MORGAN LEWIS ON ESOPs

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CALENDAR OF EVENTS

IRS CORRECTS 409(P) REGULATIONS

In our January newsletter, we discussed the Temporary Regulations that were issued in December 2004 relating to the anti-abuse rules for S corporation ESOPs under Section 409(p) of the Internal Revenue Code. In that article we expressed our surprise that the regulations had incorporated the ownership-attribution rules of Code Section 318 into the test for determining who is a disqualified person. We observed that this was not consistent with the language of Section 409(p) or its legislative history. On March 12, 2005, the IRS issued a notice correcting the Temporary Regulations, deleting the offending provision. It is expected that further corrections will be made, including the removal or revision of the example in the Temporary Regulations which still applies the now-eliminated ownership-attribution rules.

CLASS CERTIFICATION GRANTED IN UNITED AIRLINES ESOP CASE

In February 2005, a federal court held that a suit brought on behalf of the participants in the United Airlines ESOP against the ESOP trustee and administrative committee could proceed as a class action. Summers v. UAL Corporation ESOP, N.D. Ill. No. 03 C 1537 (February 17, 2005). The underlying complaint alleges that the trustee and the administrative committee breached their fiduciary duties to the ESOP participants by continuing to hold UAL stock during a period when the stock price declined more than 80% in value.

In order for a class to be certified, the following four threshold elements must be met: (1) the class must be so numerous that it is impractical to join all members individually; (2) there must be questions of law or fact common to the class; (3) the claims of the representative plaintiffs must be typical of the class; and (4) the representative plaintiffs must be able to fairly and adequately protect the interests of the class.

The proposed class in the UAL case clearly was numerous, and common issues were present, so the court's decision focused on the last two standards – typicality and adequacy. The defendants argued that the claims of the representative plaintiffs were not typical of the class since 125 plan participants had signed releases in favor of the defendants but the named plaintiffs had not. The court disagreed, and stated that it could easily address the release issues separately, as part of the class action.

The defendants also claimed that the plaintiffs could not adequately represent the interests of the entire class, because there were conflicting positions among

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Court Decision in EDS Class Action Suit Garners Attention From the ESOP and Business Communities

A recent federal district court decision has drawn attention from the ESOP community, because of the chilling effect the decision could have on employers' willingness to offer company stock as an investment option to employees. In re Electronic Data Systems Corp. "ERISA" Litigation. 224 F.R.D. 613, 2004 WL 2616225 (E.D.Tex.) The case involves the Electronic Data Systems Corporation ("EDS") 401(k) plan. The court's decision, which permits the participants in the EDS plan to maintain a class action against the plan fiduciaries, includes certain interpretations of ERISA that are unfavorable to fiduciaries. The decision has been appealed, and The ESOP Association, the ERISA Industry Committee, the American Benefits Counsel, the U.S. Chamber of Commerce, and the National Association of Manufacturers have filed amicus briefs challenging the court's decision.

The EDS lawsuit is one of numerous class actions that have been brought against ERISA fiduciaries in the wake of the market downturn of 2000-2001. These cases – often referred to as "stock drop" cases — involve ESOPs and other qualified plans that invest in employer stock. In the EDS case, as in most stock drop cases, the plan fiduciaries are alleged to have breached their fiduciary duty by continuing to invest in company stock during a period of decline and failing to monitor the actions of other fiduciaries. These claims were brought by the plan participants on behalf of the plan under Section 502(a)(2) of ERISA.

The issue before the court was whether it should certify the proposed class. The court dealt with, and rejected, a number of arguments similar to those raised in the United Airlines ESOP case discussed above. For example, the defendants took the position that the plaintiffs' claims were not typical of the class, citing the fact that some class members had signed releases. However, the court determined that the releases did not bar this type of claim. The defendants also argued that there was a conflict, because some class members had elected to continue trading in EDS stock. The court found that these objections were irrelevant, because the plaintiffs were not suing to recover damages to any individual accounts. Rather, they were suing on behalf of the plan as an entity, to recover for the harm done to the plan as a whole. In effect, stated the court, each class member is deemed to be bringing the exact same suit on behalf of the plan, so there can be no conflict among members' claims.

Finally, the defendants argued that the named plaintiffs' claims could not be typical of the class because of the nature of the defense available to the fiduciaries under ERISA Section 404(c). That section shields ERISA fiduciaries from liability for losses that result from the participants' exercise of control over their accounts. The defendants argued that this would require individual determinations of whether class members exercised control, thus preventing any one individual's claim from being typical. The court disagreed. The court noted that the ERISA Section 404(c) defense is "inapplicable to shield plan fiduciaries from liability for imprudently selecting the plan's investment options and overseeing their performance." In essence, it held that the losses in question did not result from any participant's exercise of control; rather, they resulted from the fiduciary's allegedly imprudent selection of investment options. The court noted that any other construction of ERISA Section 404(c) would conflict with the fiduciaries' duty to act solely in the interest of participants. In addition, the court expressed doubt as to whether ERISA Section 404(c) could ever be applied to claims brought on behalf of the plan as an entity. It found the ERISA Section 404(c) defense to be personal in nature, only applicable to individualized claims. But in this case, the claims were brought on behalf of the plan as an entity, not by any individual participant.

The defendants in the EDS case have appealed the decision to the Fifth Circuit court of appeals, claiming that the class should not have been certified. As noted above, various industry groups have filed amicus briefs in support of the defendant's appeal. These briefs note that federal law favors employer stock being included as an investment option in benefit plans, that these plans provide flexibility and control by permitting employees to make their own investment decisions, and that ERISA Section 404(c) is intended to shield fiduciaries from liability when participants make their own individual investment decisions. As one of the briefs summarized the issue: "The court's ruling… transfers the entire economic risk of loss to plan fiduciaries, whose fault in hindsight was to allow participants to make their own investment choices from among the plan's various investment alternatives." In addition, the appeal briefs state that it was improper for the court to ignore substantial differences among the class members merely because their claims are technically considered to be brought on behalf of the plan.

The industry amicus briefs caution that if class actions like this continue to be certified, employers may well stop offering employer stock programs as investment options under their

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Mandatory Rollover Rules Go Into Effect March 28

The IRS's new rollover rules for employee benefit plan accounts of less than $5,000 have been widely publicized, and most readers of this newsletter are already aware of them. All qualified plans, including ESOPs, that allow for involuntary cash-out distributions of accounts of less than $5,000 are subject to these new rules and must comply. While all affected plans must begin operating in compliance with the new rules by March 28, 2005, the IRS recently clarified that the actual plan amendments do not have to be signed by then.

The new regulations require that cash-out amounts over $1,000 must be automatically rolled over to an IRA set up for the benefit of the participant unless the participant consents to receive the distribution directly. This leaves plans with two choices to implement by March 28, 2005: either (a) reduce the involuntary cash-out amount to $1,000, or (b) implement provisions to transfer accounts over $1,000 but less than $5,000 to an IRA if participant consent is not obtained. Note that these requirements do not apply to involuntary cashouts resulting from the required minimum distribution rules.

If you decide to continue involuntary cashouts over $1,000 and provide for an automatic rollover, you should contact your recordkeeper or administrator to ensure that procedures are in place to hold these distributions in the plan until you are able to set up IRAs to accept the distributions. If you cannot find an IRA provider, you will have to default to not distributing accounts over $1,000. We understand that it may be difficult to find vendors interested in establishing these IRAs unless they have other relationships with the company or the plan.

Regardless of your decision, your plan will have to be amended by December 31, 2005 (or by the first plan year-end occurring on or after March 28, 2005, if your plan is not a calendar-year plan). Important note: for fiscal-year plans there may not be much time. For example, if your plan year ends March 31, your amendment must be in place by March 31, 2005.

Calendar of Events

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 the "Ask the Experts" panel discussion.

April 15, 2004
Ohio Employee Ownership Center
2005 Annual Conference
Akron Hilton West
Akron, OH
Brian Hector will be making a presentation on S Corporation ESOP anti-abuse rules titled, "Special Rules for S-Corp ESOPs."

April 20-22, 2005
The National Center for Employee Ownership (NCEO)
NCEO/Beyster Institute Annual Conference
Grand Hyatt San Francisco on Union Square
San Francisco, CA
John Kober will be making a presentation on "Strategic Alternatives for Employee-Owned Companies" and David Ackerman will be presenting on "Advanced ESOP Fiduciary Concerns."

May 11-13, 2005
National ESOP Association
28th Annual Conference
Grand Hyatt Washington
Washington, D.C.
John Kober will be making a presentation entitled: "Governance," David Ackerman and Erin Turley will be speaking on the subject of recent ESOP fiduciary cases, and Riva Johnson will be doing a regulatory and legislative update.

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."

Court Decision in EDS Class Action Suit Garners Attention From the ESOP and Business Communities

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retirement plans, in order to protect themselves from the risk of a class-action suit under ERISA whenever there is a decline in share value.

It remains to be seen how the EDS case will be decided on appeal. The results will be of great interest to plan sponsors and fiduciaries, and we will keep you informed of developments in this case. If the EDS decision is affirmed, plan sponsors and fiduciaries may well re-examine the benefits of offering company stock as an investment option in individual account plan.

Class Certification Granted in United Airlines ESOP Case

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the class members about whether and when the UAL stock should have been sold. Indeed, numerous participants had sent letters to the trustee asking that the stock not be sold. The judge held that, for purposes of determining whether there was a conflict, "the desires of the Plan participants are by and large irrelevant." According to the opinion, the ESOP committee is bound to make an independent decision about what is in the best general interest of the plan participants as investors, regardless of what action some of them may have individually requested. The opinion continues: "Defendants cannot avoid liability against certain class members on the breach of the fiduciary claims by arguing that Defendants were merely complying with those Plan participants' wishes. The desires of the Plan participants did not relieve Defendants of their fiduciary duties."

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