

# ESOP LEGAL NEWS



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District court upholds prudence claim, dismisses communications and monitoring claims brought by participants in Community National Bank Corporation Employee Stock Ownership Plan; Eleventh Circuit adopts presumption of prudence, upholds district court judgment dismissing claims brought by participants in Home Depot, Inc. Employee Stock Ownership Plan; Second Circuit upholds district court judgment dismissing claims brought by participants in JP Morgan 401(k) Savings Plan; District court applies presumption of prudence at pleadings stage to dismiss claims alleging breach of fiduciary duty brought by participants in Sovereign Bankcorp, Inc. Employee Stock Ownership Plan; Department of Labor files complaint alleging breaches of fiduciary duties and prohibited transactions; Assistant Secretary of Department of Labor lists ESOPs as audit priority, discusses re-proposal of regulation redefining term "Fiduciary"; Pro-ESOP Legislation Garner Support.

## IN THE COURTS

### District Court Upholds Prudence Claim, Dismisses Communications and Monitoring Claims Brought by Participants in Community National Bank Corporation Employee Stock Ownership Plan

On May 10, 2012, the United States District Court for the Middle District of Florida issued an [Opinion](#) granting in part and denying in part a motion to dismiss claims brought by participants in the Community National Bank Corporation Employee Stock Ownership Plan against members of the board of directors and officers of the sponsor corporation.

The court upheld the participants' claim that the defendants failed to prudently and loyally manage the plan. The participants alleged that the defendants knew that employer securities were no longer a suitable and appropriate investment for the plan, and was an unsafe and unsound investment in light of the corporation's improper business and banking practices. The participants further alleged that the defendants continued to offer corporation stock as an investment option despite their knowledge. The defendants contended that ERISA does not require a fiduciary to diversify investments in employer securities in order to satisfy its duty of prudence. The court disagreed and cited the Eleventh Circuit's recent ruling in *Lanfear v. Home Depot, Inc.*, \_\_\_ F.3d \_\_\_, 2012 WL 1580614 (11th Cir. May 8, 2012) for the proposition that a fiduciary abuses its discretion by acting in compliance with the directions of the plan when the fiduciary could not have reasonably believed that the settlor would have intended for him to do so under the circumstances.

The court dismissed without prejudice the participants' claim that the defendants breached their duty to inform the participants by failing to provide complete and accurate information regarding the corporation and its stock, and by conveying inaccurate information regarding the soundness of corporation stock and the prudence of investing in it. The court found the participants asserted no specific facts to support their claim, and found only general allegations concerning the defendants' communications.

The court dismissed without prejudice the participants' claim that the defendants breached their duty to monitor by failing to (i) prevent the plan's sizeable losses arising as a result of its investment in corporation stock, (ii) to ensure that other fiduciaries appreciated the true extent of the corporation's highly risky and inappropriate business practices, and (iii) to remove appointees whose performance became inadequate. The court found the participants alleged no specific facts to support their claim.

## **Eleventh Circuit Adopts Presumption of Prudence, Upholds District Court Judgment Dismissing Claims Brought by Participants in Home Depot, Inc. Employee Stock Ownership Plan**

On May 8, 2012, the United States Court of Appeals for the Eleventh Circuit issued an [Opinion](#) upholding a district court judgment dismissing claims brought by participants in the Home Depot, Inc. Employee Stock Ownership Plan against the corporation, the board of directors, investment and administrative committees, and various officers.

The participants alleged that the defendants breached their duty of prudence because the defendants knew about fraudulent use of return-to-vendor chargebacks and stock option backdating that resulted in an artificially inflated stock price, and despite this knowledge, the defendants did not divest the plan of employer securities and continued to offer stock to participants and invest matching funds and direct contributions in employer securities. The court distinguished the participants' allegations from a duty to diversify claim, reasoning the claim was that the defendants acted imprudently by offering, and failing to divest the plan of, employer securities because the defendants knew the stock price was inflated, not because of the percentage of plan assets comprised of employer securities.

The court joined the Second, Ninth, Fifth, and Sixth Circuits in adopting the presumption of prudence. In addition, the court rejected the participants' position that the presumption should not apply at the pleadings stage. The court reasoned the presumption was not an evidentiary presumption, but rather a standard of review. The court reasoned the defendants were not required to divest the plan of employer securities simply because they knew the price of the securities would decline. The court emphasized that market timing investing is not how prudent pension funding works. The court concluded that the participants failed to establish the defendants abused their discretion by following the plan document.

The participants contended that the defendants breached their duty to disclose complete and accurate information when they took

inaccurate statements from Forms 10-K and 10-Q and put them into a Form S-8 and the stock prospectuses disseminated to participants. The court reasoned the defendants were acting in their corporate capacities, not their fiduciary capacities when they filed the Form S-8 and distributed stock prospectuses.

The participants contended that the defendants also breached their duty to disclose by failing to disclose the fraudulent use of return-to-vendor chargebacks and stock option backdating. The court upheld the dismissal of the claim, concluding that the defendants were not required to disclose nonpublic information to participants and that the summary plan description adequately warned participants of the risks of investing in employer securities.

## **Second Circuit Upholds District Court Judgment Dismissing Claims Brought By Participants in JP Morgan 401(k) Savings Plan**

On May 8, 2012 the United States Court of Appeals for the Second Circuit issued an [Opinion](#) upholding the judgment of a district court granting defendants' motion for judgment on the pleadings and dismissing claims brought by participants in the JP Morgan 401(k) Savings Plan, which included a company common stock fund designated as an employee stock ownership plan.

The court recited its recent decisions, which adopted the presumption of prudence. See *In re Citigroup ERISA Litig.*, 662 F.3d 128, 136, 142 (2d Cir. 2011); see also *Gearren v. McGraw-Hill Cos.*, 660 F.3d 605, 610 (2d Cir. 2011). The court concluded the participants failed to allege sufficient facts to rebut the presumption. The participants contended the presumption did not apply because the terms of the plan offered the defendants unfettered discretion as to whether to offer employer securities. The court disagreed, concluding that the presumption applied and the plan's terms strongly favored investment in employer securities.

The court rejected the participants' claim that the defendants breached their duty to disclose by failing to disclose information about the corporation's financial condition and by making misleading statements about the corporation to participants. The court reasoned that the defendants had no duty to disclose nonpublic information pertaining to the performance of employer securities. The court further reasoned that defendants' statements within SEC filings were made in a corporate rather than in a fiduciary capacity. The court concluded that the district court properly dismissed the participants' claim that the defendants failed to properly monitor plan fiduciaries because the claim was derivative of the other claims, which were properly dismissed.

## **District Court Applies Presumption of Prudence at Pleadings Stage to Dismiss Claims Alleging Breach of Fiduciary Duty Brought By Participants in Sovereign Bankcorp, Inc. Employee Stock Ownership Plan**

On April 17, 2012, the United States District Court for the Eastern District of Pennsylvania issued a [Memorandum](#) dismissing four of five counts in a class action complaint filed by participants in the Sovereign Bancorp, Inc. Employee Stock Ownership Plan against Sovereign Bancorp, Inc., certain directors, and certain committees.

The court dismissed the participants' claim that the defendants breached their fiduciary duties of prudence by continuing to invest in employer securities. The participants argued against application of the presumption of prudence at the pleadings stage and argued, in the alternative, that they rebutted the presumption by alleging the defendants artificially inflated the share price through risky and improper activities. The court applied the presumption of prudence at the pleadings stage and held the plaintiffs failed to plead sufficient facts to rebut the presumption. *Contra Pfeil, v. State Street Bank and Trust Co.*, 671 F.3d 585, 593 (6th Cir. 2012) (recent decision declining to apply presumption at pleadings stage). The court concluded the allegations regarding the artificial inflation of the share price were too non-specific and conclusory to properly state a claim. In addition, the court dismissed the participants' claims of breach of duty to monitor, remove, or replace plan fiduciaries and of breach of duty as a co-fiduciary. The court reasoned these claims were derivative of the alleged breach of fiduciary duty claim, and held that the claims failed because the complaint failed to adequately state any claim for breach of fiduciary duty.

The court dismissed the participants' claim that the defendants breached their duty to disclose complete and accurate information to participants because certain SEC filings were false and misleading. The court reasoned the SEC filing were fiduciary communications because the SPD incorporated the filings by reference. The court held that the participants failed to state a plausible claim because they failed to identify how particular disclosures were misleading or what information the defendants knew but did not disclose. The court further held that the participants could not establish damages in light of the efficient market hypothesis.

The court dismissed the participants' claim of breach of the duty of loyalty. Participants alleged that the compensation of the director defendants was tied to the share price and that several directors had taken loans from the sponsor. However, the court held that the participants failed to plead facts to support the claim and to rebut the presumption of prudence.

The court upheld the participants' claim against the sponsor and one committee alleging these defendants caused the plan to engage in a prohibited transaction by causing the plan to pay above reasonable market interest rates on loans between the employer and the plan. The employer loaned the plan approximately \$40 million dollars through five separate transactions. The interest rate on each loan was ten percent per annum and the loan was collateralized by the unallocated shares in the suspense account. The court held the reasonableness of the interest rate was a question of fact requiring the presentation of evidence. The court dismissed the same claim lodged against the board of directors and committee citing the participants' failure to plead sufficient facts to state a claim against them.

## **Department of Labor Files Complaint Alleging Breaches of Fiduciary Duties and Prohibited Transactions**

On April 25, 2012 the Secretary of the Department of Labor filed a

[Complaint](#) alleging a prohibited transaction and breaches of fiduciary duties by certain fiduciaries of the Parrot Cellular Employee Stock Ownership Plan.

The plan sponsor and trustees engaged the services of an independent fiduciary and investment manager with respect to the plan's acquisition of shares from a former director and officer of the corporation.

The Secretary provided a litany of flaws and inaccuracies that allegedly would have been uncovered during a thorough and objective review and analysis by a prudent fiduciary, including mathematical errors, inappropriate valuation adjustments, the use of overly optimistic projections, and the failure to consider a \$12,000,000 deferred compensation arrangement. The Secretary emphasized the fact that the appraiser failed to consider a prior valuation report, performed approximately one year earlier, that concluded the fair market value of the sponsor was less than 25% of the valuation arrived at by the appraiser.

The Secretary alleges the defendants breached their duties of prudence, loyalty, and adherence to plan documents and caused the plan to engage in a prohibited transaction by causing the plan to purchase the shares for more than adequate consideration and without a proper valuation of the shares.

## **AGENCY NEWS**

### **Secretary of Department of Labor Lists ESOPs as Audit Priority, Discuss Re-Proposal of Regulation Redefining Term "Fiduciary"**

On April 30, 2012 the Department of Labor [listed](#) ESOPs as a top audit priority and affirmed the Department's intent to impose liability on appraisers during the AICPA Employee Benefits Conference. Assistant Secretary of Labor Phyllis Borzi explained that ESOPs require special vigilance from auditors. She claimed the Employee Benefits Security Administration ("EBSA") has witnessed incidents where auditors accepted improper valuation methodologies and assumptions that later caused serious problems for participants. She noted that EBSA anticipates re-proposing its fiduciary regulation once it clarifies aspects of the rule and that clarification and re-proposal could be complete within "a couple of months." Assistant Secretary Borzi explained that the regulation would seek to impose liability on individuals who represent themselves as financial advisers when giving individualized investment advice. She further explained that a financial service provider who represents herself as a trusted advisor must put her client's financial interests first.

## **ON CAPITOL HILL**

### **Pro-ESOP Legislation Garner Support**

Since April 22, 2012 H.R. 1244, The "[Promotion and Expansion of Employee Ownership Act of 2011](#)" gained six cosponsors to arrive at seventy-five total cosponsors. Representatives Cathy McMorris Rodgers (R-WA), Rush Holt (D-NJ), Greg Walden (R-OR), Thomas

Marino (R-PA), John Lewis (D-GA), and Thomas "Tom" Latham (R-IA) have cosponsored the bill. The bill is currently pending before several House Committees and one House Subcommittee. The bill: amends Code Section 1042 to allow an S Corporation shareholder to defer recognition of capital gain realized from the sale of employer securities to an ESOP; adds a new section to the Code permitting banks to deduct 50% of the interest received from a qualified securities acquisition loan; adds a new section to the Code requiring the Secretary of the Treasury to establish the "S Corporation Employee Ownership Assistance Office" to foster employee ownership of S Corporations; and amends the Small Business Act to permit a corporation eligible to participate in loan, contracting assistance, or business development programs to remain eligible to participate after an ESOP acquires 50% or more of the equity of a corporation.

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