a fiduciary of legal responsibility or liability. Two cases stand out in support of this position.

In one of these cases, *Moore v. Williams*, the defendant fiduciary and plaintiffs were parties to an agreement that provided for payment of interim

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legal fees, or advancement of those fees, unless and until the defendant was found guilty of breach of fiduciary duty.<sup>6</sup>

The *Moore* court explained that “[a]lthough ERISA prohibits, as against public policy, any agreement that purports to relieve a fiduciary of responsibility or liability under ERISA for breach of fiduciary duty ... that prohibition does not prevent advancement of expenses until liability is determined.” The court ordered plaintiffs “to advance to Defendant ... legal expenses until and unless he is determined to be liable on plaintiffs’ claims that he breached fiduciary duties to the Fund.”

In a second case (*Central States Pension Fund v. American Nat’l Bank*), the court analyzed “whether reimbursement for expenses incurred in defending charges of breach of fiduciary duty relieves the fiduciary of any responsibility or liability” in violation of ERISA.<sup>7</sup> The court held that it does not because “[t]he reimbursement of litigation costs does not shield a fiduciary from any liability or responsibility whatsoever; it merely covers legal fees and litigation costs. Certainly, the reimbursement would not relieve a fiduciary of liability that may be imposed .... Accordingly, [ERISA] does not render void the contract reimbursement provisions.”

Two scholars who examined the issue agreed that advancement of legal fees is appropriate because “prior to a determination on the merits of breach of fiduciary duty litigation, an advance cannot, by definition, relieve the fiduciary of any responsibility or liability.”<sup>8</sup>

It is unclear whose arguments the Ninth Circuit will find most persuasive, but while the *Couturier* case remains pending before the court, there are a number of steps that fiduciaries can take to protect themselves. First, fiduciaries should reassess whether the fees charged for their services are commensurate with the risk of litigation. As shown in the *Couturier* case, the cost of fiduciary litigation can be substantial and in many cases will far outweigh whatever fees the fiduciary has earned from service to the ESOP. Second, and of equal importance, fiduciaries should ensure that adequate insurance coverage is in place in the event that their contractual indemnification agreements do not pass muster with a court. Had the insurance coverage protecting the *Couturier* fiduciaries been more extensive, the issue of attorney’s fees advancement from the plan sponsor might not ever have arisen. **ti**

#### Endnotes

<sup>1</sup>This background on ESOPs is available on the Web site of the ESOP Association, a trade group, at [www.esopassociation.org/about/about\\_what\\_is.asp](http://www.esopassociation.org/about/about_what_is.asp).

<sup>2</sup>See *Abraham v. Norcal Waste Sys.*, 265 F.3d 811, 816 (9th Cir. 2001) (noting that an “ESOP is an employee benefit plan within the meaning of ERISA.”).

<sup>3</sup>These uses of an ESOP are described at [www.esopassociation.org/about/about\\_use.asp](http://www.esopassociation.org/about/about_use.asp).

<sup>4</sup>*Johnson v. Couturier*, No. 05-02046, 2008 U.S. Dist. LEXIS 82902 (E.D. Cal. Sept. 26, 2008).

<sup>5</sup>See 29 CFR 2510.3-101(h)(3); see also “Final Regulation Relating to the Definition of Plan Assets,” 51 Fed. Reg. 41262, at § VII.B.1 (Nov. 13, 1986).

<sup>6</sup>See *Moore v. Williams*, 902 F. Supp. 957, 967 (N.D. Ia. 1995).

<sup>7</sup>See *Central States Pension Fund v. American Nat’l Bank*, No. 77-4335, 1979 U.S. Dist. LEXIS 4335 (N.D. Ill. Oct. 26, 1979).

<sup>8</sup>See John R. Cornell and James J. Little, “Indemnification of Fiduciary and Employee Litigation Costs under ERISA,” 25 B.C. L. Rev. 1, 28 n. 230 (1983) (emphasis added).

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