

ESOP Plan Sponsor Held Liable for Issuance of 10-Year Note to Satisfy Repurchase Obligation

June 25, 2009

In a case recently decided by a federal district court in Indiana, *Craig v. Smith*, 2009 WL 438635 (S.D. Ind. Feb. 20, 2009), Ontario Corporation was held to have violated ERISA by issuing a 10-year promissory note in payment for shares that had been credited to the account of a former employee, Charles A. Craig, under the company's employee stock ownership plan (ESOP), as it violated the requirement that the term of any note issued in satisfaction of a terminated ESOP participant's put right could not exceed five years.

Background

In 1999, Craig reached an agreement with the president of Ontario to retire at the end of June 2001. As required by law, and as provided in the ESOP plan document, Craig had both the right to receive his benefits in the form of company stock and the right to sell that stock back to the company at its most-recent appraised value. The stock was appraised twice per year, as of June 30 and as of December 31. Craig became aware of the December 31, 2000 valuation in March 2001. That valuation was the highest at which the stock ever had been valued.

In early 2001, the president of Ontario requested Craig to extend his employment with the company until the end of September 2001, which Craig was willing to do provided that he would be able to sell his ESOP shares at a price equal to their appraised value as of December 31, 2000. The president of Ontario agreed to this and arranged for Craig to apply for an in-service withdrawal. The plan allowed for in-service withdrawals after age 65. Craig applied for an in-service withdrawal in April 2001 and then immediately exercised his right to sell to the company the shares that were distributed to him from his ESOP account. The company issued a 10-year promissory note to Craig in payment for his shares.

In the fall of 2000, Ontario's profits began to decline, and the company eventually defaulted on the ESOP note. It made its last principal payment on December 15, 2003 and its last interest payment on February 15, 2004. After the default, Craig brought an action against both Ontario and the ESOP for benefits due to him and for breach of fiduciary duty.

Claim for Benefits

With respect to his claim for benefits, Craig argued that both Ontario and the ESOP had violated the Internal Revenue Code (the Code) and the plan by issuing a 10-year note without adequate security. With

respect to the alleged failure of the company to provide “adequate security,” the court found that the note provided that it would become due and payable in full if the company defaulted in the payment of any installment due. The court ruled that this constituted adequate security. However, the court went on to find that the ESOP note violated the requirement, set forth both in the Code and in the plan, that the term of any note issued in satisfaction of a terminated ESOP participant’s put right could not exceed five years.

Ontario and the ESOP offered two reasons why the ESOP should not be held to the terms of the plan. First, they argued that Craig waived his right to a five-year note by failing to object to the payment terms when they were proposed to him. The court rejected this argument on the ground that a plan participant may waive rights under ERISA only on a knowing and voluntary basis and that there was no evidence that Craig was aware of the requirement in the plan and in the Code that the term of any note issued to him in payment for his ESOP shares could not exceed five years.

The second argument advanced by the company for allowing the use of the 10-year note was that Craig had not been deprived of any benefits under the ESOP because the note was issued to him as part of a package of retirement benefits that was quite favorable to him. Although the court acknowledged that this argument had some equitable force, it ruled that the ESOP remained bound by the terms of the plan. The court stated that “ERISA does not excuse the violations of Plan terms because of good intentions.” Therefore, the court held that the ESOP was liable to Craig for benefits that he lost as a result of receiving a 10-year note rather than a five-year note.

Claim of Breach of Fiduciary Duty

Craig also brought a claim against Ontario for breach of fiduciary duty. To prove this claim, the court stated that Craig had to establish the following: (1) that the company was a plan fiduciary, (2) that the company breached its fiduciary duty, and (3) that the breach caused harm to Craig.

The court found that the company was a fiduciary because it was the plan administrator. Although the company delegated most of its responsibilities to an ESOP committee, the court stated that the company retained a duty to monitor the ESOP committee and that it failed to do so. In this regard, the court noted that the president, a vice president, and the treasurer of the company were members of the ESOP committee and that they all knew that the ESOP committee was violating the plan and the Code when it approved the issuance of a 10-year note to Craig. The court stated that the ESOP committee members could not “simply forget the information they obtain as ESOP committee members when they are acting as corporate officers.” Although the company’s fiduciary duties were narrower than the duties of the ESOP committee, the company nevertheless violated its fiduciary duty to monitor the ESOP committee when officers of the company knew of the plan’s violation and took no action to correct it. Finally, the court found that Craig had proved that he was harmed by the breach of fiduciary duty. The damages awarded were the difference between what the company paid on the 10-year note and what it would have paid on a five-year note if it had ceased payment at the same time.

If you have any questions or would like further information on the ESOP issues discussed in this case, please contact any one of the following Morgan Lewis attorneys:

Chicago

David Ackerman

312.324.1170

dackerman@morganlewis.com

Theodore M. Becker

312.324.1190

tbecker@morganlewis.com

Brian D. Hector

312.324.1160

bhector@morganlewis.com

Elizabeth S. Perdue	312.324.1180	eperdue@morganlewis.com
Louis L. Joseph	312.324.1726	louis.joseph@morganlewis.com

Dallas

Riva T. Johnson	214.466.4107	riva.johnson@morganlewis.com
John A. Kober	214.466.4105	jkober@morganlewis.com
Erin Turley	214.466.4108	eturley@morganlewis.com

Los Angeles

Scott E. Adamson	213.612.7365	sadamson@morganlewis.com
------------------	--------------	--

San Francisco

Marc R. Baluda	415.442.1399	mbaluda@morganlewis.com
Nicole A. Diller	415.422.1312	ndiller@morganlewis.com
D. Ward Kallstrom	415.422.1308	dwkallstrom@morganlewis.com

Washington, D.C.

Gregory C. Braden	202.739.5217	gbraden@morganlewis.com
Daniel L. Hogans	202.739.5510	dhogans@morganlewis.com
Gary B. Wilcox	202.739.5509	gwilcox@morganlewis.com

About Morgan, Lewis & Bockius LLP

Morgan Lewis is an international law firm with more than 1,400 lawyers in 22 offices located in Beijing, Boston, Brussels, Chicago, Dallas, Frankfurt, Harrisburg, Houston, Irvine, London, Los Angeles, Miami, Minneapolis, New York, Palo Alto, Paris, Philadelphia, Pittsburgh, Princeton, San Francisco, Tokyo, and Washington, D.C. For more information about Morgan Lewis, please visit www.morganlewis.com.

IRS Circular 230 Disclosure

To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein. For information about why we are required to include this legend, please see <http://www.morganlewis.com/circular230>.

This LawFlash is provided as a general informational service to clients and friends of Morgan, Lewis & Bockius LLP. It should not be construed as, and does not constitute, legal advice on any specific matter, nor does this message create an attorney-client relationship. These materials may be considered Attorney Advertising in some states.

Please note that the prior results discussed in the material do not guarantee similar outcomes.

© 2009 Morgan, Lewis & Bockius LLP. All Rights Reserved.