ESOP Benefit Distributions - A Little Guidance on Financial Disclosure
2.1.10

In a recent California case, *Balsley v. Delta Star Employee Stock Ownership Plan*, the U.S. District Court in San Francisco added a little flesh to the bare bones questions of what if any financial disclosure must a company make to ESOP participants in connection with their benefit distributions.
The plaintiff sued the ESOP and its fiduciaries for (i) a breach of ERISA fiduciary duty and (ii) failure to provide information required under Section 502(c) of ERISA. The motion to dismiss only addressed the breach of fiduciary duty claim.

Some facts: The plaintiff alleged that after his termination of service in November, 2007, he was offered a lump sum distribution of his ESOP account using the fair market value of the stock as of December 31, 2006. At that time the stock was worth $22.38 per share. The Company's chief financial officer ("CFO") allegedly told the plaintiff that "cash may not be available in the future to buy back Balsely's [plaintiff's] shares, and that the lump sum offer would not remain open." The plaintiff stated he relied on these two representations of the CFO. The plaintiff accepted the lump sum. He later learned that the December 31, 2007 valuation was $142.45. Apparently, the Company was a having a very strong financial year that resulted in a substantially higher stock value.

The fiduciary defendants made the following arguments:

First, the defendants argued the plaintiff lacked legal standing to bring the case. The fiduciaries argued that Section 502(a)(2) of ERISA does not provide a remedy for individual damages and that plaintiff would have to show an injury to the ESOP generally that impacted the value of his account. (See our prior blog on the *LaRue* decision of the U.S. Supreme Court on this point). The Court granted the defendant's motion to dismiss, although it noted that the plaintiff could pursue the breach of fiduciary claim under Section 502(a)(3) of ERISA. (Again, see *LaRue*).

Second, the Court then addressed the plaintiff's fiduciary claims, presumably because the claims will be resubmitted under Section 502(a)(3). The Court began by noting the rule in *Varity Corp. v. Howe*, 516 U.S. 489, 506 (1996) in which the U.S. Supreme Court held that: " . . .to participate knowingly and significantly in deceiving a plan's beneficiaries in order to save the employer money at the beneficiaries' expense is not to act 'solely in the interest of the participants and beneficiaries.'" The *Varity* case stands for the proposition that a fiduciary that deceives participants can be liable, even though the fiduciary provides the minimum information required under ERISA. Here, the plaintiff alleges the deception came in the form of both "omissions" and "affirmative misrepresentations."

As to the omissions, the plaintiff claims that the CFO had knowledge the Company was having a record sales year, and that the stock value had increased. Defendants argued that Section 404(a) of ERISA only creates duties "with respect to the plan" and so an omission of information about the company is not actionable. However, the Court compared this situation to *Varity* and found the statements about the limited availability of the lump sum distribution could be connected to the offering and may have created grounds for asserting the omission related to the administration of the plan. The court found that plaintiff's arguments were sufficient to survive a motion to dismiss.

If the court finds this omission of information constitutes a breach of fiduciary duty (at this point, it is just a decision on a motion to dismiss) the district court may cause ESOP companies to consider whether any material financial information about the company needs to be disclosed to participants who are assessing whether to elect to receive a current benefit distribution. Of course, it is possible the plaintiff will not prevail on this point at trial, as the burden shifts to the plaintiff to prove the misleading nature of the omission and the connection to plan administration under *Varity*.

As to the affirmative misrepresentations, plaintiff claims he was told (i) cash may not be available in the future to buy plaintiff's shares and (ii) the lump sum offer would not remain open. The court found for the defendants on the first statement. The court felt a company could have strong revenues and profits but still not have sufficient cash available to make benefit distributions. On the second statement, the court found for the plaintiff on the ground that plaintiff may be able to show that the ESOP trustees would again consider in the future whether to offer lump sum distributions.

Finally, the court found that neither the Company nor the ESOP trustees could be held liable as fiduciaries for the omissions or misleading statements made by the CFO. For this reason, the fiduciary breach claims against the Company and the ESOP trustees were dismissed. Only the fiduciary claim against the CFO remains. (The CFO did not contest his status as a plan fiduciary).

Final scorecard on the motion to dismiss: the plaintiff will have to resubmit his fiduciary claims under Section 502(a)(3); the claim based on omission of disclosure of company financial performance may go forward against the CFO (but not the company or trustees); the misrepresentation claim based on the possible lack of cash in the future is dismissed; the misrepresentation claim based on availability of a lump sum option in the future remains against the CFO.

Since the decision of the court is only on a motion to dismiss and not a trial on the merits, it would be a mistake to read too much into the decision at this point. Tow observations to keep in mind: first, the court seemed to recognize there is no general ERISA fiduciary duty for ESOP trustees to provide financial information about the company' performance in connection with benefit distributions; second, under the court's *Varity* approach, it is important for the fiduciaries of an ESOP to ensure that information is not provided to distributees that could be misleading.