

Morgan Lewis

Managing an ESOP Company in  
Challenging Economic Times

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Steps to Avoid Litigation & How  
to Proceed if Avoidance Fails

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# Overview

- Legal Environment
- Types of Claims
- Best Practices to Avoid Litigation/Defend Claims
- When a Lawsuit is Filed

# Legal Environment

- Private Lawsuits
  - Private actions likely to increase
  - Plaintiffs must report lawsuits to Department of Labor (DOL)
- Government Investigations
  - Department of Labor/IRS audits/investigations
  - Disgruntled employees/plan participants may file complaints with DOL

# Legal Environment

- Who gets sued?
  - **Fiduciaries**
    - Trustee
    - Fiduciary Committees (and members)
    - Appointing Fiduciaries
    - Functional Fiduciaries
  - **Recordkeeper**
  - **Other Service Providers**

# Types of Claims

- Civil Litigation
  - Participant Claims
  - Trustee Claims
  - DOL/IRS Claims
- Criminal Actions-DOL has criminal task force

# Types of Claims

- ESOP Transaction Claims
  - Prohibited Transactions
- Valuation Claims
  - Trustee approves valuations that turn out to be wrong
  - Stock declines in value
- Misrepresentation/Omission Claims
  - Plan fiduciaries knew or should have known about the circumstances adversely affecting the company, and breached their fiduciary duty by affirmatively misleading or failing to warn plan participants of risks.

# Types of Claims

## Department of Labor Actions:

- Broad subpoena and investigatory powers
- Standing is not an issue
  - ERISA grants Secretary of Labor standing to sue
- Can lead to criminal indictments in addition to civil penalties
  - Willful violation of ERISA reporting and disclosure requirements – up to \$5,000 in fines per individual, \$100,000 for any other entity, and possible 1 year imprisonment
  - Knowingly making false statements or concealing or failing to disclose any fact needed to prepare ERISA reports - \$10,000 fine, 5 years imprisonment, or both
- Statute of Limitations
  - May be suspended under Tolling Agreement

# Types of Claims

## Remedies:

- Recovery of money due Plan
- Equitable remedies
- Attorney fees
- Statutory penalties
  - \$110/day for reporting violations
  - 502(l) penalty for fiduciary breach; 20% of recovery amount
- DOL often seeks removal of trustees and bar orders
- Report to IRS

# Best Practices to Avoid Litigation/Defend Claims

- More formalized corporate governance structures to eliminate possible conflicts of interest
- Outside directors
- Independent trustees/fiduciaries
- Proactive management and monitoring
- Board committees to delineate roles and responsibilities
  - Audit, Compensation, Corporate Governance, ESOP, Investment and Nomination

# Best Practices to Avoid Litigation/Defend Claims

- Counseling and Advice
  - Attorneys
  - Financial Advisors
  - Valuation Advisors
  - Third-Party Administrators
  - Compensation Consultants
  - Independent Fiduciary

# Best Practices to Avoid Litigation/Defend Claims

- Communication
  - Communication among Board of Directors, management, and fiduciaries
  - Consultation with legal counsel and other advisors
  - Accurate and timely communications with employees/plan participants

# Best Practices to Avoid Litigation/Defend Claims

- Properly Appoint Fiduciaries
  - Carefully evaluate candidates and document the selection process
  - Verify that candidates' qualifications are consistent with their duties
  - Require that those to whom legal responsibility has formally been delegated assume an active role and exercise that responsibility
  - Provide training to internal fiduciary candidates

# Best Practices to Avoid Litigation/Defend Claims

- If you are an Appointed Fiduciary – Know your Fiduciary Duties
  - Follow the Plan documents
  - Avoid:
    - Conflicts of Interest
    - Self-Dealing
  - Prudent investment of Plan assets
  - Proper disclosure to participants

# Best Practices to Avoid Litigation/Defend Claims

- Monitor Fiduciaries
  - Appointing fiduciaries should communicate with appointed fiduciaries and monitor their actions
    - Performance
    - Fees and costs
    - Significant events
    - Replace non-performing fiduciaries

# Best Practices to Avoid Litigation/Defend Claims

- Properly utilize committees
  - **ESOP Committee – Consider “baking” plan administration into the plan document**
    - If the ESOP Committee is the Plan Administrator, the ESOP Committee should administer the plan
  - **Investment Committee**
    - Consider committee members - non-officers and non-board members
    - Confirm and monitor compliance with investment policy
    - Work with independent fiduciary with respect to company stock

# Best Practices to Avoid Litigation/Defend Claims

Valuation - Know the requirements

- “Fair Market Value”
- The Trustee is the responsible party for setting value
- Proper Process:
  - Review the report
  - Ask questions
  - Review the valuation approach(es)
  - Review and question methodology used to determine value
  - Document the review process

# Best Practices to Avoid Litigation/Defend Claims

- Results versus Process (“Prudence, not Prescience”)
  - Courts are increasingly concerned with Process
  - Proof of process is often the key component of a winning case
    - “Fair market value” a matter of opinion – a good faith determination is required
    - Investigation
    - Prudent Process vs. End Result

# Best Practices to Avoid Litigation/Defend Claims

- Document the Process
  - Document all decisions, including steps taken to make decisions (prudent process)
  - Develop and follow written investment policy
  - Develop and follow written distribution policy
  - Take minutes of meetings

# Best Practices to Avoid Litigation/Defend Claims

- Protecting ERISA Fiduciaries
  - “Hold Harmless” provisions are void under ERISA
  - Indemnification agreements can be valid if properly structured and drafted
- Indemnification Agreements
  - Review structure
  - Review parties
  - Review legal fee advancement provisions
  - Review limitations
  - Review Board authorization

# Best Practices to Avoid Litigation/Defend Claims

- Protecting ERISA Fiduciaries
  - Verify that the Plan has the proper ERISA-required Fidelity Bond to protect against theft of assets
  - Fiduciary Liability Insurance
    - Review policy for named insureds, coverage gaps and restrictions, dollar limitations, etc.
      - Purchased by:
        - » Plan (proper recourse is required!)
        - » Employer/Plan Sponsor
        - » Fiduciary

# When a Lawsuit is Filed

- Contact Attorney Immediately
- Check Insurance Coverage
  - Promptly notify insurance carrier of claim/suit
- Issue Litigation-Hold Memorandum
- Consider Jurisdiction/Venue Issues
- Consider Statute of Limitations
- Special Issues – Multiple Defendants
- Communications Issues

# Questions?

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