

Stock Drop Case Updates and IRS Notice Clarifying Meaning of “Readily Tradable” Employer Securities

By Robert W. Edwards, Steiker, Fischer, Edwards & Greenapple, P.C., Providence, RI; Edited by Sharon B. Hearn, Krieg DeVault, Indianapolis, IN, and Susan Peters Schaefer, McDermott Will & Emery LLP, Chicago, IL

CASE LAW DEVELOPMENTS

Stock Drop Cases

Two recent “stock drop” decisions provide an interesting counterpoint on how different courts address the “*Moench* presumption,” an issue that may have to be definitively resolved by the United States Supreme Court. In *Moench v. Robertson*, 62 F.3rd 553 (3rd Cir. 1995), the Court of Appeals for the Third Circuit considered when an ESOP fiduciary’s duty to act prudently requires taking action to stop purchasing (or to dispose of) employer securities held in the plan, when doing so would conflict with both Congressional intent and language in the plan documents. The district court in *Moench* held that plan language providing for investment in employer securities trumps a plan fiduciary’s obligation to act prudently, and entered summary judgment in favor of the defendant fiduciaries, even though the company stock at issue had declined in value from \$18.25/share to less than \$.25/share before the plan sponsor filed for bankruptcy protection. On appeal, the Court of Appeals held that an ESOP fiduciary is entitled to a presumption that it acted consistently with ERISA by investing in employer securities, but that the presumption can be rebutted by establishing that continued investment under the circumstances amounted to an abuse of discretion. On the facts before it, the *Moench* court reversed the lower court’s decision and remanded the case for further proceedings.

In *Veera v. Ambac Plan Administrative*

Committee, et. al., 2011 U.S. Dist. Lexis 1194 (S.D.N.Y. 2011), a plan participant sued the Administrative, Investment and Compensation Committees under the Ambac Financial Group, Inc. Savings Incentive Plan seeking to represent a class of plan participants who invested their plan accounts in Ambac stock before Ambac filed for bankruptcy protection and the stock became effectively worthless. The plaintiff alleged that Ambac, a financial services company that insured both public debt and private collateralized debt obligations, made a fundamental change in its business strategy and lowered its underwriting standards without disclosing these risks to plan participants, such that the continued offering (and holding) of Ambac stock became imprudent. The plan documents required that the Ambac stock fund be offered as an investment fund under the plan, but did not affirmatively require that the stock fund be maintained permanently, or restrict the authority of the Investment Committee over the stock fund.

The defendants filed a motion to dismiss on the ground that, because the plan required that Ambac stock be offered as an investment option, they had no discretion over the offering, and therefore no fiduciary liability could result from their inaction. The district court acknowledged that the extent of fiduciary protection afforded by specific provisions in a plan document has been the subject of conflicting holdings in the Second Circuit, but concluded that

plan language alone will not automatically shelter a defendant from fiduciary liability. The court emphasized that an ERISA fiduciary’s obligation to act “in accordance with plan documents” is tempered by the requirement that reliance on the documents must be “consistent with the provisions of ERISA.” The court also found that the Ambac plan did not remove all the defendants’ discretion over the stock fund in any event, and pointed out that the purposes underlying ERISA “cannot be obviated or torn asunder by the drafters of plan documents.” The court then considered whether the *Moench* presumption would apply, and held that in the context of a motion to dismiss, the plaintiff deserved the opportunity to present facts that could overcome the presumption, and pointed out that even if *Moench* were to apply, the Ambac stock at issue suffered a precipitous decline, losing more than 99% of its value, and that could be sufficient to overcome the presumption.

Faced with similar claims, the Minnesota District Court took a different approach in *Wright v. Medtronic, Inc.*, 2011 U.S. Dist. Lexis 923 (D.Minn., 2011). The Medtronic case was the plaintiffs’ third attempt to recover for losses incurred when Medtronic stock, held in the Medtronic ESOP, declined in value from 2006 through 2008. The third amended complaint alleged that the Medtronic Compensation and Qualified Plan Committees, as well as its Board of Directors, breached their ERISA duties when they permitted the ESOP to continue to hold Medtronic stock when they knew or should have known that problems the company was experiencing with its defibrillator and bone graft products, as well as its payment of illegal kickbacks to doctors, made the plan’s continued investment in Medtronic stock imprudent. Responding to a motion to dismiss, the Minnesota court embraced the *Moench* presumption and noted that the plaintiffs’ allegations were “nowhere near” the type of allegations necessary to overcome the presumption. In this case, stock declines of 19% and 16% were insufficient as a matter of law

to prevent entry of a motion to dismiss, with prejudice.

The Medtronic court made some additional holdings that were quite favorable to the defendants. The plaintiffs alleged that misrepresentations made in the Company's SEC filings were incorporated by reference into the plan summary plan description and constituted separate grounds for relief. The court found that a recovery for alleged misrepresentations requires a showing that the loss must have "resulted from" the misrepresentations. Since the plaintiffs did not allege that they had read and relied on these misrepresentations, their claim failed. The Court rejected the argument that because the losses were incurred on behalf of the plan as a whole, actual misrepresentations would not have to be proven, concluding that this was beside the point because no recovery (whether on behalf of the plan or an individual), is supportable under ERISA unless there is an allegation that some individual read and relied on the misrepresentation. Further, the court found that even if incorporation by reference of misleading SEC communications into the summary plan description was a fiduciary action, the plaintiffs' claim that the failure to correct the misleading communications was itself a violation could not stand. Again, absent a claim of reliance, claims founded on misrepresentation will not fare well in the Eighth Circuit.

Finally, the Medtronic court rejected the argument that ERISA imposes an affirmative duty on corporate insiders who act as fiduciaries to disclose to plan participants material nonpublic information about the corporation that might affect the value of the corporation's stock. Instead, participants in a qualified plan, like any other investors who believe that material information has been unlawfully withheld, must seek relief under the securities laws.

REGULATORY DEVELOPMENTS

IRS Notice 2011-19 Clarifies Meaning of "Readily Tradable" Employer Securities

In Notice 2011-19 the IRS provides guidance clarifying when employer securities will be deemed to be "readily tradable" on an established securities market. Consistent with the definition of "publicly traded employer securities" in the final regulations issued last year under Code §401(a)(35), the Notice provides that a security will be "readily tradable on an established market" if it is either 1) traded on a national securities exchange that is registered under Section 6 of the Securities Exchange Act of 1934, or 2) traded on a foreign national securities exchange that is officially recognized, sanctioned or supervised by a governmental authority and the security is deemed by the Securities and Exchange Commission as having a ready market under SEC Rule 15C3-1.

Prior to the Notice, a tangled web of definitions in different sections of the Code and ERISA led to confusion about when employer securities would be considered "readily tradable" for ESOP purposes and, consequently, whether the securities were subject to annual appraisal, put option, and other requirements applicable to securities that are not readily tradable on an established market. Based on the definition of "publicly traded" in Reg. §54.4975-7(b)(1)(iv), some practitioners believed that securities traded over the counter would qualify if they were quoted on a system sponsored by a national securities association registered under Section 15 of the Securities Exchange Act. Conflicting private letter rulings (See PLR 9529043 and PLR 200052014) added to the uncertainty.

The Notice establishes a bright line test that may have a significant impact on some ESOP companies. ESOP sponsors whose stock is traded over the counter must obtain independent appraisals and offer put options on shares distributed from their ESOP. Pass through voting will have to be offered by certain stock bonus plans that previously relied on the exception in Code §401(a)(22) for employers whose stock is not "readily tradable" on an established market. On the other hand, additional sales of over the counter securities to an ESOP will qualify for Section 1042 rollover treatment. The new guidance may prove to be especially problematic for domestic ESOPs with a foreign parent whose securities are now considered to be "readily tradable." Under current SEC rules, a security included on the FTSE Group All-World Index is deemed to be readily tradable. Because the stock of such a foreign parent is readily tradable, a nonpublicly traded domestic subsidiary would not be able to establish and maintain an ESOP funded with its own domestic stock; only the parent corporation's stock would be a qualifying employer security.

The Notice is generally effective for plan years beginning on or after January 1, 2012. However, for plans sponsored by a member of a controlled group, none of whose members has securities that are readily tradable on a qualifying foreign national securities exchange (and none of whose members has securities that are readily tradable on a national securities exchange), the effective date is deferred to January 1, 2013.

The author of the Legal Update is a member of The ESOP Association's Advisory Committee on Legislative and Regulatory Issues. The author reviewed this article with Committee Chair, Laurence A. Goldberg, Sheppard, Mullin, Richter & Hampton, San Francisco, CA.