Morgan Lewis on ESOPs

A NEWSLETTER FROM THE ESOP TEAM AND THE EMPLOYEE BENEFITS PRACTICE ■ www.morganlewis.com

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IRS Issues Proposed Regulations Denying Deduction for Redemption of Stock Held by an ESOP

On August 24, 2005, the IRS issued proposed regulations that confirm the IRS's position that payments in redemption of stock held by an ESOP are not tax deductible. These proposed regulations are the IRS's latest response to an issue that has been a subject of disagreement between the IRS and the Ninth Circuit Court of Appeals. The proposed regulations also provide guidance on deductions for dividends paid on securities which are not securities of the employer sponsoring the ESOP.

Section 404(k) of the Internal Revenue Code permits a C corporation to take tax deductions for dividends paid on shares held by an ESOP, if the dividends are paid or distributed to participants in the ESOP. Some corporations have taken the position that redemption payments on stock held by an ESOP should also be treated as deductible dividends under Section 404(k). Their argument was that the redemptions were essentially equivalent to dividends because they did not result in a "meaningful reduction" of an ESOP's overall interest in the company whose stock was being redeemed. This argument was rejected by the IRS in its Revenue Ruling 2001-6, but was upheld by the Ninth Circuit Court of Appeals in the 2003 case of *Boise Cascade Corp. v. United States*. The IRS has repeatedly condemned such deductions and has stated that it believes the *Boise Cascade* case was incorrectly decided.

In issuing the proposed regulations, the IRS is now formally rejecting the *Boise Cascade* decision. The proposed regulations expressly state that (1) no deduction will be allowed for any amount paid by a corporation to reacquire its stock, and (2) treating such payments as dividends constitutes an avoidance or evasion of taxation. The proposed regulations will go into effect on the date they are published as final regulations in the *Federal Register*. However, the IRS made it clear that before the regulations become effective, the IRS will continue to challenge such deductions in cases outside the Ninth Circuit.

Another issue addressed by the proposed regulations arises from the fact that an ESOP may be maintained for the benefit of employees of more than one corporation, and may hold stock of a number of corporations within the same controlled group. For example, an ESOP sponsored by a U.S. subsidiary of a foreign parent may hold stock of the parent as well as of the subsidiary. When dividends are paid on the parent corporation's stock to the benefit of employees of the subsidiary, the question arises as to whether the parent or the subsidiary would be entitled to take the deduction. In one 2002 private letter ruling (P.L.R. 200237036), the IRS had permitted a U.S. subsidiary to take the deduction for dividends paid to the ESOP on the parent's stock. However, the proposed regulations reverse this position, and make it clear that only the payor of the dividend may take the deduction, regardless of whether employees of multiple corporations benefit under the ESOP.

Comments to the proposed regulations may be submitted until November 23, 2005. ■

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Recent Cases Demonstrate a Growing Split Among Federal Courts

on the Right of Participants in Individual Account Plans to Recover Losses from Fiduciary Breaches

Recent court decisions illustrate the growing split among federal courts on whether participants in individual account plans, such as Section 401(k) plans and ESOPs, can sue as a class on behalf of the plans to recover for fiduciary breaches when the breaches affect only certain accounts within the plans.

In the case of *Fisher v. J.P. Morgan Chase & Co.*, decided on August 25, 2005, the U.S. District Court for the Southern District of New York held that Section 401(k) plan participants could not maintain a class action against plan fiduciaries for breach of their fiduciary duties. The plaintiffs alleged that the company and its plan fiduciaries breached their duties by imprudently investing in company stock and negligently supervising plan managers. However, the judge found that the participants did not have standing to sue for damages on behalf of the plan, because the damages sought would benefit certain individual participants rather than the plan as a whole. According to the court, the plaintiffs were "not suing to recoup plan assets, but rather 'to recover benefits to which the class members believe they are individually entitled.'" In support of its ruling, the court cited a number of decisions, including the Fifth Circuit case of *Milofsky v. American Airlines, Inc.*

By contrast, the Third Circuit Court of Appeals recently permitted participants in a defined benefit plan to maintain an action on behalf of the plan as a whole, and to seek damages from plan fiduciaries for losses due to fiduciary breaches, even though the alleged violations affected only a subset of the plan participants. In the case of *In re Schering-Plough ERISA Litigation*, the plaintiffs alleged that the company, its directors, and the plan administration committee breached their fiduciary duties by continuing to offer company stock as an investment option when the fiduciaries allegedly knew the stock's value was artificially inflated. In deciding to permit the suit to proceed, the Third Circuit rejected the fiduciaries' argument that the participants were seeking only individualized relief rather than damages for losses to the plan as a whole. The court noted that "while the plan is, indeed, an 'individual account plan,' this does not preclude the plan from having losses," and "[t]he fiduciary's liability is not limited to plan losses that will ultimately redound to the benefit of all participants." The court distinguished and criticized the majority's ruling in the *Milofsky* case.

Given the above split among federal courts, practitioners will be interested in following future developments in the *Milofsky* case, which was decided earlier this year by a three-judge panel, with Chief Judge Carolyn Dineen King dissenting. A petition has recently been granted to have the case reheard by the full panel of the Fifth Circuit. ■

The Delaware Chancery Court Rejects

Shareholders' Claims That Disney's Board Breached Its Fiduciary Duties

On August 9, 2005, the Delaware Chancery Court rejected claims made by Disney's shareholders that members of Disney's board breached their fiduciary duties to shareholders in connection with the hiring and firing of Michael Ovitz one of the founders of the premier Hollywood talent agency, Creative Artists Agency at a cost of $140 million for his 14-month tenure at Disney.

The court was clearly appalled at the manner in which decisions involving Mr. Ovitz were made, and what passed for corporate governance at Disney in the mid-1990s. In one passage, the court is particularly critical of Michael Eisner, then president and board member: "[B]y virtue of his Machiavellian (and imperial) nature as CEO, and his control over Ovitz's hiring in particular, Eisner to a large extent is responsible for the failings in process that infected and handicapped the board's decision making abilities. Eisner stacked his . . . board of directors with friends and other acquaintances who, though not necessarily beholden to him in a legal sense, were certainly more willing to accede to his wishes and support him unconditionally than truly independent directors."

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McKesson Revisited

ESOP Fiduciaries Were Not Required to Divest Plan of Company Stock or Disclose Insider Information

On July 29, 2005, the U.S. District Court for the Northern District of California ruled that members of McKesson Corp.'s board of directors did not breach their fiduciary duties when they failed to divest the company's ESOP of employer stock, despite the fact that they knew of accounting irregularities at the company's merger partner. According to the decision, the board could not be liable for failing to diversify the plan out of company stock, because doing so would have violated insider trading laws.

The case involved an ESOP sponsored by McKesson Corp., which merged with HBOC in January 1999. Before the merger, a due diligence report prepared for McKesson by Deloitte & Touche identified a number of accounting problems at HBOC, including overstatement of revenues and understatement of reserves. Nonetheless, the merger proceeded, and the McKesson plan was merged with HBOC's plan in April 1999. Shortly thereafter, the company made a public announcement about the accounting irregularities, and the McKesson-HBOC stock price dropped sharply. According to the pleadings, the McKesson ESOP lost over $800 million as a result. McKesson employees brought a class action against McKesson, its board of directors and the ESOP trustees, claiming breach of fiduciary duty. In a previous decision in the case, the court had dismissed the first complaint but had indicated that the plaintiffs would be allowed to file an amended complaint to plead additional facts.

In their amended complaint, the plaintiffs claimed that (1) before the merger, the board breached its fiduciary duties by failing to diversify the plan out of company stock and by failing to conduct a fiduciary review of the plan in light of the risks presented by the merger, and (2) after the merger, the board breached its fiduciary duties by not divesting the plan of company stock before the accounting improprieties had been announced to the public.

In rejecting the plaintiffs' claims and dismissing the case, the court applied the "abuse of discretion" standard that had been developed in two other federal district court cases: *Moench v. Robertson* (3d Circuit) and *Kuper v. Ionvenko* (6th Circuit). Under this standard, because ERISA expressly exempts ESOPs from a duty to diversify, a fiduciary's decision to follow the plan and retain investments in company stock enjoys a strong presumption of reasonableness. This presumption can be rebutted by a showing that the fiduciary abused its discretion by following the plan. Specifically, a plaintiff must show that the ESOP fiduciary could not have reasonably believed that continued adherence to the plan was in keeping with the original intent of the plan.

With the *Moench/Kuper* standard in mind, the court dismissed the plaintiffs' claims that the board had violated its fiduciary duty by not divesting the plan of company stock before the merger. The court observed that the merger was "dangerous" and that a reasonable fiduciary should have recognized that the merger "might" cause loss to the plan. However, the court held that a fiduciary's merely knowing there was the possibility of a stock decline is insufficient to establish the fiduciary's imprudence. The case did not present the sort of "deteriorating financial circumstances" required under *Moench, Kuper*, and their progeny.

The court also considered, and rejected, the plaintiffs' claims that the board should have diversified out of company stock after the merger and before the accounting improprieties were announced. The court noted that, if the board members had divested the ESOP of company stock before there was a public announcement of the accounting problems, they would have violated the securities laws' prohibitions against insider trading. The court held that ERISA does not preempt the securities laws, and a fiduciary cannot be liable for failing to diversify when doing so would violate insider trading laws. Other federal court decisions have suggested that, under similar circumstances, a fiduciary should disclose material non-public information. However, the *McKesson* court disagreed with these holdings on public policy grounds. For example, in the case of *In re Enron*, the Texas district court stated that a fiduciary should either disclose the material information to the public, or make selective disclosures to plan participants. However, according to the *McKesson* court, "although this course of conduct complies with the securities laws, it would severely harm plan participants" because it would cause the stock price to drop immediately. Another approach suggested by the *Enron* case selective disclosure to plan participants—was also rejected by the court as contrary to public policy, since it would benefit plan participants at the expense of general shareholders. Finally, the court noted that the plaintiffs would have redress for their claims under the securities laws.

The *McKesson* decision can be seen as offering comfort to ESOP fiduciaries that face the dilemma of trying to comply with both ERISA and the securities laws. However, given the inconsistency among the decisions in this area, a fiduciary's comfort level may well depend on which court ends up hearing the case. ■

New SEC Rules May Benefit Public ESOP Companies

Public ESOP companies may benefit from new rules adopted by the Securities and Exchange Commission on June 29, 2005. The new rules make significant revisions to the registered offering framework under the Securities Act of 1933 and are intended to eliminate unnecessary and outmoded restrictions on registered offerings. The new rules will be most significant for a new category of large, already public companies that will be categorized as "well-known seasoned issuers" or "WKSIs."

The new rules address three main areas: (1) permissible communications before and after the filing of a registration statement, (2) timely delivery of information to investors without imposition of regulatory delays, and (3) improvement of registration and other procedures in the registered offering process.

The new rules relax the prohibition on "gun jumping" —communications viewed as constituting offers made prior to the filing of the registration statement and written communications constituting offers that are made during the waiting period between the date of filing and the date the registration is declared effective. Generally, the new rules allow issuers to make communications before and during the registered offering process and provide safe harbor protections under which communications made at certain times will not be deemed to constitute offers.

The new rules also codify the SEC's interpretation of the Securities Act with respect to liability for information conveyed to an investor. The new rules expressly state that only information conveyed before the time of an investment decision should be taken into account. Information conveyed after the time of the contract sale cannot be used as a defense to liability.

Finally, the new rules eliminate a number of longstanding regulatory requirements that could delay the offering process ("speed bumps"). For example, immediate takedowns from registration statements are permitted. Further, the new rules provide for automatic shelf registration in certain circumstances. A WKSI is eligible for automatic effectiveness on filing.

Blank check, shell and penny stock issuers, delinquent filers, companies with "going concern" audit opinions, issuers that have filed for bankruptcy and issuers that are found guilty of violating the anti-fraud requirements are ineligible under the new rules. ■

Calendar of Events

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 herein, please see www.morganlewis.com/circular230.

September 20, 2005
Webcast on S Corporation ESOPs

National Center for Employee Ownership

David Ackerman's topic during this webcast will be "Legal Issues."

September 21-22, 2005
10th Annual Multi-State ESOP Conference

The New Jersey/New York and Pennsylvania/Delaware Chapters of The ESOP Association
Hilton Scranton Hotel & Conference Center
Scranton, PA
Morgan Lewis is a break sponsor for this event.

September 29-30, 2005
The 2005 California/Western States Chapter Conference

The ESOP Association

Hyatt Grand Champions Resort

Indian Wells, CA

Scott Adamson will be making a presentation on "The Role of Trustees and Fiduciaries as Internal or External Guardians of the Tent."

October 28, 2005
Mississippi Tax Institute

Mississippi Society of Certified Public Accountants

Hilton Jackson

Jackson, MS

Riva Johnson will be making a presentation on ESOPs

November 10-11, 2005
Two-Day Technical Conference

The ESOP Association

Caesars Palace

Las Vegas, NV

David Ackerman's speaking topics will be "General Responsiblities of ESOP Fiduciaries" and "Legal Aspects of Corporate Governance of an ESOP Company." John Kober's topic will be "Capital Market Type of ESOP Transaction," Erin Turley's topic will be on "Fiduciary and Corporate Governance Caselaw Update," and Riva T. Johnson will be presenting on two topics, "Inside Trustee Issues" and "The Legislative, Regulatory and Caselaw Update."

November 16, 2005
Challenges & Solutions for Mature ESOP Companies

The National Center for Employee Ownership

Holiday Inn Costa Mesa

Costa Mesa, CA

Scott Adamson will be making a presentation on "Handling the Repurchase Obligation."

December 1, 2005
2005 AEC Mergers & Acquisitions Summit

ZweigWhite

Palm Beach, FL

The Breakers

Morgan Lewis is a sponsor of this event. John Kober will be making a presentation with John Hommel, Senior Vice President, North Star ESOP & Fiduciary Services, LLP, on "Structures Used to Create Shareholder Liquidity and Implementation of Management Succession Using an ESOP."

The Delaware Chancery Court Rejects
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At the same time, the court emphasized that compliance with fiduciary duties is not always enough to meet or to satisfy what is expected by the best practices of corporate governance. Under Delaware's business judgment rule, directors are protected if they can be shown to have followed proper procedures and did so in good faith. The court concluded that the worst that can be said of Disney's directors is that they may have been guilty of "ordinary negligence," which, the court concluded, is not enough to constitute a breach of fiduciary duty.

The court did not dispute that the decisions to hire and fire Mr. Ovitz were poor ones. But, the court noted that even where decision makers act as faithful servants, the wisdom of their judgments will vary. The redress for failures that arise from faithful management must come from the markets and not from the court. Otherwise, "the entire advantage of the risk-taking, innovative, wealth-creating engine that is the Delaware corporation would cease to exist, with disastrous results for shareholders and society alike." ■

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