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RECENT CLASS-ACTION CASES SURVIVE MOTIONS TO DISMISS, ADDRESS STANDING ISSUES

POLAROID ERISA LITIGATION

On March 31, 2005, a New York district court issued an opinion in *In re Polaroid ERISA Litigation*, holding that participants in the Polaroid Corp. Section 401(k) plan can proceed in their suit against individual fiduciaries of the plan. The suit claimed that Polaroid officers and directors breached their fiduciary duties to participants by maintaining plan investments in Polaroid common stock despite knowing that the investments were imprudent. During the period from October 1999 to December 2002, Polaroid's stock price dropped from $25.88 a share to a low of $0.01 per share, and the company declared bankruptcy.

The defendants moved to dismiss the case, claiming that they did not have authority to eliminate the Polaroid stock fund as an investment option, since the plan documents mandated that the stock fund be offered. The court disagreed, stating that "the fact that the plan required investments in Polaroid stock does not ipso facto relieve defendants of their fiduciary obligations." While fiduciaries enjoy a presumption of prudence for following plan documents, the court noted that, per *Moensch v. Robertson*, this presumption can be overcome. To do so, the plaintiffs would have to show (1) that there was a precipitous decline in stock value, and (2) that the fiduciaries had knowledge of the impending collapse. In this case, the court held that the plaintiffs had made sufficient allegations about the decline in stock price and about the fiduciaries' knowledge to withstand a motion to dismiss.

Finally, the court addressed the claim that the defendants breached their fiduciary duties by failing to disclose nonpublic information about Polaroid's financial situation to plan participants. The court admitted that the case law from different circuits is inconsistent. In the absence of any Second Circuit precedent on the issue, the court took the position that an ERISA fiduciary has an affirmative duty to disclose nonpublic information to participants when the fiduciary knows that silence might be harmful.

AOL TIME WARNER SECURITIES AND ERISA LITIGATION

In a recent decision, *In re AOL Time Warner, Inc. Securities and "ERISA" Litigation*, the court allowed the plaintiffs to go forward with many of their claims against executives of AOL Time Warner in connection with the company's Section 401(k) plan. The plaintiffs had brought four claims concerning the defendants' alleged breaches of fiduciary duties: (1) that it was imprudent for the plans to invest in AOL's stock fund during the period in question; (2) that the defendants made misrepresentations and failed to disclose material information to plan participants; (3) that board members

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Recent Class-Action Cases Survive Motions to Dismiss, Address Standing Issues

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failed to properly appoint and monitor fiduciaries; and (4) that certain officers and directors breached their duties of loyalty by selling their own AOL stock while at the same time allowing the plans to remain invested in the stock fund. The decision was a response to the defendants' motion to dismiss the claims.

The court denied the motion to dismiss with respect to most of the claims, for reasons similar to those stated in the *Polaroid* decision discussed above. However, the court dismissed the claims against a subsidiary of AOL Time Warner, stating that the subsidiary was merely a plan sponsor and was not a named or functional fiduciary with respect to investment decisions. The court also dismissed the claim that the defendants had breached their duties by selling their own stock. The court noted that fiduciary liability attaches only to those actions that are performed in a fiduciary capacity, not in a personal capacity.

American Airlines Class Action

In a recently decided Fifth Circuit case styled *Milofsky v. American Airlines, Inc.*, the court held that the plaintiffs in the case did not have standing under Section 502(a)(2) of ERISA to sue fiduciaries of American Airlines' Section 401(k) plan. The plaintiffs claimed that American had breached its fiduciary duties by failing to effect the transfer of their account balances from their previous plan to American's plan in a timely and prudent manner, resulting in a decrease in their account balances. The case was brought as a class action under Section 502(a)(2) of ERISA, which allows plan participants to sue on claims which benefit the plan as a whole. The court dismissed the plaintiffs' claims, finding that in essence the case was about "an alleged particularized harm targeting a specific subset of plan beneficiaries, with claims for damages to benefit members of the subclass only, and not the plan generally."

The plaintiffs did allege that their claims inured to the benefit of the plan as a whole. However, the court found that position to be inconsistent with the plaintiffs' demand that damages be allocated among the plaintiffs' individual accounts. "We cannot adopt an interpretation that would allow a plaintiff, merely by praying that relief pass through the plan into individual accounts, to eviscerate the standing requirement by engaging in a legal fiction that the suit benefits the plan as a whole." The court noted that the plaintiffs would be able to sue for individualized relief under other sections of ERISA.

Other Class-Action Developments

In March 2005, a class-action lawsuit was filed against Krispy Kreme Doughnut Corporation and certain of its current and former officers, asserting breaches of fiduciary duty in connection with the company's Section 401(k) plan and profit-sharing stock ownership plan. The plaintiffs contend that the defendant fiduciaries failed to prudently manage the plan assets by continuing to offer the company's stock as an investment option, failed to provide accurate information about the risks of investing in the company's stock, and failed to monitor the fiduciaries' appointees.

Conseco, Inc. has agreed to pay $10 million to settle a class-action lawsuit filed by employees against fiduciaries of Conseco's Section 401(k) plan alleging violations of ERISA for stock losses relating to the company's 2002 bankruptcy. In its annual report, Conseco said that it expects that a substantial portion of the settlement will be paid by its insurer, despite counterclaims filed by the insurance company disputing liability under the policy.

IRS Issues Guidance on Taxability of Net Unrealized Appreciation in Certain Corporate Transactions Involving ESOPS

The Internal Revenue Service has issued two new private letter rulings, Private Letter Rulings 200509032 and 200507016, which provide additional guidance about the tax treatment of net unrealized appreciation in certain corporate transactions involving ESOPs.

Special tax rules apply to a distribution from an ESOP that consists totally or partially of employer securities. Section 402(e)(4) of the Code provides the general rule that the net unrealized appreciation on distributed employer securities, to the extent attributable to employee contributions, will not be

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taxed until the securities are sold or otherwise disposed of in a taxable transaction. ("Net unrealized appreciation" is the amount by which the fair market value of the securities on the date of distribution exceeds the trustee's basis in the securities.) In the case of a lump-sum distribution, net unrealized appreciation, whether attributable to employer or employee contributions, will go untaxed until a subsequent sale or distribution. Under Code Section 402(j), a transaction will be disregarded for purposes of determining net unrealized appreciation where the trustee disposes of securities of the employer and reinvests the proceeds in securities of the employer within 90 days.

In Private Letter Ruling 200509032, the IRS determined that a corporate transaction will be disregarded for purposes of determining net unrealized appreciation where the trustee disposes of securities of the employer and reinvests the proceeds in securities of the employer at the direction of ESOP participants. The IRS determined that the protections of Section 402(j) applied to the transaction, even though the sale and reinvestment would be done at the direction of participants. Thus, the net unrealized appreciation would be disregarded if the reinvestment occurred within 90 days.

In Private Letter Ruling 200507016, the IRS demonstrated its willingness, in appropriate circumstances, to extend the 90-day reinvestment period by a substantial amount. The situation presented involved a publicly traded company that proposed to spin off stock of a subsidiary, after the subsidiary had completed an initial public offering of stock. The parent company's ESOP would receive shares of the subsidiary's stock in the spin-off. Following the spin-off, the trustee of the ESOP would sell shares of the spun-off subsidiary and reinvest the proceeds in stock of the parent.

The company was concerned that if the ESOP sold the former subsidiary's stock and quickly reinvested the proceeds, this would adversely affect the market price for both the subsidiary's and parent's stock. An investment bank prepared a detailed analysis and concluded that, to avoid a loss of value to the ESOP, the sales and purchases needed to take place over a period of at least 612 days. Based on these facts, the IRS agreed to extend the reinvestment period from 90 days to 612 days in this case. As a result, the sale and reinvestment transactions could occur over a lengthy period without jeopardizing the ESOP's status as an employee stock ownership plan designed to invest primarily in employer securities. Further, the IRS determined that the basis in the stock sold would carry over for purposes of determining net unrealized appreciation.

Calendar of Events

April 20-22, 2005

The National Center for Employee Ownership (NCEO)
NCEO/Beyster Institute Annual Conference
Grand Hyatt San Francisco on Union Square
San Francisco, CA
John Kober will be making a presentation on "Strategic Alternatives for Employee-Owned Companies" and David Ackerman will be presenting on "Advanced ESOP Fiduciary Concerns."

May 4, 2004

Second Annual Wealth Symposium
St. Regis Houston
Houston, TX
Erin Turley will be speaking on the use of ESOPs and family limited partnerships.

May 11-13, 2005

National ESOP Association
28th Annual Conference
Grand Hyatt Washington
Washington, D.C.
John Kober will be making a presentation entitled "Governance," David Ackerman and Erin Turley will be speaking on the subject of recent ESOP fiduciary cases, and Riva Johnson will be doing a regulatory and legislative update.

May 17-19, 2005

The National Hardware Show and Lawn and Garden World
National Hardware Show 2005
Las Vegas Convention Center and Sands Expo and Convention Center
Las Vegas, NV
Brian Hector will be presenting on the benefits of ESOPs for business owners.

June 6-7, 2005

American Institute for Certified Public Accountants
Retirement Planning Conference
Bellagio
Las Vegas, NV
David Ackerman will be speaking on ESOPs.

July 12-14, 2005

Strategic Research Institute
2005 Alternative Investment Roundup
Waldorf Astoria
New York, NY
John Kober will be speaking on the topics "The 1998 Tax Law Change Created Opportunities for Private Equity Groups, Management Groups and Lenders to Use" and "ESOPs – Management-Led Buyouts and Private Equity Group Co-Investment Opportunities."

September 6, 2005

Dallas Area Paralegal Association
Family Law Section
The Belo Mansion
Dallas, TX
Jason Ray will be making a presentation on "ERISA Issues in Family Law."

Per Supreme Court, Employee-Owner Qualifies as Plan Participant Under ERISA

Retirement benefits held by qualified plans are generally protected from claims of creditors and third parties under both ERISA and the Code. With a few exceptions, under ERISA's "anti-alienation" provisions, neither the creditors of the participants nor the creditors of the employer can access benefits or assets of a qualified plan. These exceptions include claims pursuant to qualified domestic relations orders (QDROs), federal tax levies, and judgments against participants who breached fiduciary duties or committed crimes against the qualified plan.

There had been a split in the courts, however, as to whether the owner of a business, who also happens to be an employee, is entitled to have his or her plan benefits protected from creditors. The Supreme Court, in its 2004 decision in *Yates v. Hendon*, 124 S. Ct. 1330 (2004), finally resolved this issue in favor of employee-owners. Yates was the sole shareholder and owner of a professional corporation that maintained a profit-sharing plan for the benefit of Yates, his wife, and at least one other employee. Yates repaid loans that he owed to the profit-sharing plan just three weeks before creditors filed an involuntary petition against him under the Bankruptcy Code. The creditors claimed that these payments were preferential transfers and should be repaid by the plan to the bankruptcy estate. They claimed that ERISA's anti-alienation provisions could not be relied upon to prevent the recovery, because Yates, as sole shareholder, was not an "employee" under ERISA and, accordingly, was not eligible for the protection of ERISA's anti-alienation provisions. The bankruptcy court, the district court, and the Court of Appeals for the Sixth Circuit agreed with the creditors.

On appeal, the Supreme Court rejected the Sixth Circuit's finding that one could not be both an owner-employer and an employee for purposes of ERISA. The Supreme Court specified that the working owner of a business could qualify as a participant in a pension plan covered by ERISA if the plan included one or more employees other than the business owner and his or her spouse. Without even turning to case law, the Supreme Court concluded that the text of ERISA contained specific guidance in Titles I and IV, primarily through negative inference, that working owners could be plan participants. For example, the exemption from Title I for certain deferred compensation plans in which employee-owners participate "would be unnecessary" if working owners could not qualify as participants in ERISA plans. In addition, Title IV does not apply to plans "established and maintained *exclusively* for substantial owners," which implies that it covers plans in which substantial owners participate along with other employees. The Supreme Court went on to state that the lower courts had missed a key point in ERISA – the fact that a working owner may have dual status as an employee and participant and as an employer.

According to the Supreme Court, the lower courts had incorrectly interpreted certain regulations promulgated under ERISA which defined the term "employee" to exclude working owners. The Supreme Court clarified that this definition is only pertinent to the section of the regulations where it appears, relating to whether a plan is without employees, and should not be extended more generally. The Court noted that the intent of Congress to promote uniform treatment of pension benefits was advanced by the Court's interpretation of ERISA. "The working employer's opportunity personally to participate and gain ERISA coverage serves as an incentive to the creation of plans that will benefit employer and non-owner employees alike." The Court also noted that its conclusion corresponded with the Department of Labor's advisory opinion on employee-owners, which views them as qualified participants in ERISA plans.

Yates v. Hendon clearly leaves open the possibility that owner-only plans are subject to creditor risk. In fact, several courts have held that ERISA does not protect plans whose *only* participants are owner-employees. In addition, Department of Labor regulations take the position that plans that cover only partners or sole proprietors are not protected from creditors. Based on the carefully crafted language in *Yates*, which applied ERISA only to plans which cover one or more employees other than the business owner, the Supreme Court would not extend ERISA coverage to plans with only owner-employees as participants.

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