

MAY 2005

COMMENTS PRESENTED AT IRS HEARING ON RULE 409(P) REGULATIONS

In the January 2005 issue of *MORGAN LEWIS ON ESOPs*, we discussed the IRS's new temporary and proposed regulations relating to Section 409(p) of the Internal Revenue Code (Code), which were issued in December 2004 (the "New Regulations"). At a public hearing held by the IRS on April 20, 2005, The ESOP Association presented its comments and proposals relating to the New Regulations, covering a number of areas of concern to ESOP-owned companies and ESOP practitioners.

The provisions of Code Section 409(p) are designed to eliminate the use by S Corporations of ESOPs that have only one or a few participants. Under this Code section and its regulations, an ESOP that holds shares of an S corporation is prohibited from accruing benefits for, or allocating benefits to, certain persons who are identified as "disqualified persons" during any "non-allocation year." Definitions of the terms "disqualified person" and "non-allocation year" are contained in the statute, and are expanded upon in the New Regulations. If a company violates Section 409(p), it will be subject to an excise tax equal to 50% of the amount of the prohibited allocation.

In its comments, The ESOP Association commended the efforts made by the IRS and the Treasury Department to eliminate abuses by companies that purportedly use ESOPs to improperly avoid the

payment of taxes. However, The ESOP Association noted that further clarification and guidance are needed so that taxpayers can effectively comply with Section 409(p).

For example, the New Regulations include a new defined term – "impermissible accrual" – which appears to have the effect of imposing multiple penalties for a single stock allocation in violation of Section 409(p). Under the temporary regulations previously in effect, penalties would only be imposed if stock were allocated to a disqualified person's account during a nonallocation year. Allocations made during previous years would not be taken into account. However, under the New Regulations, Section 409(p) would be violated if a disqualified person had any stock in his or her account during a nonallocation year, including any stock that had been allocated in prior years. The new provision would thus appear to impose a double penalty on the first nonallocation year, and to repeatedly impose a penalty for every year thereafter. The ESOP Association noted that this result did not appear to be intended by the statute.

In its comments, The ESOP Association also recommended that the New Regulations be revised to permit certain corrective transfers to take place automatically in order for an ESOP-owned company to avoid a violation of Section 409(p). Under the temporary

(continued on page 2)

IN THIS ISSUE

- 1 COMMENTS PRESENTED AT IRS HEARING ON RULE 409(P) REGULATIONS
- 2 COURT DISMISSES EMPLOYEE'S CLAIM THAT FIRM'S STOCK WAS AN IMPRUDENT INVESTMENT
- 3 PASS-THROUGH VOTE MAY BE REQUIRED FOR SUBSIDIARY ASSET SALES

CALENDAR OF EVENTS

Morgan Lewis

C O U N S E L O R S A T L A W

MORGAN LEWIS ON ESOPs

© 2005 Morgan, Lewis & Bockius LLP.
All Rights Reserved.

This newsletter is provided as a general informational service to clients and friends of Morgan, Lewis & Bockius LLP. It should not be construed as imparting legal advice on any specific matter.

COURT DISMISSES EMPLOYEE'S CLAIM THAT FIRM'S STOCK WAS AN IMPRUDENT INVESTMENT

The U.S. District Court for the Northern District of California dismissed a lawsuit filed by a former employee against Calpine Corp., its board of directors and members of the company's retirement plan administrative committee (*In re Calpine Corp. ERISA Litigation*, N.D. Cal., No. C-03-1685 SBA). The lawsuit, brought by a former employee, alleged that the company, the board and the plan administrative committee breached their fiduciary duties by failing to prudently and loyally manage plan assets and allowing employees to invest their retirement plan assets in the company's stock. The court dismissed the lawsuit on March 31, 2005.

In dismissing the lawsuit, Judge Armstrong found that the plaintiff had

failed to overcome the presumption that investment in Calpine stock was prudent. According to the court, Calpine's financial statements demonstrated that the company was a viable concern and did not show the "deteriorating financial circumstances" that are required to rebut the presumption of prudence.

The former employee also alleged that the defendants breached their disclosure duties under ERISA by misrepresenting Calpine's finances in news releases, bond prospectuses and other unidentified "public filings." The court stated: "These allegations fail as a matter of law because there is no general fiduciary duty of disclosure under ERISA. To the extent an affirmative duty of disclosure exists under ERISA, it is limited to the

disclosure of information about the plan, plan benefits, or plan expenses."

While the court dismissed most of the lawsuit's claims, it gave the plaintiff permission to file an amended complaint within 30 days to address whether the defendants breached their fiduciary duties under ERISA by making affirmative misrepresentations to the plan participants about Calpine stock. The court agreed with the plaintiff that Calpine and the administrative committee were ERISA fiduciaries. At the same time, the court held that members of the board of directors were fiduciaries only to the extent that they had power to appoint members of the administrative committee. ■

COMMENTS PRESENTED AT IRS HEARING ON RULE 409(p) REGULATIONS

(continued from page 1)

regulations previously in effect, many ESOPs included "fail safe" provisions that were designed to ensure that the plans did not violate Section 409(p). Under these provisions, in order to prevent a nonallocation year from occurring, excess shares would automatically be transferred out of the ESOP to the non-ESOP portion of the plan. Under the New Regulations, however, these types of "fail safe" provisions would no longer be effective. The ESOP Association submitted that these types of automatic transfers should be allowed. Because the transferred balances would be subject to unrelated business income tax, there should not be a concern about automatic reallocations not being implemented in practice.

The ESOP Association also urged the IRS to reconsider the provisions of the New Regulations that would terminate the status of a plan as an ESOP in the event of a Section 409(p) violation. The association noted that this represents a severe penalty that would hurt employees, and recommended that a voluntary correction program be implemented instead.

It remains to be seen whether, and how, the IRS will respond to these comments on the New Regulations. In the meantime, ESOP companies and practitioners should review their plans to make sure that they are in compliance, and consider taking remedial steps prior to July 1, 2005, as provided in the New Regulations. ■

MORGAN LEWIS ON ESOPs www.morganlewis.com

EDITORS

JOHN KOBER 214.438.1552
JKOBER@MORGANLEWIS.COM

DAVID ACKERMAN 312.324.1170
DACKERMAN@MORGANLEWIS.COM

ELIZABETH PERDUE 312.324.1180
EPERDUE@MORGANLEWIS.COM

JOSEPH RONAN 215.963.5793
JRONAN@MORGANLEWIS.COM

Morgan Lewis
C O U N S E L O R S A T L A W

PASS-THROUGH VOTE MAY BE REQUIRED FOR SUBSIDIARY ASSET SALES

Companies, both public and private, often own their assets and operate their businesses through subsidiaries. In such a situation, the parent company is merely a holding company that derives income through its equity ownership in its subsidiaries, and not as a direct result of owning the operating assets. If the operating assets held by a subsidiary are sold, the question arises as to what level of approval is needed for the sale: can the asset sale be approved merely by the holding company itself, or must the shareholders of the holding company also approve the transaction? In the context of an ESOP that owns a holding company, the answer to this question will affect whether a pass-through vote

to participants is required for a subsidiary asset sale.

The decision by the Delaware Court of Chancery in *Hollinger Inc. v. Hollinger International, Inc.* offers some guidance on this issue for Delaware corporations. Section 271 of the Delaware corporation statute provides that a sale of substantially all of a company's assets must be approved by that company's shareholders. Read literally, this section appears to provide that, if a subsidiary's assets are sold, only the approval of the parent would be required, and not the approval of the parent's shareholders. However, the *Hollinger* decision suggests that, in certain circumstances, it may not be possible to rely on such a technical

interpretation of the statute. Rather, the court in this case treated the subsidiary's assets as those of the parent. Had these assets represented substantially all of the assets of the consolidated group, then approval of the parent's shareholders would have been required.

The *Hollinger* case involved a parent company, Hollinger International, Inc., which entered into an agreement to sell the assets of its indirect, wholly owned subsidiary, Telegraph Group Ltd. The subsidiary published the *Telegraph*, a leading newspaper in the United Kingdom in terms of both circulation and journalistic reputation. A stockholder of the parent commenced a suit

(continued on page 4)

CALENDAR OF EVENTS

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."

PASS-THROUGH VOTE MAY BE REQUIRED FOR SUBSIDIARY ASSET SALES

(continued from page 3)

in the Court of Chancery seeking to enjoin the sale on the grounds that the stockholders of the parent had the right to vote on the sale because, although held by the subsidiary, the *Telegraph* constituted all or substantially all of the assets of the parent on a consolidated basis. Hollinger argued that no vote of the parent was necessary, because the sale involved assets owned by the subsidiary and not the parent.

The court refused to decide the matter on the grounds of the technical statutory interpretation. Instead, it treated the assets of the subsidiary as if they were owned directly by the

parent. In reaching this conclusion, the court was persuaded by the “obvious reality” that the sale process was directed and controlled by the parent. After deciding to treat the assets of the subsidiary as those of the parent for purposes of the stockholder vote issue, the court decided that the *Telegraph* assets did not constitute substantially all of the assets of the parent, and, therefore, that no vote of the parent’s stockholders was required.

A holding company engaged in the sale of the assets of its subsidiary should carefully analyze applicable state corporate law to determine

whether approval must be sought from the shareholders of the parent company. This analysis should consider not only the appropriate corporate statute, but also applicable judicial precedent (such as the *Hollinger* case for a Delaware corporation). This review may suggest that a vote by the shareholders of the parent corporation is required under state law, for example, where the assets of the subsidiary constitute substantially all of the parent’s assets on a consolidated basis. If that is the case, then a pass-through vote to ESOP participants would be required as well. ■

THE MORGAN LEWIS ESOP Team

David Ackerman	Chicago	312.324.1170	dackerman@morganlewis.com
Scott Adamson	Los Angeles	213.612.7365	sadamson@morganlewis.com
Craig Bitman	New York	212.309.7190	cbitman@morganlewis.com
Brian Dougherty	Philadelphia	215.963.4833	bdougherty@morganlewis.com
John Ferreira	Pittsburgh	412.560.3350	jferreira@morganlewis.com
Brian Hector	Chicago	312.324.1160	bhector@morganlewis.com
Riva Johnson	Dallas	214.438.1557	riva.johnson@morganlewis.com
John Kober	Dallas	214.438.1552	jkober@morganlewis.com
Renee Lewis	Chicago	312.324.1128	rlewis@morganlewis.com
Michael Peipert	Chicago	312.324.1126	mpeipert@morganlewis.com
Elizabeth Perdue	Chicago	312.324.1180	eperdue@morganlewis.com
Jason Ray	Dallas	214.438.1562	jray@morganlewis.com
Joseph Ronan	Philadelphia	215.963.5793	jronan@morganlewis.com
Gary Rothstein	New York	212.309.6360	grothstein@morganlewis.com
Erin Turley	Dallas	214.438.1558	eturley@morganlewis.com
Allison Wilkerson	Dallas	214.438.1560	awilkerson@morganlewis.com