MORGAN LEWIS ON ESOPs

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

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RECENT DOL FIELD GUIDANCE AND WORLDCOM CASE PROVIDE COMFORT TO DIRECTED TRUSTEES

In the last two months, there have been two important developments relating to the liability of directed trustees of ERISA plans, particularly in connection with purchases of publicly traded securities. In December 2004, the U.S. Department of Labor (DOL) issued Field Assistance Bulletin 2004-03 on the subject. Then, on February 1, 2005, a federal district court relied on that bulletin and prior case law to exonerate the directed trustee of WorldCom's Section 401(k) plan. Both the field assistance bulletin and the WorldCom case make it clear that, even though a directed trustee is a fiduciary under ERISA, its fiduciary duties are quite limited, particularly when it comes to decisions about whether to invest in employer securities.

In Field Assistance Bulletin 2004-03, the DOL provided guidance regarding the fiduciary responsibilities of a directed trustee. The DOL noted that where the plan document expressly provides that the trustee is subject to the direction of a named fiduciary, the trustee's fiduciary responsibilities are significantly limited, provided that the directions (a) are made in accordance with the plan's terms and (b) are not contrary to ERISA. In order to determine if a direction is in accordance with the plan's terms, the directed trustee must review all of the plan documents and determine whether the direction is proper. If the terms of the plan documents are ambiguous, the trustee should request — and may rely on — an interpretation from the named fiduciary responsible for interpreting the plan.

The directed trustee may not follow a direction if it is determined to be contrary to ERISA. In this connection, the DOL discussed four situations in the bulletin: (i) prohibited-transaction determinations; (ii) prudence determinations; (iii) the duty to act on inside (nonpublic) information; and (iv) the duty to act on public information.

The DOL stated that a directed trustee must follow processes that are designed to avoid prohibited transactions. This obligation can be satisfied by obtaining representations from the named fiduciary that the plan follows procedures for identifying prohibited transactions.

With respect to prudence determinations, the DOL stated that a directed trustee does not have an obligation to determine the prudence of every transaction. Rather, the named fiduciary has primary responsibility for this. The DOL went on to state that the directed trustee's obligation to question market transactions involving publicly traded stock on prudence grounds also is quite limited. The primary circumstance in which such an obligation could arise is one where the directed trustee possesses material nonpublic information regarding a security. In that case, the DOL's view is that, prior to following a direction that would be affected by the inside information, the directed trustee should inquire about the named fiduciary's knowledge and consideration of the inside information. Finally, the DOL stated in the bulletin that, absent material nonpublic information, a directed trustee rarely will have an obligation under ERISA to question the prudence of a direction to purchase publicly traded securities at the market price. Mere knowledge of speculative media reports, or even knowledge of an investigation, would not constitute sufficient knowledge giving rise to a duty to act. The DOL noted that stock prices fluctuate as a matter of course and therefore "even a steep drop in a stock's price would not, in and of itself, indicate

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that a named fiduciary's direction to purchase or hold such stock is imprudent and, therefore, not the proper direction."

The DOL's field assistance bulletin was very timely, and it proved persuasive to the federal district court in the *WorldCom, Inc. ERISA Litigation* case, decided on February 1, 2005. *WorldCom* involved a class action brought by the participants in WorldCom's Section 401(k) plan. Among other things, the plaintiffs claimed that Merrill Lynch, the directed trustee of the Section 401(k) plan, should have suspended purchases of WorldCom stock when it learned that the SEC was investigating the company. According to the plaintiffs, the directed trustee's failure to act constituted a breach of fiduciary duty. The court disagreed, and granted summary judgment for the directed trustee.

In its decision, the court analyzed the plan documents in detail, and found that Merrill Lynch was subject to the direction of WorldCom, the named fiduciary. In determining what standard applies to directed trustees, the court gave great deference to the guidance contained in the DOL's field assistance bulletin, noting that the bulletin was well reasoned and contained a careful analysis of complex issues. Following the guidance in the bulletin as well as consistent prior case law, the court held that, as a directed trustee, Merrill Lynch was an ERISA fiduciary. However, its fiduciary responsibilities were more limited than those of a discretionary trustee.

According to the WorldCom court (citing the bulletin), a directed trustee rarely will have an obligation to question the prudence of a direction to purchase publicly traded securities at the market price, unless (a) the directed trustee has material nonpublic information, or (b) the directed trustee knows or should know of "reliable public information that calls into serious question the company's short term viability as a going concern." This standard is slightly different from the one set forth in the bulletin—the court applied a "reliable information" standard instead of a "clear and compelling evidence" standard and focused on short-term rather than long-term viability. Applying this standard, the court found that Merrill Lynch was entitled to summary judgment. None of the information possessed by Merrill Lynch rose to the level of seriousness or certainty that would require Merrill Lynch to question the direction it received. For example, the court noted that at the time in question, WorldCom's decline was not out of step with declines suffered by other companies in its industry, and none of the public announcements indicated the impending collapse of the company.

The issuance of Field Assistance Bulletin 2004-03 and the holding in the WorldCom case provide substantial comfort for directed trustees. Numerous "stock drop" cases have been filed under ERISA in recent months. The bulletin and the WorldCom holding establish that neither the DOL nor the courts will impose judgments against directed trustees of employee benefit plans that invest in employer securities merely by reason of a decline in the value of the employer securities, even where the decline is very steep. Directed trustees do not have to second-guess plan fiduciaries that provide directions to invest in publicly traded employer securities and generally have no duty to act on public information. To establish a claim, participants will have to prove that the directed trustee had compelling information calling into serious question the plan sponsor's short-term ongoing viability, which will be a rare circumstance.

Tax-Free Treatment Denied for Failure to Timely File 1042 Election

In the recently decided case of *Estate of Clause v. Commissioner of Internal Revenue,* the Tax Court denied tax-free treatment for a sale of stock to an ESOP, because the taxpayer failed to file a statement of election on a timely basis. The taxpayer sold all of his stock to an ESOP in 1996 for approximately $1.5 million. Under Section 1042 of the Internal Revenue Code, the taxpayer was eligible to elect to defer tax on his gain from the sale, as long as he purchased "qualified replacement properties" within one year of the sale and met certain other procedural requirements, including timely filing an election. The taxpayer filed his 1996 federal income tax return by April 15, 1997, but he did not report the sale of stock to the ESOP on that return and did not include a statement of election pursuant to Section 1042 of the Code with the return. The IRS began an examination of the taxpayer's 1996 tax return in 1999. In 2001, the taxpayer filed an amended tax return for 1996 which included a statement of election under Section 1042, predated to March 4, 1997.

Not surprisingly, the court denied the taxpayer's attempt to make the election on a retroactive basis. The court noted that the taxpayer obviously had failed to comply with the election requirements set forth in the statute, and it rejected the taxpayer's argument that he was entitled to the benefits of Section 1042 because the failure to file the election was "purely administrative in nature." The court also rejected the taxpayer's argument that he had substantially complied with the statute. The court noted that the taxpayer's return for 1996 not only failed to include the election statement, but also reported none of the information required to be provided in the statement. In fact, the return made no mention of the sale at all.

The court observed that the taxpayer had relied upon his accountant in connection with the preparation and filing of his 1996 tax returns and expressed sympathy for the taxpayer's plight. However, the court stated that the duty of filing an accurate tax return cannot be avoided by

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placing responsibility on an agent.

We note that in other situations, the IRS has granted some relief to taxpayers who fail to meet all of the requirements of Section 1042. For example, in Private Letter Ruling 8707016, the IRS granted a taxpayer additional time to file his statement of purchase with respect to qualified replacement properties. However, in that situation, the taxpayer had timely filed his Section 1042 election with his tax return. In the *Estate of Clause* case, by contrast, the taxpayer had not attempted to meet any of the Section 1042 filing requirements in his tax return for the year of the sale.

Trustee Held Liable for Failing to Adequately Investigate Purchase of Employer Securities

In the recently decided case of *Henry v. Champlain Enterprises, Inc.*, an independent ESOP trustee was held liable for $7.75 million in damages in connection with a purchase of employer securities. The plaintiffs were participants in an ESOP sponsored by Champlain Enterprises, Inc. The trustee of the ESOP purchased preferred stock of the plan sponsor for $60 million. The plaintiffs alleged that this purchase constituted a prohibited transaction because the sellers were parties in interest and because the purchase price exceeded fair market value. ERISA prohibits ESOP trustees from purchasing employer securities from parties in interest unless the purchase is for not more than "adequate consideration."

The DOL's regulations interpreting ERISA establish a two-part test for determining "adequate consideration." First, the purchase or sale price must reflect the security's fair market value and, second, this value must result from a determination made by the plan trustee or named fiduciary in good faith. The court in *Champlain Enterprises* stated that the trustee bore the burden of proving both of the elements of the "adequate consideration" defense and that it failed to meet that burden.

The court noted that there were a number of important issues for the trustee to consider in connection with the determination of the value of the preferred stock that it purchased. Although the trustee retained a well-recognized independent appraisal firm to serve as its financial advisor, the court found that the trustee had failed to establish that it had properly evaluated the valuation report. The trustee was not able to present any significant documentation regarding the scope of its analysis of the valuation report and, because the transaction occurred ten years prior to the trial, the trustee's representatives were not able to recall any specific details regarding their conduct in connection with the transaction. Under these circumstances, the court stated that, at best, it could not be answered whether the trustee had properly evaluated the valuation report and, at worst, the trustee had failed to do so. Either way, the court ruled that the trustee had failed to satisfy its burden of proving that it had determined the fair market value of the preferred stock in good faith, which required a reasonable investigation of the valuation report. Therefore, the court ruled that the purchase by the ESOP of the preferred stock was a prohibited transaction under ERISA.

To determine the damages to which the plaintiffs were entitled, the court had to determine the value of the preferred stock purchased by the ESOP. It found neither the trustee's financial advisor nor the plaintiffs' expert witness to be credible. The court noted that the trustee's financial advisor was informed before it commenced its work that the sellers wished to receive $60 million for a 30% interest in the company. Therefore, the court concluded that the financial advisor did not start with an open mind or an independent approach to valuation. The court stated with disapproval that after weeks of favorably reviewing data and making adjustments to the terms of the convertible preferred stock, the financial advisor arrived at the exact price set in the initial offer from the sellers. What the court failed to comprehend, however, was that the financial advisor and the trustee had negotiated substantial enhancements to the rights associated with the preferred stock, which even the plaintiffs' expert acknowledged increased the value of that stock. The court found the plaintiffs' expert to lack credibility because he was hired to make the case for the plaintiffs with as low a valuation as possible. The court then arbitrarily determined that the value of the preferred stock was approximately halfway between the valuations determined by the trustee's financial advisor and the plaintiffs' expert. Ironically, the court gave no explanation

Calendar of Events

February 24-25, 2005
The ESOP Association
7th Annual S Corporation ESOP Seminar
Hyatt Regency, Orlando, FL

David Ackerman will be making a presentation on the topic of "Fiduciary Issues in S Corporation ESOPs." Riva Johnson and John Kober will be participating in a "Corporate Governance in ESOP-Owned S Corporations" panel discussion.

March 18, 2005
The Chicago Bar Association
Employee Benefits Seminar – Part Two
321 S. Plymouth Court, Chicago, IL

David Ackerman will be making a presentation on "ESOPs as a Succession Planning Strategy."

April 12, 2005
The ESOP Association Michigan Chapter Annual Spring Conference
Clarion Hotel and Conference Center
Lansing, MI

David Ackerman will be making a presentation on "The ABC's of ESOPs" and will be participating in an "Ask the Experts" panel discussion.

April 15, 2005
Ohio Employee Ownership Conference
Annual Meeting
Akron Hilton West, Fairlawn, OH

April 20-22, 2005
National Center for Employee Ownership
2005 Annual Conference
Grand Hyatt Hotel, San Francisco, CA

David Ackerman will be making a presentation on "Advanced ESOP Fiduciary Concerns."

May 11-13, 2005
The ESOP Association
28th Annual ESOP Conference
Grand Hyatt Hotel Washington
Washington, DC

of how it arrived at its determination of value and, thus, was guilty of the same lack of documentation for which it condemned the trustee.

The obvious lesson of the *Champlain Enterprises* case is that ESOP fiduciaries should carefully document the procedures they follow in reaching important decisions. In connection with purchases of employer securities, we recommend that ESOP trustees maintain careful notes of their visits to employer plants, of their interviews of officers and other key employees of the employer, and of their meetings with their financial advisors. In addition, we recommend that ESOP trustees that have developed internal review committees or other review procedures keep careful minutes of their meetings or other procedures. ESOP trustees should also demand thorough written reports from both their financial and legal advisors, review the reports carefully and discuss them with their advisors, and maintain written records of these discussions. The court's opinion in the *Champlain Enterprises* case, as well as opinions in other recent cases, make clear that, when it comes to questions regarding the exact scope and nature of a trustee's due-diligence investigation, courts will not take "I don't remember" for an answer.

Exempt Loan May Be Prepaid with Redemption Proceeds, Per IRS

The IRS has issued a private letter ruling stating that an ESOP may use the proceeds of a redemption of stock held in the ESOP's suspense account to prepay an exempt loan. In its ruling, the IRS confirmed that this prepayment would not jeopardize the loan's exemption from the prohibited-transaction rules. In addition, even though the value of the allocated shares would increase as a result of the redemption, this increase would not be considered an "annual addition" for purposes of Internal Revenue Code Section 415(c), and thus the limitations of that section would not apply.

Under PLR 200504040, the IRS reviewed the following fact situation. Company A established an ESOP, and loaned the ESOP funds to purchase shares of Company A stock. The loan was intended to be an exempt loan under the applicable exempt loan regulations. The loan was secured by a pledge of the shares purchased with the loan proceeds, and the pledged shares were held in the ESOP's suspense account. Company A anticipated that the ESOP loan would be repaid through a combination of contributions to the ESOP and dividends on the shares of stock held by the ESOP. At some point after the establishment of the ESOP, Company A elected to be taxed as an S corporation.

Because of decreased demand for the company's products, Company A had to reduce its payroll, resulting in a decrease in the level of contributions that could be made to the ESOP. The company's board of directors determined that it would not be able to pay substantial dividends because the company was not performing well enough. As a result, the level of contributions plus dividends were not expected to be sufficient to meet the loan repayment schedule. The company concluded that it needed to terminate the ESOP, redeem the unallocated shares and use the proceeds to repay the ESOP loan, and, if necessary, forgive any principal balance of the loan that remained after the prepayment. As a result of the redemption, prepayment and forgiveness, the value of the participants' accounts would increase, because the total value of the company would now be divided among fewer shares.

Company A requested two rulings from the IRS. First, it asked for confirmation that the proposed use of proceeds from the redemption of unallocated shares to prepay the loan would not cause the loan to fail to be exempt from the prohibited-transaction rules. The IRS confirmed that this procedure would not result in a loss of the exemption. The IRS noted that there was no per se prohibition in the rule against prepaying an exempt loan, and that the plan was being terminated for financial and business reasons.

The company also requested a ruling to the effect that neither the forgiveness of the loan nor the resulting increase in value of allocated shares would constitute annual additions to participants' accounts for purposes of Code Section 415. The regulations with respect to Code Section 415 define annual additions by reference to contributions and forfeitures, and not by reference to mere value increases. However, the regulations also permit the Commissioner to treat other transactions between the plan and the employer as giving rise to annual additions. In this ruling, the IRS confirmed that the increase in value would not constitute an annual addition for purposes of Section 415.

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