MORGAN LEWIS ON ESOPs

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

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BEST PLAN PRACTICES FOR RETIREMENT PLANS HOLDING COMPANY STOCK

It seems that hardly a week passes by without news of yet another company or plan fiduciary being sued by employees over drops in the value of company stock held by the company's retirement plan. Most of the attention has been engendered by the spectacular collapse of several large public companies whose 401(k) retirement plans were invested in stock of the sponsoring employers. In particular, several articles have been written, and more will undoubtedly be written, on what the Enron and WorldCom plan fiduciaries did or did not do as company stock prices declined dramatically over a very short period of time. Because of these developments, companies are, and should be, focusing on best practices for governance of their retirement plans. This article will review some of the fiduciary issues being faced by ESOP companies and their fiduciaries, and describe some best plan practices for addressing these issues.

WHO ARE THE FIDUCIARIES?

The answer may seem obvious, but the first question that arises in most fiduciary lawsuits involving retirement plans is "Who are the plan's fiduciaries?" In other words, who can the plaintiffs sue for a breach of fiduciary duty? In determining who the fiduciaries are, the courts take a close look at (1) who the designated fiduciaries of the plan (2) who are the individuals that influence the investment decisions of the plan are, and (3) who is responsible for appointing and monitoring the other fiduciaries.

A review of the plan documents and the minutes of board of directors meeting will usually reveal who the "named" or "designated" fiduciaries are. For example, a committee typically will be designated as the principal fiduciary for plan investments, including an investment in company stock. However, a broadly worded designation can pose a trap for the unwary. For example, if a plan document or board resolution simply names the "company" as the fiduciary of the plan, a court may hold that all of the members of the board of directors and/or the officers of the company are plan fiduciaries.

In addition, other individuals or groups may be treated as plan fiduciaries, even if they are not specifically named or designated as such in the plan documents. For example, individuals (such as corporate officers or members of the board of directors) who actually make or influence the investment decisions of a retirement plan — the people actually "calling the shots" on these matters — may be considered fiduciaries. In addition, those who appoint or monitor the designated plan fiduciaries can themselves be considered fiduciaries, at least with respect to those functions.

Best Plan Practices: Designate and Educate. It may be impossible to control completely whom a court will ultimately determine to be the fiduciaries of a retirement plan. However, best plan practices can be used to make sure fiduciary roles are specifically designated up front as much as possible. For example, companies adopting best plan practices are ensuring that their plans specifically des-

continued on page 2

IN THIS ISSUE

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ignate selected individuals to serve as committee members or other plan fiduciaries, or designate a specific independent fiduciary, as opposed to the appointments being the sole responsibility of the board of directors or an officer of the company.

In addition, and perhaps more importantly, best plan practices should include educating fiduciaries and potential fiduciaries (such as the board of directors) as to their roles and responsibilities with respect to retirement plans. Officers and board members are often unaware of the fact that, in a given situation or in connection with a certain decision, they are acting as plan fiduciaries with an obligation to act in the plan participants' best interests. When board members are made aware of the different hats they wear (and of when they are wearing them), they are better equipped to make decisions based on the proper fiduciary standards.

Finally, companies following best plan practices are establishing well-thought-out written retirement plan governance procedures addressing the companies' fiduciary obligations that traditionally have not been addressed in the retirement plan documents, and they are adopting, following and keeping these procedures up to date. For example, ESOP committee charters, ESOP voting policies, ESOP communication policies, statements of QDRO policy and statements of investment policy are being established with an emphasis on best practices and fiduciary obligations.

An ESOP Fiduciary's Conflicting Duties

Fiduciaries of ESOPs continue to struggle with the sometimes competing requirements of ERISA and the ESOP plan documents. For example, the plan documents and ERISA mandate that the assets of an ESOP be primarily invested in company stock, while ERISA requires that the fiduciary act in the exclusive interest of the participants and in a prudent manner. In times of economic stress and dropping stock prices, it can be difficult for a trustee to navigate these requirements, and the current legal standards of fiduciary duty are somewhat uncertain. This is an area of the law that is evolving as litigation moves through the courts.

The leading view, and one that is useful for fiduciaries trying to come to grips with what they should be doing, derives from a 1995 Third Circuit decision, *Moench v. Robertson*. *Moench* essentially stands for the proposition that there is a "presumption" that it is prudent for the fiduciary of an ESOP to invest in company stock. Therefore, an ESOP fiduciary should be able to hold company stock under a number of circumstances when, for any other type of retirement plan investments, a prudent fiduciary would conclude that those assets should be sold. However, this is a *rebuttable* presumption and, under certain extreme circumstances, an ESOP fiduciary may be forced to conclude that company stock is an imprudent investment, no matter what the plan documents contractually require. How extreme must the circumstances be in order to require an ESOP fiduciary to divest the plan of company stock? *Moensch* and its progeny focused on circumstances involving a *precipitous decline* in value and a fiduciary's knowledge of the company's *impending collapse*. However, some courts have rejected *Moensch* (holding that an ESOP trustee, unlike other trustees, does not have a specific obligation to diversify ESOP plan assets if that would violate the terms of the plan), and some courts have formulated or applied the *Moensch* standard differently. The "right answer" for a particular fiduciary may well depend on which court hears the case.

Best Plan Practices: Monitor and Document, Document and Monitor. An ESOP fiduciary's determination of whether to continue to hold or invest in company stock will be based on facts and circumstances, including the extent of the fiduciary's knowledge and the severity and imminence of the company's financial distress. Again, it may be impossible to second-guess how a court will ultimately view a fiduciary's decisions, particularly given the possibility of different legal standards being applied and the fact that a court will have the benefit of hindsight. However, fiduciaries adopting best plan practices are implementing processes for (a) regularly monitoring the company's stock performance and financial performance, (b) documenting this monitoring, and (c) documenting the fiduciaries' deliberations about the company's financial performance and other issues affecting the decision to hold or divest the plan of employer stock. Regardless of the legal standard that is ultimately applied by a court, a fiduciary that adopts such procedures will be better equipped to show that it was appropriately monitoring the company's financial situation, and that its decisions were based on a full consideration of the facts and circumstances.

The Challenges Encountered by Insider Fiduciaries

A recurring theme in company stock–related fiduciary litigation is that the fiduciaries failed to act in the sole interest of plan participants in deciding to purchase, sell, vote, tender or retain the company stock investment in the retirement plan. Insider fiduciaries are more susceptible to these types of claims, given the multiple responsibilities they have within a company and the high potential for actual, or perceived, conflicts of interest.

In addition, as the recent highly

publicized cases are making evident, insider fiduciaries face a dilemma when it comes to managing nonpublic or confidential information, and deciding whether such information should be used for the benefit of the plan or disclosed to plan participants. Reconciling this situation can be very difficult in the current environment. One early case, *Hall v. Policy Systems,* generally held that a plan fiduciary does not have a duty to disclose any information to a participant if the disclosure would violate securities laws, and that fiduciary committee members are not obligated to make trading decisions based on insider information they possess. However, the situation may turn out to be more complicated if the fiduciary has gained confidential information from a board of directors' meeting or officers' meeting. In its amicus brief filed in the *Enron* case, the Department of Labor took the position that the officers of Enron, who were also plan fiduciaries and who held nonpublic information, were not protected from liability because of the need to comply with insider trading laws. According to the DOL, the officers could have (i) disclosed the insider information to all shareholders (i.e., the participants of the retirement plan and the public), (ii) eliminated Enron's stock as a plan investment, or (iii) reported to the SEC and the DOL that misinformation was being provided to the participants. Obviously, applying the DOL's standards (which are not law) will be very difficult for fiduciaries in certain situations. In addition, court decisions in recent cases have criticized the DOL's position, stating that ERISA does not preempt insider trading laws or require disclosures that would further reduce the value of assets held by a plan.

Best Plan Practices: Consider Independent Discretionary Fiduciaries. For a number of reasons, including those discussed above, more and more companies are appointing independent discretionary fiduciaries for their retirement plans. The primary purpose of the independent fiduciary is to ensure unbiased oversight of the plan and its investments. Of course, the independent fiduciary must be qualified, and the board of directors or a designated committee must monitor the fiduciary's activities. However, use of an independent fiduciary can help relieve the company and its board from a certain level of actual, or perceived, conflicts of interest.

Companies are also appointing individuals to serve on their retirement plan committees who do not have access to inside information about the companies financial situation and marketplace issues. This means that the chief executive officer, president, chief financial officer, chairman of the board and other members of the board of directors do not serve on any fiduciary retirement plan committee, unless their expertise is essential to the committee's function.

Diversification Issues

Public companies, and in some cases private companies, are considering how their retirement plans can be designed to reduce some of the market risks associated with employee investments in company stock, and thereby at the same time potentially reduce exposure to fiduciary litigation. Companies are exploring options to revise their retirement plans to provide additional diversification rights, especially in situations where employees direct some or all of their salary reduction deferrals into company stock investments. By shifting some of the investment decisions to the participants, this approach may have the benefit of putting less pressure on plan fiduciaries to make proper decisions as to when to buy, sell or hold company stock in the plan.

By providing additional diversification options, companies are also hoping to take advantage of the protections of ERISA Section 404(c). Section 404(c) generally provides that if a retirement plan permits participants to exercise investment control over their accounts, no person who is otherwise a fiduciary will be liable for any loss that results from a participant's decision to invest in company stock. This may not represent a panacea for ESOP fiduciaries, however. Courts have held that Section 404(c) does not necessarily protect fiduciaries who are responsible for deciding what investment options will be made available to participants. However, for practical and legal reasons and because of recent events, the trend has been to allow greater employer diversification rights.

Best Plan Practices: Consider Expanded Diversification Rights. Companies implementing best plan practices should consider the benefits and risks of expanding diversification rights under their retirement plans. While increased diversification does reduce the risk of employees "putting all their eggs in one basket," there are also potential downsides to be considered. For example, for a private company, increased diversification rights will put increased pressure on the company's cash flow, as shares must be repurchased to provide funds to participants who are diversifying their accounts. Repurchases in excess of those required by statute may be limited under the company's senior loan documents, which will need to be reviewed. And at a certain point, if the number of shares of company stock held by the ESOP as a whole is substantially reduced through diversification, the plan may cease to be an ESOP because it is no longer "primarily invested" in company stock. Finally, if a company is hoping to benefit from the protections of Section 404(c), it must make sure that it is in compliance with the disclosure requirements of that section.

The Role of Employee Communications

Historically, much of the responsibility for communications relating to employee benefits (including ESOPs) has been placed in the hands of the human resources department, with assistance from plan administrators and other

continued on page 5

McKesson Revisited Yet Again – District Court Applies a Bright-Line Test to Exempt ESOP Fiduciaries from Liability for Failure to Diversify

On September 9, 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. The facts of the case, and the court's prior tentative rulings, were outlined in detail in the September issue of Morgan Lewis on ESOPs.

In its final decision, the district court absolved the fiduciaries of liability for failure to diversify the plan out of company stock, based on the court's reading of ERISA Section 404, which states that, for ESOP fiduciaries, "the diversification requirement. . . . and the prudence requirement (only to the extent it requires diversification) . . . are not violated by acquisition or holding of [company stock]." 29 U.S.C. § 1104(a)(2). The court rejected and strongly criticized *Moensch v. Robertson*, the Third Circuit case that has been relied on by federal courts for years for the proposition that, while ESOP fiduciaries enjoy a presumption of prudence for investing in company stock, that presumption is rebuttable. Under certain circumstances, according to *Moensch* and its progeny, an ESOP fiduciary who fails to diversify a plan out of company stock can be liable for breaching the duty of prudence, even if it means the fiduciary must violate the express terms of the plan.

The court carefully examined the reasoning in *Moensch*, and found it to be flawed. Noting that the exemption language of Section 404 is sweeping and unqualified, the court stated that "Congress fashioned a bright-line exclusion for ESOP fiduciaries from liability for their alleged failure to sell company stock." While ESOP fiduciaries could still breach their fiduciary duties by engaging in various forms of imprudence, such as overpaying for securities, charging a commission or acquiring stock for prohibited reasons, the court found that mere failure to diversify was exempt from attack. The court also stated:

> *Moensch* questionably jumps from the premise that ESOP fiduciaries are generally subject to the duty of prudence to the determination that ESOP fiduciaries may breach the duty of prudence by refusing to sell company stock. The duty of prudence is broader than – and in fact encompasses – the duty of diversification. *Moensch* does not appear to recognize that there is nothing inconsistent with section 404 simultaneously (1) imposing a multi-faceted duty of prudence upon ESOP fiduciaries and yet (2) exempting them from one particular aspect of it: the duty to diversify.

Based on its holding that ERISA Section 404 prohibits claims against fiduciaries for failing to diversify an ESOP, the court dismissed most of the plaintiffs' claims against the fiduciaries. The court also found that, even if the *Moensch* standard were applied, the circumstances presented did not rise to the level of imminent financial collapse required by *Moensch* to overcome the presumption of prudence. However, the court did allow the plaintiffs to proceed on their claim that the fiduciaries breached their duties by contributing company stock to the plan instead of cash. Unlike the claims that the court dismissed, this particular claim involved an allegedly imprudent judgment made by the fiduciaries within the terms of the plan.

Given the widespread acceptance of *Moensch* in many federal courts, it is difficult to say whether the Northern District's position will be followed in other jurisdictions.

IRS Announces Retirement Plan Dollar Limitations for 2006

The Internal Revenue Service has announced the 2006 cost-of-living adjustments to dollar limits applicable to retirement plans.

- The limitation on the annual benefit under a defined benefit plan under Code Section 415(b)(1)(A) is increased from $170,000 to $175,000.
- The dollar limit under Code Section 416(i)(1)(A)(i), relating to the definition of "key employees" in a top-heavy plan, is increased from $135,000 to $140,000.
- The limitation on annual additions to the accounts of individual participants in defined contribution plans under Code Section 415(c)(1)(A) is increased from $42,000 to $44,000.
- The annual compensation limit under Code Sections 401(a)(17), 404(l), 408(k)(3)(C) and 408(k)(6)(D)(ii) is increased from $210,000 to $220,000.
- The dollar limit under Code Section 409(o)(1)(C)(ii) for determining the maximum account balance in an employee stock ownership plan subject to a five-year distribution period is increased from $850,000 to $885,000, while the dollar amount used to determine the lengthening of the five-year distribution period is increased from $170,000 to $175,000.
- The dollar limit used in the definition of "highly compensated employee" under Code Section 414(q)(1)(B) is increased from $95,000 to $100,000.
- The annual compensation limitation under Section 401(a)(17) for eligible participants in certain governmental plans that, under the plans as in effect on July 1, 1993, allowed cost-of-living adjustments to the compensation limitation under the plans under Section 401(a)(17) to be taken into account, is increased from $315,000 to $325,000.
- The compensation amounts under Treasury Regulation Section 1.61-21(f)(5)(i), regarding the definition of "control employee" for fringe benefit valuation purposes, is increased from $80,000 to $85,000. The compensation amount under Treasury Regulation Section 1.61-21(f)(5)(iii) is increased from $170,000 to $175,000.
- The limitation under Code Section 402(g)(1) on the exclusion of elective deferrals described in Code Section 402(g)(3) is increased from $14,000 to $15,000.
- The limitation under Code Section 408(p)(2)(E) for SIMPLE retirement accounts remains unchanged at $10,000.
- The limitation on deferrals under Code Section 457(e)(15) for deferred compensation plans of state and local governments and tax-exempt organizations is increased from $14,000 to $15,000.
- The dollar limit under Code Section 414(v)(2)(B)(i) for catch-up contributions to an applicable employer plan, other than a plan described in Code Section 401(k)(11) or Section 408(p), for individuals age 50 or over has increased from $4,000 to $5,000. The dollar limit under Code Section 414(v)(2)(B)(ii) for catch-up contributions to an employer plan described in Code Section 401(k)(11) or Code Section 408(p) for individuals age 50 or over has increased from $2,000 to $2,500.
- The minimum compensation under Code Section 408(k)(2)(C) regarding SEPs remains at $450.

Calendar of Events

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."

Best Plan Practices for Retirement Plans Holding Company Stock

continued from page 3

service providers. In some cases, the chief financial officer and other members of firm management may have had some input or involvement in those communications. In addition, in communicating information about benefit plans, many companies have tended to rely on plan documents, such as summary plan descriptions (SPDs), which comply with ERISA requirements but may not necessarily be user friendly or responsive to employees' questions and concerns.

Best Plan Practices: Focus on Proactive Employee Communications. In light of the recent activity involving retirement plans that invest in employer stock, companies employing best plan practices are focusing more on the type and tone of their communications with employees, to ensure such communications are frequent, objective, accurate and neutral. Companies are also focusing on the way

continued on page 6

Best Plan Practices for Retirement Plans Holding Company Stock

continued from page 6

information is conveyed to employees in town hall employee meetings, in an effort to avoid giving or misrepresenting information because of enthusiasm. Companies are taking a fresh look at their SPDs and updating them to make sure they are accurate and readable, and are beefing up SPDs and other communications to include disclosures concerning the risks associated with owning company stock and the importance of a diversified retirement portfolio, and, where appropriate, detailed and user-friendly descriptions of distribution procedures and options. Finally, companies are becoming more proactive in communicating matters involving their ESOPs throughout the year as developments occur, rather than limiting communications to an annual report of the company's stock value.

In conclusion, it is important to be aware of the case law as it continues to evolve in this area, and companies, fiduciaries, and ESOP committee members should proceed by implementing best practices to address retirement plan matters as they arise from time to time.

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