

ESOP LEGAL UPDATE

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CURRENT LITIGATION

- Tribune
- Amsted
- Couturier
- Antioch

CURRENT LITIGATION (CONT.)

The Tribune Company

- Dan Neil et al. vs. Sam Zell et al.
 - Filed September 2008
 - Filed in California. Defendants won change of venue to Chicago
 - Suit is stayed with respect to the Tribune Company due to their Chapter 11 filing
 - Litigation continues with respect to other defendants

CURRENT LITIGATION (CONT.)

Amsted

- Armstrong et al vs. LaSalle Bank
 - Defendants won on summary judgment
 - Plaintiffs appealed. Appeals court ruled favorably in giving deference to institutional trustees but remanded to lower court for facts and circumstances determination if trustee abused the deference
 - Plaintiffs filed for change of venue
 - That decision is waiting for the appeals court

CURRENT LITIGATION (CONT.)

Johnson v. Couturier

- Company is The Employee Ownership Holding Company (“TEOHC”) of Noll Manufacturing
- Complaint filed in October 2005 alleging breach of ERISA fiduciary duty and corporate fiduciary duty (Trustees were corporate officers and board members)
- Cost of defense exhausted \$5 million insurance policy
- In 2007, Gibraltar bought all company assets for \$20 million. \$5 million distributed to participants

CURRENT LITIGATION (CONT.)

Johnson v. Couturier (cont.)

- Plaintiffs won TRO & preliminary injunction to prevent company from paying defendants' legal fees from the \$15 million remaining proceeds
- Expedited appeal from preliminary injunction has been filed requesting oral arguments
- Amicus brief has been filed on behalf of institutional trustees
- Amicus brief has been filed on behalf of DOL

CURRENT LITIGATION (CONT.)

Johnson v. Couturier (cont.)

Public Policy

- TRUSTEES

- “To attract the caliber of fiduciary necessary, courts have recognized the public policy importance of providing appropriate assurances that litigation expenses will be advanced.”

- DOL

- “the specific concerns presented in this case, and the specific policies of ERISA in general and section 410 in particular, which expressly “void[s]” such agreements as “against public policy,” override the general policy in favor of honoring contractual agreements to indemnify corporate officers and directors

CURRENT LITIGATION (CONT.)

Johnson v. Couturier (cont.)

ERISA §410

- TRUSTEES

- ERISA §410 “merely prohibits agreements that diminish the statutory obligations of a fiduciary”

- DOL

- The payment of defense fees here does not come within the literal terms of §410(b), however, because the arrangements here do not involve the purchase of the insurance by the plan or any other party.

CURRENT LITIGATION (CONT.)

Johnson v. Couturier (cont.)

Precedents

- TRUSTEES

- ERISA Interpretive Bulletin 75-4 – “So long as the terms of the indemnification agreement do not relieve the trustee fiduciaries of liability... the entity related to the Association may agree to indemnify the Trust and the trustee.”

- DOL

- “to permit indemnification agreements which do not relieve a fiduciary of responsibility or liability” under ERISA, reasoning that provisions “which leave the fiduciary fully responsible and liable, but merely permit another party to satisfy any liability incurred by the fiduciary in the same manner as insurance and therefore not void under 410(a)

CURRENT LITIGATION (CONT.)

Johnson v. Couturier (cont.)

Not Plan Assets

- TRUSTEES

- Decades of regulatory and case law holding that the assets of a company whose shares are owned by an ESOP are not plan assets.

- DOL

- Bulletin 75-4 rejected arrangements where indemnification is made by a plan. In the context of a company wholly owned by an ESOP, indemnification by the company violates 410 for the same reasons that indemnification by a plan violates 410.

CURRENT LITIGATION (CONT.)

Johnson v. Couturier (cont.)

DOL Positions

- ERISA's goal of "providing for appropriate remedies, sanctions and ready access to Federal courts" to remedy fiduciary breaches, 29 U.S.C. §1001(b), would be thwarted if breaching fiduciaries who control a wholly ESOP-owned company could legitimately enter into or benefit from such indemnification arrangements.
- ERISA fiduciaries have an obligation to affirmatively act to protect plan assets from dissipation, which, in the context of an ESOP that is the company's sole shareholder may include a fiduciary obligation to bring a shareholder derivative action, rather than stand idly by while all the equity value is siphoned off the the benefit of corporate insiders to the detriment of the plan.

CURRENT LITIGATION (CONT.)

Antioch Case

- Bonnie Fish et al vs. Greatbanc Trust Company et al
 - Litigation filed in March 2009 relating to a 2003 second stage ESOP transaction
 - Plaintiffs allege that the trustee didn't take repurchase liability into account when establishing a floor price for shares already in the ESOP from a prior transaction

Plan Document Compliance

The Heroes Earnings Assistance and Relief Tax Act (“HEART Act”)

- Provides military employees with additional rights/enhanced benefits under employer-sponsored pension plans
- Must be adopted on or before the last day of 2010 plan year
 - Some provisions are effective January 1, 2009, and others are retroactive to January 1, 2007

Plan Document Compliance

HEART Act (cont.)

- Required Plan Changes
 - Provide survivors of plan participants who die or become disabled while performing military service any additional benefits that would have been provided for those who die/become disabled as active employees
 - Effective for deaths/disabilities occurring after January 1, 2007
 - Active military servicemen and women who receive “differential wage pay” are deemed to be active employees and such differential wage pay is treated as compensation for plan purposes
 - Optional under final Code Section 415 regulations but mandatory under HEART Act
 - Effective January 1, 2009

Plan Document Compliance

HEART Act (cont.)

- Required Plan Changes
 - Eligible military participants may elect to receive “in-service” distributions from the participant’s elective deferrals
 - Participant is treated as having been severed from employment during any period the participant is on active duty for a period of more than 30 days
 - If elected, participant must not make elective deferrals during 6-month period beginning on the date of distribution
 - In-service distribution is subject to the 10% early withdrawal penalty, (unless the employee qualifies for the waiver of the penalty for distributions that constitute “qualified reservists distributions” as described below).
 - Effective for 2009 plan year

Plan Document Compliance

Worker Retiree and Employer Recovery Act of 2008

- 2009 Required Minimum Distribution (“RMD”) Relief
 - Waiver of RMDs from qualified retirement plans and IRAs for the 2009 calendar year
 - Persons who reach age 70 1/2 in 2009 will take their 1st RMD by December 31, 2010
 - Persons who reached age 70 1/2 in 2008 still must take their RMD under the normal rules
 - Distributions that would otherwise be RMDs may become “eligible rollover distributions”
 - Plans may or may not offer to treat suspended RMD as direct rollovers

Plan Document Compliance

Worker Retiree and Employer Recovery Act of 2008 (cont.)

- Non-Spouse Beneficiaries Rollovers Made Permanent
 - PPA allowed non-spouse beneficiaries to rollover amounts from a qualified plan to an IRA beginning in 2007
 - IRA treated as an “inherited IRA”
 - For plan years beginning after December 31, 2009, non-spousal beneficiary rollovers are required
 - Rollovers by non-spouse beneficiaries are subject to the same rules as other eligible rollovers (i.e., such rollovers are subject to direct rollover requirements, notice requirements and mandatory withholding requirements)

Plan Document Compliance

Worker Retiree and Employer Recovery Act of 2008 (cont.)

- Roth Rollovers
 - PPA permits rollovers from a tax-qualified plan (403(b) plans and 457 plans) to Roth IRAs, subject to the following conditions:
 - Rolled over amount generally must be included in income; and
 - Adjusted gross income limits are imposed on the ability to perform such rollovers in 2008 and 2009 (limits do not apply in 2010)
 - Worker, Retiree and Employer Recovery Act clarifies that these conditions do not apply to direct rollovers to a Roth IRA from a Roth 401(k) or Roth 403(b) plan

IRS Remedial Amendment Cycle

| Last Digit of EIN | Cycle | Initial Submission Period | Next Submission Period |
|--------------------------|--------------|----------------------------------|-------------------------------|
| 1 or 6 | A | 01/31/2007 | 01/31/2012 |
| 2 or 7 | B | 01/31/2008 | 01/31/2013 |
| 3 or 8 | C | 01/31/2009 | 01/31/2014 |
| 4 or 9 | D | 01/31/2010 | 01/31/2015 |
| 5 or 0 | E | 01/31/2011 | 01/31/2016 |

Revised IRS Sample Plan Language on 409(p) Transfers

- Issued March 24, 2009, to replace SPL issued in July, 2008
- Provides for transfer of employer securities from ESOP part of plan to non-ESOP plan or non-ESOP part of plan as a means of preventing 409(p) violation (Nonallocation Year or NAY)
- Revised SPL provides discretion to plan administrator to determine the minimum amount to be transferred that would result in ownership by disqualified persons (DQPs) within a range of 40% to 49.9% (original SPL used 49.9%).
- Transfer process must result in minimum transfer of employer securities and, in effect, requires transfer priority from HCEs who are DQP's on a bottom up basis (lowest to highest number of shares) and then, if necessary, from all DQP's top down (highest to lowest number of shares).
- Any income taxes on profits under Code Section 512 must be paid by the non-ESOP account of the DQP and, if necessary to pay such taxes, the employer shall redeem shares from the account of the DQP based upon the current fair market value of the shares.

ERISA Fiduciary Standards

- *Armstrong v. Amsted Industries*, (Dis. Ct., 2004) and *Armstrong v. LaSalle Bank* (7th Cir., 2006)
 - Independent trustee experienced with ESOPs should be granted deferential review and court should not substitute its judgment unless the trustee decision was arbitrary and capricious
 - Not the responsibility of the ESOP trustee to independently investigate the business decisions of the company (related to costly acquisition)
 - Remand to trial court on issue of whether LaSalle Bank, Trustee, should have performed analysis of repurchase obligation after costly acquisition.
- Compare *Reich v. Valley National Bank* (DC, NY, 1993): Independent trustee held to prudent expert standard in leveraged ESOP stock purchase.

ERISA Fiduciary Standards

- *Summers v. State Street Bank*, (7th Cir., 2006)
 - Upheld lower court that State Street Bank did not violate its fiduciary duties by failing to sell UAL stock in the ESOP more quickly.
 - Plaintiffs did not make a compelling case about when the sale should have occurred and Trustee not required to outsmart the market.
 - Judge Posner also opined on ESOPs:
 - Inefficient method of wealth accumulation by employees
 - No reason for taxpayers to encourage employee ownership
 - Evidence that ownership would improve corporate performance was “weak and makes no theoretical sense.”

Corporate/ESOP Governance Conflicts

- *Donovan v. Bierwirth* (2nd Cir., 1982): Executives resisting hostile takeover should not serve as ESOP fiduciaries.
- *Howard v. Shay* (DC, PA, 1996): In conflict over valuation, ESOP fiduciaries who have reason to question valuation have duty to get second opinion.

Evolution of the Prohibited Transaction

Front-Door Looting

- *Reich v. Valley National Bank* (DC, NY, 1993): Price at which shareholders sold stock to ESOP in leveraged transaction was in excess of adequate consideration and trustee breached fiduciary duty under ERISA.

Back-Door Looting

- *Delta Star v. Patton* (DC, PA, 1999): Excessive executive comp both a breach of fiduciary duty under ERISA and corporate waste under Delaware corporation law.

Valuation as a Fiduciary Function

Trustee Duties on Valuation

- *Reich v. Valley National Bank*: Trustee has duty of independent investigation and independent judgment similar to prudent expert.
- *Howard v. Shay*: ESOP fiduciaries who have reasons to question valuation have duty to get second opinion.

Valuation as a Fiduciary Function (cont.)

Repurchase Obligation

- *Foltz v. U.S. News* (D.C. Cir., 1989):
Recognized that valuation for purposes of maintaining an ESOP may be lower than price paid by an outside buyer.
- *Armstrong v. Amsted Industries* (7th Cir., 2006):
Explicit recognition of high level of trustee diligence required in determination of repurchase obligation in remand to trial court.

ESOP Trustee Liability

Fernandez v. K-M Industries Holding Co., Inc. (N.D. Calif., Nov. 14, 2008)

- On November 14, 2008, the District Court for the Northern District of California denied an ESOP's successor trustee's summary judgment motion on the basis that:
 - (a) the claims against the successor trustee for failing to remedy an alleged breach of fiduciary duty by a predecessor trustee are potentially valid; and
 - (b) the applicable statute of limitations did not bar plaintiff's claims against the successor trustee

ESOP Trustee Liability (cont.)

Fernandez v. K-M Industries Holding Co., Inc. (cont.)

- Issue: Whether a successor trustee may be held independently liable under 29 U.S.C. Section 1105 (ERISA Section 405) for liability for breach of co-fiduciary?
 - District Court ruled YES!!
- Court relied on a DOL opinion and held that while North Star could not be held vicariously liable for the breaches of fiduciary duty committed by Moore, it was potentially liable for its failure to remedy the alleged breaches of fiduciary duty that occurred before it was appointed successor trustee if it failed to act despite its knowledge of the breaches, which would constitute an independent breach of fiduciary duty
- “No fiduciary shall be liable with respect to a breach of fiduciary duty under ERISA Section 409(b), if such breach was committed before he became a fiduciary”
 - Thoughts?

ESOP Trustee Liability (cont.)

Fernandez v. K-M Industries Holding Co., Inc. (cont.)

- Court also held 6-year SOL applied and that North Star could have remedied the breaches by filing suit against the other defendants in connection with the 1998 and 1999 ESOP transactions
- District Court concluded, with respect to the ERISA fiduciary breach claims against North Star, that the question is not when Plaintiff's learned of the other defendants' breaches, but rather when they learned of the successor trustee's breaches
 - North Star alleged that Plaintiff's claims would have been time-barred before it took over as successor trustee

ESOP Trustee Liability (cont.)

Fernandez v. K-M Industries Holding Co., Inc. (cont.)

- Plaintiff's are challenging successor trustee's failure to remedy breaches made by other fiduciaries in connection with the 1998 and 1999 ESOP transactions.
 - Not directly challenging the 1998 and 1999 ESOP transactions
 - Does this make it easier for plan participants to sue when the SOL has expired? Thoughts? Comments?
- District Court ruled the failure of North Star to act was independently actionable under ERISA 1105(a)(3), and thus, the Plaintiff's claims are not time-barred

Individual Participant Claims

LaRue v. DeWolff (U.S. S.Ct., Feb. 2008)

- Participant Claims

- Claims arising under §502(a)(1) – Benefit Claims
- §502(a)(2) – Plaintiffs must demonstrate a “**loss to the Plan**” as defined by §409 (29 USC §1109)
- §502(a)(3) – Equitable relief which seeks recovery of amounts that could “**clearly be traced to particular fund or property.**”

Individual Participant Claims (cont.)

LaRue v. DeWolff (cont.)

- Participant in a 401(k) Plan who lost approximately \$150,000.00 when the Trustee allegedly did not follow the participant's instructions.
 - It doesn't look like a claim for benefits under §502(a)(1).
 - He is just one Plan participant, so how can his claim constitute a “loss to the Plan” under §502(a)(2)?
 - His losses look a lot like damages, rather than “particular funds or property” as required by §502(a)(3).

Individual Participant Claims (cont.)

LaRue v. DeWolff (cont.)

§502(a)(2) Holdings

- The text of §409 states that recovery is available for “any loss to the Plan.”
- LaRue's 401(k) Plan account is a sub-account within the Plan, so his losses are therefore losses within the Plan
- LaRue's loss is therefore a loss that constitutes a “loss to the Plan”

Individual Participant Claims (cont.)

LaRue v. DeWolff (cont.)

- The Court achieves this result by distinguishing **defined benefit** (“DB”) plans (like pension plans) from **defined contribution** (“DC”) plans like 401(k) plans and ESOPs)
- This distinction makes little sense – DB plans can make individualized errors, too.

Conflicts of Interest

MetLife v. Glenn, 128 S.Ct. 2343 (2008)

- Claims for benefits case
 - Exhaust administrative remedies
 - Limited administrative record
 - Deference usually granted to the administrator
- Court held that an insurance company that both makes decisions as to benefit eligibility and pays benefits is conflicted and that courts should consider such a conflict as one of any number of factors in reviewing the insurer's duty to deny benefits

Conflicts of Interest

MetLife v. Glenn (cont.)

- MetLife served as both the insurer and the claims administrator for a long-term disability plan maintained by Sears
 - MetLife denied a claim for benefits made by an employee with a heart condition on the ground that medical treatment had improved her condition to the point where she was no longer disabled
 - After exhausting administrative appeals, the employee sued in district court which applied the arbitrary and capricious standard and upheld the denial of her claim

Conflicts of Interest

MetLife v. Glenn (cont.)

- On appeal, Sixth Circuit overturned lower court stating that the arbitrary and capricious standard does not apply where the plan administrator has a conflict of interest
 - Sixth Circuit decision appealed to the Supreme Court
 - Five judge majority Supreme Court concluded that insurance companies that both devise and pay claims have an inherent conflict
 - Court stated that a conflict should “be weighed as a factor in determining whether there is an abuse of discretion”
 - Conflict is just one factor among many in determining whether a plan fiduciary abused its discretion in making claim determinations.

Tim Jochim

Tim Jochim, Director, Kegler, Brown, Hill & Ritter

- National authority on employee stock ownership plans (ESOPs) and business succession. He also has expertise in corporate finance, merger/acquisition and employee benefits.
- Adjunct professor of corporate finance at the Capital University School of Law, Columbus, Ohio.
- Member of corporate boards and frequent speaker to business and trade organizations.
- Author of Employee Stock Ownership and Related Plans (Greenwood Press, 1982), and of articles published in Ohio Business (October, 1988), The Journal of Employee Ownership Law and Finance (Fall, 1998), Taxation for Accountants (July, 1998) and Taxation for Lawyers (September-October, 1998).
- Co-founder of the Ohio Chapter of The ESOP Association and a member of the legislative committee of The ESOP Association.
- Recognized in Marquis Who's Who in the Midwest and in Benton's Who's Who.

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Brian D. Hector

- Practice on ERISA and employee benefits law including the areas of ESOPs, qualified plans, all types of executive compensation, fiduciary liability, and related securities law issues.
- Served as counsel to companies and shareholders regarding the use of ESOPs in numerous transactions, including equity repurchases, ownership succession transactions, and corporate reorganizations. He has also represented lenders and trustees in ESOP transactions.
- History working with all types of benefit plans, executive compensation arrangements, IRS and Department of Labor self-correction programs, plan terminations, cafeteria plans, health and welfare plans, Keogh plans, VEBA's, multiple employer plans, prohibited transactions and prohibited transaction exemptions, Section 404(c) issues, partial terminations, benefit plans for tax-exempt organizations including Section 457 plans, church plans, and Section 403(b) plans, and split-dollar and corporate-owned life insurance arrangements. He has also represented several clients before the IRS and the Department of Labor in connection with employee benefits matters.
- Lectured extensively regarding employee benefits and ESOPs. He speaks regularly at the annual national conferences of The ESOP Association, the National Center for Employee Ownership, at their local and regional conferences, and at numerous other seminars.
- Mr. Hector is also an adjunct professor at John Marshall Law School teaching in the area of executive compensation.
- Practice Accolades - ERISA Litigation, Listed in the highest tier for National ERISA Litigation Practice in *Chambers USA 2008*
- Member, the ESOP Association; Member, National Center for Employee Ownership; Member, American Bar Association (Taxation Division); Member, Illinois State Bar Association (Employee Benefits Division); Member, Chicago Bar Association (Employee Benefits Committee); Member, Illinois Chapter of the ESOP Association Board Member; Member, Advisory Board, Leading Lawyers Network

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Vaughn Gordy

- Mr. Gordy joined GreatBanc Trust: Company in 2005. Before joining GreatBanc Trust, he led the Employee Stock Ownership Plan (ESOP) Trustee Services practice for ten years at LaSalle Bank N.A. During his career, Mr. Gordy also served as Controller and Chief Financial Officer for several companies, as well as Chief Operating Officer for a manufacturer.
- Mr. Gordy's extensive experience encompasses the design and administration of ESOP transactions for both closely held and publicly traded corporations. He regularly speaks at ESOP conferences, and is a co-author of industry articles and publications. Mr. Gordy is an active member of Employee-Owned S Corps of America (ESCA) where he has served on the Advisory Board since the organization was founded. He is also an active member of the ESOP Association, the National Center for Employee Ownership and the National Association for Corporate Directors.
- Mr. Gordy received a bachelor of science degree in accounting from Pennsylvania State University and a master of business administration degree from the J.L. Kellogg Graduate School of Management at Northwestern University. Mr. Gordy served five years with the U. S. Air Force as a C-130 pilot including two years in Vietnam where he was awarded the Distinguished Flying Cross. He currently serves as Senior Vice President: at GreatBanc Trust where he leads- the Qualified Retirement Plan Services group.

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