Court Upholds ESOP's Change in Investment Conversion Rules

September 2, 2011 by Sheppard Mullin

A district court in Arizona has upheld an ESOP Committee's decision to amend the timing and manner in which terminated employees' company stock accounts are converted to other investments. Prior to the amendment, the ESOP provided the committee with the discretion at any time to "determine (based upon a nondiscriminatory policy) that the Accounts of former Employees will be diversified and invested in Trust Assets other than [Company] Stock." The district court found that the Committee's actual practice was to convert investments as soon as the ESOP had sufficient cash to do so. The amendment in May 2007 provides that a terminated participant's company stock will be converted to other investments effective at the end of the plan year in which the participant terminates employment. The plaintiff was a participant who was considering whether to participate in a reduction in force (RIF) in September 2006. The plaintiff was told by a member of the Committee that it would take approximately two years for the account to be converted. Since the plan year ended in September, the plaintiff expected her account would not be converted to other investment until 2007 or 2008. When the Committee amended the policy in May 2007, the change was applied to all terminated employees, and so the plaintiff's account was converted as of September 30, 2006. The plaintiff filed the lawsuit seeking the increase in the stock value from 2006 to 2007.

The plaintiff based her claim on at least two legal arguments under ERISA:

Fiduciary Breach - First, plaintiff claimed the Committee breached its ERISA fiduciary duties by (i) making an affirmative misrepresentation to her that her account would remain invested in company stock for approximately two years, and (ii) applying the amendment retroactively to employees who had already terminated employment at the time of the amendment's adoption.

The court first examined several ERISA cases that have held that a plan administrator has a duty not to make affirmative material misrepresentations to a plan participant who asks about plan provisions. These cases have also held that a fiduciary has a duty not to make misrepresentations to try to induce employees to make a certain decision. The court found that the change in investment policy was not under "serious" consideration until at least February 2007, and that the statements made to plaintiff in September 2006 were accurate when made. In addition, the court noted that there was no evidence the Committee was aware plaintiff's decision to accept the RIF depended on the answer to her question about the investment. The court found the Committee could not have been trying to induce the plaintiff to accept the RIF.

In considering the retroactivity argument, the court found that the prior policy left discretion to the Committee on the timing of investment conversions. The court noted that for this reason the pre-amendment policy would also have permitted an investment conversion as of the end of the year in which the participant terminated employment. In addition, the court found that while the investment conversion turned out to be a bad investment decision for the plaintiff, there was no evidence put into the record by the plaintiff that the Committee knew the stock value had increased when the amendment was adopted. Finally, the plaintiff argued that the Committee applied the change retroactively to benefit the company by allowing it to buy back the shares at a lower price, and that this position was based on repurchase liabilities performed by the company. However, the court found that the plaintiff's court filings did not support this position. In addition, the court made a broad statement that even if the early buy back of the shares would have benefited the company, "ESOPs are exempt from the strict prohibition against self-dealing that is applicable to other plans under ERISA." (The quoted language is from the Moench case.) While an ESOP fiduciary may qualify for an exemption from the prohibited transaction of self-dealing, such a fiduciary may still be found to have breached his or her general fiduciary duties through acts of self-dealing. This could have been the result in this case had the court found that the company was trying to benefit itself. Finally, to the plaintiff's argument that the retroactive application violated the ERISA "anti-cutback" rule, the court found that future growth in value was an "expectation" but not an accrued benefit.

Benefits Claim The plaintiff also made the argument that regardless of whether a fiduciary breach had occurred, the ESOP did not pay out the benefits as promissed under the plan. In holding for the defendants, the court found that the old policy could have been applied to come to the same result as the new policy. In addition, the court found that in assessing the Committee's level of self interest in the outcome, the record did not support a finding that the Committee knew the company stood to gain from the change in policy. Under ERISA case law, the decision of the Committee would be held to a higher standard if it had a financial interest in the outcome.

Peggy J. Beaston v. The Sundt Companies, et. al, 2011 U.S. Dist. LEXIS 93817 (August 15, 2011)

For further information please contact a member of the Sheppard Mullin ESOP team.