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## MALPRACTICE CLAIMS MAY BE BROUGHT IN STATE COURT AGAINST FIRM THAT ALLEGEDLY UNDERVALUED STOCK HELD IN ESOP

In a recent ruling that could have an impact on professional service providers within the ESOP community, a federal district court magistrate held that ERISA does not preempt a state law claim for professional malpractice brought against a firm that provided valuations for an ESOP.

### BACKGROUND

Ameritas Investment Corp. valued the stock of Clark Brothers Transfer, Inc. in connection with the termination of Clark Brothers' ESOP. Based on the valuation price, all company stock held in the ESOP was redeemed and the ESOP was terminated. Within a year, the company was sold for a price substantially higher than the amount paid to the ESOP participants in the redemption.

Two plan participants filed suit in state court against Ameritas for professional malpractice, negligent misrepresentation, and breach of contract, alleging that Ameritas had rendered opinions that significantly undervalued the company stock held by the ESOP. Ameritas removed the case to federal court on the ground that the claims were preempted by ERISA. The plaintiff plan participants filed a motion to remand the case to state court.

### THE COMPLETE PREEMPTION DOCTRINE

Under the complete preemption doctrine, a state law claim can be converted

into a claim under federal law if it can be shown that a federal statute has so completely covered the subject matter area in question that all claims should be deemed to fall only under the federal statute. When such preemption is established, the claim can be removed from state court to federal court, federal court procedures will apply instead of state court procedures, and the legal standards under the applicable federal statute will be applied instead of state law standards.

### ERISA AND FEDERAL PREEMPTION

The magistrate applied a three-prong test to determine whether the complete preemption doctrine should apply in this case: (1) whether the plaintiff has standing under ERISA Section 502(a) to pursue its claim; (2) whether the claim falls within the scope of an ERISA provision that the plaintiff can enforce under Section 502(a); and (3) whether the claim requires an interpretation of the ESOP plan.

The magistrate found that the first prong of the test had been met, because the plaintiffs, as participants in the ESOP, had standing to assert claims under ERISA.

The second prong of the test, however, was not met, according to the magistrate. In analyzing the second prong, the magistrate focused on the scope of ERISA Section 502(a)(2), which allows a participant or beneficiary to seek relief against a plan fiduciary for losses to the plan caused by breach of a fiduciary duty owed to the plan. The magistrate stated that

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“in every case charging breach of fiduciary duty under ERISA, the threshold question is not whether the actions of some person employed to provide services under a plan adversely affected a plan beneficiary’s interest, but whether that person was acting as a fiduciary when committing the alleged acts set forth in the complaint” (citing the United States Supreme Court’s decision in *Pegram v. Herdrich*).

The magistrate held that the complaint did not support a claim against Ameritas for breach of fiduciary duty owed to the plan, because Ameritas was not a plan fiduciary. Ameritas was hired to provide stock valuation opinions to the ESOP’s Administrative Committee. Ameritas did not manage or administer the plan, or invest assets for or render investment advice to the plan, and it was not responsible for providing information to or maintaining the records of plan participants and beneficiaries.

The plaintiffs’ claims also failed the third prong of the magistrate’s preemption test, because resolving the claims would not require the magistrate to interpret the terms of the ESOP. According to the magistrate, this test requires more than a “tenuous, remote or peripheral” relationship between the plan and the plaintiffs’ claims. The plaintiffs had not alleged that any specific term of the plan had been violated,

or that the terms of the ESOP defined how the stock should be valued or what method of valuation should be used. Accordingly, under the allegations of the plaintiffs’ complaint, there was a state common law duty of care regardless of whether the malpractice involved an ERISA plan, and as such the duty of care did not depend on ERISA in any way.

The magistrate, having ruled that the state law claims were not preempted, remanded the case to state court.

### IMPLICATIONS OF THE DECISION

This decision – finding that ERISA does not preempt state law claims of professional malpractice against a firm providing valuations for an ESOP – has important implications for the ESOP community. There are a number of substantive and procedural differences between state and federal claims and courts. For example, in state court, common law claims of negligence and breach of contract are often tried by a jury, whereas ERISA does not permit jury trials. Moreover, the standard of care and burden of proof, as well as the type and extent of permissible damages, are often different under state law and under ERISA.

The magistrate’s decision in this case may be subject to challenge. In support of its arguments for preemption,

Ameritas cited the U.S. Supreme Court’s recent decision in *Aetna Health Inc. v. Davila*. In that case, plan participants had brought state tort claims against ERISA plan administrators for wrongfully denying them medical coverage under certain benefit plans. The Supreme Court found that any right to recovery under those benefit plans was derived entirely from the rights and obligations established by the plans themselves, and held that the participants’ suits were completely preempted by ERISA.

Ameritas argued that the *Aetna* decision clearly holds that ERISA Sections 502(a)(1)(B) and (a)(2) not only delineate the recovery available against the plan and its fiduciaries, but also eliminate recovery for those losses from any other defendants, including non-fiduciary service providers. According to this argument, since the plaintiffs could have pursued recovery for their losses against the ESOP, its plan administrators, and its fiduciaries under ERISA Section 502(a), their claims against Ameritas should have been completely preempted by ERISA. The Ameritas magistrate rejected this argument, and found that the claims were not preempted. However, the magistrate’s order has been stayed pending review by the federal district court, so it remains to be seen whether this decision will stand.

## NO BREACH OF FIDUCIARY DUTY IN MERGING TWO ESOP PLANS

In a recent case involving the merger of two ESOP plans, the U.S. District Court for the District of New Jersey held that plan fiduciaries did not breach their fiduciary duties in allowing the merger, despite allegations that the merger caused some participants’ rights to be diluted.

### THE LAWSUIT

The case involved a leveraged ESOP sponsored by Herzog, Heine, and Geduld, Inc. (“HHG”), a privately held NASDAQ market maker. Under the terms of the ESOP and related agreements, HHG was required to make contributions to the ESOP, and the ESOP in turn used those funds to repay

the loan that the ESOP had taken to purchase the HHG stock. As the ESOP repaid its debt, HHG shares would be released from a suspense account and allocated into participants’ accounts. Unallocated shares would continue to be held in the suspense account.

In July 2000, in response to a tender offer, the ESOP trustee sold the ESOP’s

## NO BREACH OF FIDUCIARY DUTY IN MERGING TWO ESOP PLANS

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stake in HHG to Merrill Lynch. In exchange, the ESOP received shares of Merrill Lynch worth approximately \$354 million. The allocated and unallocated HHG shares were converted into allocated and unallocated Merrill Lynch shares, and the unallocated shares continued to be held in a suspense account. At the time of the acquisition, close to 27% of the ESOP's holdings remained unallocated.

Following the acquisition, Merrill Lynch merged the HHG ESOP into the Merrill Lynch ESOP and announced that the Merrill Lynch ESOP would allocate any future releases of Merrill Lynch shares to all participants in the Merrill Lynch ESOP, including to Merrill Lynch employees who had never worked for HHG. Thus, unallocated Merrill Lynch shares that were previously held in the HHG ESOP were dispersed to a wider pool of employees than if the merger had not occurred, essentially diluting the number and value of shares that would have gone to the HHG employees had the merger not taken place.

The plaintiffs in the case were former employees of HHG and participants in the HHG ESOP. They filed an action against HHG, certain executives who had been trustees of the ESOP, and the current ESOP trustee, claiming that HHG and the HHG executives had breached their fiduciary duties in negotiating and approving the Merrill Lynch merger without safeguarding HHG employees' rights to the unallocated shares. They also claimed that the ESOP trustee had breached its fiduciary duty by tendering the ESOP's

shares without first attempting to prepay the loan so as to allocate to HHG employees any HHG shares that remained unallocated.

### THE COURT'S DECISION

The court granted summary judgment in favor of the defendants on the basis that the plaintiffs were not entitled to either monetary damages or equitable relief under ERISA. With regard to the claim for monetary damages, the court (following Supreme Court and other precedents) ruled that in order to state a claim for monetary recovery for breaches of fiduciary duty under ERISA Section 409, plaintiffs must demonstrate a "loss to the plan" and this loss must inure to the plan as a whole, rather than to individual beneficiaries or a subclass of beneficiaries. In this case, however, the plan sustained no loss resulting from the merger. All HHG shares held by the ESOP, whether allocated or unallocated, were converted into Merrill Lynch stock.

In their claims for equitable relief, the plaintiffs had asked the court to either reallocate to the accounts of all HHG plan participants the value of the unallocated shares or award money damages in lieu of equitable restitution. However, the court ruled that the plaintiffs were not entitled to either form of relief. The Supreme Court has held that equitable restitution under ERISA Section 502(a)(3) is available where "money or property identified as belonging in good conscience to the plaintiff could clearly

be traced to particular funds or property in the defendant's possession." In this case, however, the court found that the plaintiffs had no vested right to the unallocated shares held in the suspense accounts, because those shares were not accrued benefits protected under ERISA. Accordingly, the plaintiffs could not show that the defendants were in possession of something that rightfully belongs to the plaintiffs, and thus could not support a claim for equitable restitution or monetary damages for loss of the shares.

The court, in ruling that the plan had not experienced a loss resulting from the merger, observed that the plaintiffs had not contended that the HHG shares were of greater value than what the ESOP received for them. Had this been the case, the result may have been different, because there would have been a demonstrable loss to the ESOP. The court was impressed by the fact that the plan as a whole gained significantly as a result of the merger transaction. While it recognized that the plaintiffs were "angry that they . . . must now 'share,' for lack of a better term, the unallocated shares with employees never employed by HHG," the court held that that had no bearing in determining liability under ERISA.

## SEC NO-ACTION LETTER ISSUED REGARDING COMPANY'S STOCK TRADING PROGRAM

On October 20, 2005, the Securities and Exchange Commission issued a favorable no-action letter in connection with a proposed stock sale and repurchase plan for TEOCO Corporation, an employee-owned company. The TEOCO plan would establish a limited trading market in company stock in order to provide liquidity for employees who own company stock and to provide other employees with the opportunity to acquire additional shares. While the plan did not involve an ESOP, some aspects of the plan and the SEC's response will be of interest to ESOP companies.

Under the plan, buy and sell orders from employees would be matched up twice a year during a specified window of time, a price would be determined based on an independent valuation, and all sales and purchases would be effected through the company. A number of protections were built into the plan, including eligibility requirements for participants, caps on the number of shares that can be sold, and provisions to ensure that participating employees receive complete information on which to base their investment decisions.

The no-action letter indicates that the SEC will not recommend enforcement action with respect to the TEOCO plan under the securities laws relating to broker-dealers, despite the fact that neither the company nor its employees or directors will be registered as broker-dealers. The SEC's letter does not address any other aspect of the securities laws, such as

whether the proposed transactions meet the requirements for exemption from registration under the Securities Exchange Act of 1934.

As ESOP companies have sought to provide more liquidity within ESOP plans, various versions of this type of "internal market" have been considered. While no-action letters are not legal precedent, this no-action letter provides a certain level of comfort to companies considering such plans, at least with respect to broker-dealer issues. As always, however, a word of caution is in order. Any company that is considering adopting an ESOP should be sure to obtain a federal and state securities law analysis of each particular transaction structure. Whether a specific transaction is structured in compliance with the securities laws will depend on all the facts of the particular transaction, including but not limited to the dollar amount involved, the sources of financing (including whether transfers are to be made from participants' 401(k) accounts), the total value of the business being acquired, the qualifications of individual investors, whether debt or equity securities are involved, the states in which investors reside, and other transactions that have occurred in the past or are anticipated to occur in the future.

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