

ESOP ADVANCED FIDUCIARY ISSUES

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ESOP ADVANCED FIDUCIARY CONCERNS

I. PURCHASE OF EMPLOYER SECURITIES

A Foster & Gallagher case

1 Facts

- a ESOP trustee purchased employer securities for \$70 million in 1995
- b sudden decline in value of company in 1998 after a dramatic change in regulatory climate relating to sweepstakes (upon which company relied heavily in its marketing efforts)
- c company goes bankrupt in 2001

2 Allegation: trustee breached fiduciary responsibility by paying more than fair market value for employer stock

3 Holding: trustee exonerated

4 Court's Findings

- a trustee determined price after careful and prudent investigation of the financial and valuation aspects of the transaction
- b trustee reasonably relied upon opinion of its independent financial advisor
- c trustee negotiated a reduction in price of almost 20 percent from the seller's original proposal
- d plaintiffs' allegation that trustee should have retained an independent accounting firm to review the company's financial statements rejected
- e legal due-diligence was deficient, but not material

B The Champlain Enterprises Case

1 Facts

- a trustee purchased 30 percent of the outstanding shares of plan sponsor's stock in 1994 for a price of \$60 million
- b trustee participated in a due-diligence meeting at plan sponsor's headquarters, but retained no documentation as to what was discussed at the meeting
- c trustee met with financial advisor to discuss preliminary valuation, but trustee's representatives took no notes at the meeting and had no recollection of what was discussed at the meeting
- d trustee's fiduciary committee met and approved transaction prior to closing
 - i. neither of the trust officers responsible for the transaction could recall if either of them had made an oral presentation to the committee
 - ii. trust officers could not recall whether recent changes in the industry were discussed

2 Plaintiffs' Allegation: trustee engaged in a prohibited transaction by purchasing employer securities for a price in excess of fair market value

3 Holding: trustee breached its fiduciary duty by failing to determine the fair market value of the employer securities "in good faith"

- a court found that price paid by ESOP trustee exceeded value of stock by \$7.75 million
- b court held that plaintiffs did not have to prove that the prohibited transaction caused them harm

4 Analysis

- a burden was on trustee to prove that it determined the value of the employer securities based on the conduct of an adequate investigation
- b trustee failed to present sufficient documentation to establish that it had undertaken an adequate investigation

II. ONGOING DUTY TO MONITOR: THE AMSTED INDUSTRIES CASE

A Facts

- 1 in August of 1999, Amsted acquired Varlen, Inc. for a price of \$788 million
 - 2 as of September 30, 1999, the last day of Amsted's 1999 fiscal year, the trustee's financial advisor determined the value of the stock of Amsted to be \$184.41 per share
 - a this was a substantial increase (32 percent) from the previous year-end value
 - b in making this determination, the financial advisor assumed that the value of Varlen was equal to the price Amsted paid for it
 - 3 during fiscal year 2000, Amsted suffered from a severe downturn in its business, and its profits declined substantially
 - 4 the appraised value of the Amsted shares as of September 30, 2000 declined to \$89.87 per share
 - 5 during fiscal year 2000, an unprecedented number of employees left the company
 - a pursuant to the terms of the ESOP in effect during Amsted's 2000 fiscal year, retired employees were entitled to demand payment of their benefits under the ESOP immediately in one lump-sum payment
 - b any employee who retired between July 1, 1999 and June 30, 2000, and who demanded payment of his or her benefits on or before June 30, 2000, was entitled to benefits calculated by reference to the September 30, 1999 valuation
 - 6 an extraordinary number of retirements and associated benefit distributions occurred during the period October 1, 1999 through June 30, 2000, which resulted in a severe cash drain from Amsted
- B Plaintiffs alleged that Amsted's officers and directors breached their fiduciary duties by –
- 1 failing to sufficiently consider the effect of the Varlen acquisition on the ESOP, and

- 2 failing to adequately plan for the company's repurchase obligation
- C Plaintiffs alleged that the trustee breached its fiduciary duties by –
- 1 failing to conduct an independent investigation of the proposed Varlen acquisition,
 - 2 failing to properly monitor Amsted's repurchase obligation, and
 - 3 accepting an allegedly-flawed valuation report
- D Holding: summary judgment granted in favor of defendants, and all of the plaintiffs' claims dismissed
- E Court Findings Regarding Amsted Defendants
- 1 Amsted defendants not subject to ERISA fiduciary duties in connection with Varlen transaction
 - a did not involve plan assets
 - b Amsted defendants were not acting as fiduciaries of the ESOP in connection with the Varlen acquisition
 - 2 although the Amsted defendants' repurchase obligation estimates for the fiscal year 2000 were wrong, their actions did not constitute imprudence
 - a Amsted defendants conducted a number of repurchase liability studies
 - b two primary factors identified by the plaintiffs to be taken into account in the repurchase liability analysis -- historical share turnover rate and employee attitudes toward the ESOP -- would not have shown that the defendants should have predicted a redemption rate of 30 percent during fiscal year 2000 (up from nine percent for the preceding two years)
 - c Amsted had \$200 million in unused credit on its credit facility
- F Court Findings Regarding ESOP Trustee
- 1 standard of review: "decisions of independent and experienced fiduciaries garner deferential review, while the decisions of fiduciaries with a conflict of interest or engaged in suspect transactions do not receive such deference"

- 2 Varlen acquisition
 - a business decision, and trustee could not be held liable for failing to override an employer's business decision
 - b the trustee had monitored the transaction
- 3 repurchase obligation: no evidence that an investigation that would have conformed to the standards proposed by the plaintiffs would have predicted the redemption crisis
- 4 valuation of stock
 - a assumption that the value of Varlen was equal to the price paid by Amsted held to be reasonable
 - b not unreasonable under the circumstances for trustee to accept valuation report that did not take a discount for lack of marketability
 - i. Amsted had a 13-year history of paying benefits to terminated ESOP participants promptly
 - ii. consistent history of appraising stock with no marketability discount

III. CONTINUING TO HOLD EMPLOYER SECURITIES

- A Issue: what fiduciary duty do trustees, or other fiduciaries with authority over plan investment, have to determine if it remains prudent to hold employer securities?
 - 1 Involves the ERISA § 404(a)(1) duties of loyalty and prudence.
 - 2 Has been raised in many recent "stock drop" cases, involving both ESOPs and 401(k) plans with company stock investment options.
- B The "Moench presumption"
 - 1 Moench v. Robertson, 62 F.3d 553 (3d Cir. 1995).
 - a ESOP established in 1986, invested all employer contribution in company stock "despite the continual and precipitous drop in its price and despite the Committee's knowledge of [the company's] precarious condition by virtue of the members' status as directors."

- b Eventually, company (and participants' ESOP accounts) became "virtually worthless."
 - i. Company officials and directed trustee expressed concerns over declining value, trustee eventually started invested company contributions in money market account.
 - ii. Class action securities fund settled for \$3.2 million, but Committee did not participate on behalf of ESOP.
 - c Class action filed alleging breaches of ERISA fiduciary duty in investing employer contributions entirely in company stock. District court granted Committee's motion for summary judgment, concluding that plan documents mandated investment of ESOP assets solely in company stock.
 - d On appeal, the Third Circuit interpreted plan's provision to invest primarily in employer securities *not to require* investment solely in employer securities. Committee argued that "THE nature of ESOPs themselves" shielded the decision to invest solely in company stock.
- 2 The Third Circuit noted the specific provisions in ERISA governing ESOPs: exemptions from diversification and prohibited transaction rules, said these arise from nature and purpose of ESOPs: "to invest primarily in qualifying employer securities," not to guarantee retirement benefits, as ESOP "by its very nature" places employee retirement assets at much greater risk.
- 3 Nonetheless, ESOPs are, except for these specific provisions, subject to ERISA, creating conflict for fiduciaries that "becomes particularly stark" when it is claimed that continued investment in employer securities violated ERISA fiduciary duty.
- 4 So, how does a court review the fiduciaries' decision to invest or continue to invest ESOP assets in employer securities? The Third Circuit thought that strict judicial scrutiny would be inconsistent with the goal of employee ownership through ESOPs; further, "basic principles of trust law require that the interpretation of the terms of the trust be controlled by the settlor's intent. That principle is not well served in the long run by ignoring the general intent behind [ESOPs] in favor of giving beneficiaries the maximum opportunities to recover their losses. . . . [C]ourts must find a way for the competing concerns to coexist."

- 5 The court then stated that, where the fiduciary is not absolutely required to invest in employer securities but is more than simply permitted to make such investments, and the fiduciary's decision to continue investing in employer securities is challenged, it should be reviewed for an abuse of discretion. Specifically:
 - a “an ESOP fiduciary who invests the assets in employer stock is entitled to a presumption that it acted consistently with ERISA by virtue of that decision,” but
 - b the plaintiff may overcome that presumption by establishing that the fiduciary abused its discretion by investing in employer securities.
 - c Such “abuse of discretion” may occur when the financial state of the company deteriorates, so that “ESOP fiduciaries who double as directors of the corporation often begin to serve two masters. And the more uncertain the loyalties of the fiduciary, the less discretion it has to act.” Thus, “courts should look closely at whether the fiduciaries investigated alternative actions and relied on outside advisors before implementing a challenged transaction [a]nd, if the fiduciary cannot show that he or she impartially investigated the options, courts should be willing to find an abuse of discretion.”
 - d The case was then remanded to the district court for fact-finding and consideration in light of these principles, which are generally referred to as “the *Moench* presumption.”

C The Moench presumption applied

- 1 The holding in *Moench* was specifically adopted by the Sixth Circuit in *Kuper v. Iovenko*, 66 F.3d 1447, 1459 (6th Cir. 1995). More recently, it has been applied in several “stock drop” cases involving ESOPs, including *In re Syncor ERISA Litigation*, 351 F.Supp.2d 970, 979-83 (C.D. Cal. 2004); *In re Duke Energy ERISA Litigation*, 281 F.Supp.2d 786, 793-95 (W.D.N.C. 2003); *In re McKesson HBOC, Inc. ERISA Litigation*, 2002 WL 31431588 at *4-*6 (N.D. Cal. 2002).
- 2 The Ninth Circuit has suggested that the *Moench* presumption may intrude on ERISA’s statutory language. In other words, the ERISA §404(a)(2) exemption from the prudence requirement, to the extent that prudence requires diversification, may be absolute, so that the prudence requirement cannot be read to support even an “albeit tempered duty to diversify.” The Ninth Circuit raised this issue, but

did not decide it. *Wright v. Oregon Metallurgical Corp.*, 360 F.3d 1090, 1097-98 (9th Cir. 2004).

- 3 The Moench presumption has also been applied in non-ESOP cases (e.g., 401(k) plans with a company stock investment alternative). See *Pennsylvania Federation v. Norfolk Southern Corp. Thoroughbred Retirement Investment Plan*, 2004 WL 228685 at *7 (E.D. Pa. 2004).
- 4 Courts are in conflict as to the point in a lawsuit when the Moench presumption will be applied: some courts have applied the presumption as the basis for a motion to dismiss, while other courts have held that it is premature to apply the presumption at that point, and allowed the case to go forward, so that the application of the presumption would be argued in connection with motions for summary judgment. Courts are also in conflict as to what allegations must be pleaded and proved in order to overcome the presumption. These issues are discussed, with citation of other cases, in *In re Sprint Corp. ERISA Litigation*, 2004 WL 1179371 at *9-*13 (D. Kan. 2004); see *also*, *Lalonde v. Textron, Inc.*, 369 F.3d 1, 3-9 (1st Cir. 2004); *Wright v. Oregon Metallurgical Corp.*, 360 F.3d 1090, 1097-99.

IV. DIRECTED TRUSTEE

A Department of Labor Field Assistance Bulletin 2004-03 (December 17, 2004). "In the Context of Publicly Traded Securities, What are the Fiduciary Responsibilities of a Directed Trustee?"

1 Background

- a The FAB was issued in response to an advisory opinion request in early 2004 on behalf of several banks and financial institutions.
- b In light of the many class action "stock drop" law suits, guidance was sought on the duties of the directed trustees involved with those cases.

2 Guidance

- a A directed trustee does not have fiduciary responsibility if it follows the "proper" direction of a named fiduciary. Accordingly, if a directed trustee knows or should know that a direction from a named fiduciary is not "proper", the trustee may not, consistent with its fiduciary responsibilities, follow the direction.

- b A direction is "proper" if it is made in accordance with the terms of the plan and it is not contrary to ERISA.
- i. To ensure that the direction is in accordance with the terms of the plan:
- the directed trustee must read the plan, the investment policy statement and other governing documents.
 - if ambiguities exist, the directed trustee must seek clarification from the named fiduciary.
- ii. A direction is contrary to ERISA if a prohibited transaction would result if the direction is followed.
- the directed trustee must follow procedures designed to avoid prohibited transactions, and may satisfy this obligation by obtaining written representations from the named fiduciary that the plan maintains and follows such procedures.
- iii. A direction is contrary to ERISA if following the direction would cause a violation of ERISA's prudence requirement.
- the directed trustee's role is "significantly limited"
 - the directed trustee does not have a "direct" or "independent" obligation to determine the prudence of every transaction, or an obligation to duplicate or second-guess the named fiduciary.
 - if the directed trustee has "material non-public information" regarding the stock, before following the direction, the directed trustee has a duty to inquire about the named fiduciary's knowledge and consideration of such information with respect to its direction.

- if the directed trustee only has "public information" regarding the stock, the directed trustee "rarely" has an obligation to question the direction unless there exists "clear and compelling" public information which "calls into serious question a company's viability as a going concern."

3 Analysis

- a The FAB is consistent with prior statements of law from the DOL and from case law - a directed trustee retains fiduciary duties, although those duties are limited.
- b The FAB retains the "know or should know" standard which requires the directed trustee to make some examination of the direction.
- c The application of the FAB to privately-held companies is not seamless
 - i. Directed trustees of privately-held companies may have a heightened duty of inquiry because all information about the company stock is "non-public."
 - ii. In the absence of public company reporting requirements, how great is the directed trustee's duty to investigate the value and viability of the privately-held company?

B In re WorldCom, Inc. ERISA Litigation, 2005 WL 221263 (S.D.N.Y. 2005)

1 Facts

- a One of many class action lawsuits filed in the wake of WorldCom's 2002 bankruptcy. This lawsuit was filed against the fiduciaries of WorldCom's 401(k) plan which permitted participants to direct investment in a company stock fund, among other funds.
- b Merrill Lynch was the trustee of the 401(k) plan and WorldCom had the power to select and change the investment funds available under the plan. Merrill Lynch was required to follow participant direction regarding investment of plan assets in those funds.

- c WorldCom was involved in a \$11 billion accounting fraud designed to overstate revenues and hide expenses. When information about the fraud became public, the company fell into bankruptcy and the company stock became virtually worthless.
- 2 Allegations: Merrill Lynch and all of the plan fiduciaries were alleged to have breached their fiduciary duties by failing to warn participants about investing in the WorldCom stock fund and failing to encourage selling the stock as information about the fraud became public.
- 3 Holding: The case against Merrill Lynch was dismissed.
- 4 Court's Analysis:
 - a The Court determined that Merrill Lynch was a directed trustee because it did not have the power to select the investment options and was required to follow the participants' investment directions.
 - b As a directed trustee, it was subject to a lower standard of fiduciary duty and had to follow directions from the named fiduciary unless it had "knowledge" that the directions would cause it to breach its duties.
 - c The Court relied heavily on the recently issued FAB 2004-03.
 - i. It found that Merrill Lynch did not have any material non-public information which require it to make a specific inquiry regarding the direction.
 - ii. The Court also found that the public information available, while indicating that WorldCom's fortunes were "declining," did not impose a duty on WorldCom to question the company's viability.