

## ESOPs Impacted by Landmark U.S. Supreme Court Case 2.26.08

The pension plan world is abuzz with last week's U.S. Supreme Court (the "Court") decision in a pension plan case, *LaRue v. DeWolff*, 552 U.S. \_\_\_\_ (2008). We don't get many decisions by the Supremes in the pension area, so it's worth some focus. We will give just a brief summary of the case (more detailed reviews available all over the Internet) and then focus on the ways the decision might impact ESOPs.

### Case Summary

The company sponsored a 401(k) plan and investment decisions were controlled by plan participants. Mr. LaRue was a participant and he claimed that the plan's fiduciaries failed to follow his investment instruction to sell securities in his account and this failure resulted in a loss of \$150,000 in the value of his account. He sued the plan's fiduciaries under Section 502(a)(2) of ERISA. This section gives a plan participant the right to bring a lawsuit for "appropriate relief" under Section 409 of ERISA. Section 409 of ERISA provides:

"Any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries by this subchapter shall be personally liable to make good to such plan any losses to the plan resulting from each such breach, and to restore to such plan any profits of such fiduciary which have been made through use of assets of the plan by the fiduciary, and shall be subject to such other equitable or remedial relief as the court may deem appropriate, including removal of such fiduciary. A fiduciary may also be removed for a violation of section 1111 of this title."

The circuit courts of appeals around the country had split over the interpretation of this section. Some circuits held that the references in Section 409 to "losses to the plan" and "restore to such plan" meant that only a loss suffered by the "entire plan" was subject to a remedy under Section 502(a)(2). Other courts found that an individual participant could bring a fiduciary breach claim for losses suffered by his individual plan account without any other loss to the plan as a whole.

In resolving this circuit court split in favor of permitting lawsuits on behalf of individual participants, the LaRue opinion contains the following highlights:

1. The Court reexamined its opinion in *Massachusetts Mut. Life Ins. Co. v. Russell*, 473 U.S. 134 (1985). In *Russell*, the Court found that Section 502(a)(2) authorized recovery for a breach of fiduciary duty under Section 409 only for the plan as an entity, and did not permit individuals to bring suit when they did not seek relief on behalf of the plan as a whole. *Russell* involved a participant in a disability plan who received his benefits but claimed consequential damages relating to the delay in the startup of the payments.

In *LaRue*, the Court found the "entire plan" concept should be restricted to defined benefit plan cases (the Court included long term disability plans in this category). The Court found the concept inapplicable to defined contribution plans (like and ESOP) in which benefits are determined on an individual account balance basis.

2. Justices Roberts and Kennedy concurred in the result in favor of *LaRue*, but they wrote a separate concurrence in which they suggested that *LaRue's* remedy is under Section 502(a)(1)(B) rather than under Section 502(a)(2). Section 502(a)(1)(B) allows a participant to sue ". . . to recover benefits due to him under the terms of his plan, to enforce his rights under the terms of the plan, or to clarify his rights to future benefits under the terms of the plan." It is possible that *LaRue* might win his case under either section; however, forcing participants to sue under 502(a)(1)(B) provides employers with some additional procedural defenses that would not be available in a breach of fiduciary duty case under Section 502(a)(2).

3. Justices Thomas and Scalia filed an additional concurring opinion. They made the point that the loss to *LaRue's* account was a "loss to the plan" even if it did not affect all accounts within the plan. They saw no reason to distinguish defined benefit plans from defined contribution plans for this purpose.

### Impact on ESOPs

So, how does this case impact ESOPs? First, let's consider ESOPs in closely held companies.

Generally, all of the participants in the plan are collectively invested in company stock. A claim that a fiduciary breached his duties in a manner that impacted the company stock value would likely impact all ESOP participants. Therefore, a claim against the fiduciaries could be brought under Section 502(a)(2) by a single affected participant, or by a class that includes one or all of the participants. This would have been true before the *LaRue* decision.

The *LaRue* decision has greater significance where a fiduciary breach may have affected only a portion of the ESOP's participants. Here are a few examples:

1. Age 55 and 10 Statutory Diversification. Suppose the limited group of participants eligible for diversification in a year (under Section 401(a)(28) of the Code) made a claim that the stock value was incorrectly determined. If those participants sued for a breach of fiduciary duty, prior to *LaRue*, a court might have held that the entire plan was not

impacted by the breach, but only a small group of participants. The claim might have been dismissed. Under the majority opinion in *LaRue*, the participants would have a right to bring the fiduciary case under Section 502(a)(2). Note that under Justice Roberts' concurrence, it is possible the participants would be required to make a claim for benefits under Section 502(a)(1)(B), rather than a fiduciary claim. That result would create a longer and tougher road for the participants.

2. Benefit Distributions. Similarly, a claim of undervaluation of stock made just by the participants receiving benefit distributions in a particular year would affect only a subset of the ESOP's participants. The before and after analysis of *LaRue* relating to a diversification election would apply equally to benefit distributions.

3. KSOP - In a KSOP, participants make individual elections to invest some or all of their salary deferral contributions into company stock. If those participants who invest in the company stock fund later sue the fiduciaries, the group would represent a subset of plan participants, rather than the plan as a whole. The *LaRue* decision would permit the affected group to bring the fiduciary claim. See discussion below on public company KSOPs.

#### **Publicly-Traded Companies with KSOPs**

Much of the ERISA-related stock drop litigation since Enron has involved participants' claims that the company stock fund in the 401(k) plan was an imprudent investment choice and that the fiduciaries are liable to any participants who invested in the fund. Prior to *LaRue*, some of these cases were dismissed by courts because only some of the KSOP's participants chose to invest in the company stock fund. Since others elected not to invest in company stock, some courts said there was no loss to the "entire plan" but rather individual losses to affected participants. After *LaRue*, this sort of defense will no longer be available. The affected participants should be able to maintain their claims. Under Justice Roberts' concurrence, it is possible that participants will need to bring these claims under Section 502(a)(1)(B) as a benefit claim rather than as a 502(a)(2) fiduciary breach case.

#### **Summary**

The *LaRue* decision undoubtedly expands the universe of possible fiduciary breach cases. For ESOPs in closely held companies, the impact may be limited to a handful of situations in which one or more individual participants have a particular right under the ESOP that is not enjoyed by all participants. For ESOPs in publicly traded companies, the *LaRue* decision will allow many more plaintiffs to avoid an early stage dismissal of their case and increase the likelihood of getting to a trial on the merits of the underlying fiduciary claim. With so many public company cases pending in the courts, it will be an interesting year.