



PROGRAM MATERIALS

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Trends in ESOP Litigation

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Trends in ESOP Litigation



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Agenda

- *ERISA Fiduciaries*
- *ERISA Fiduciary Duties*
- *Prohibited Transactions*
- *Supreme Court Cases Relevant to ESOP Litigation: Intel Corp. Inv. Policy Comm. v. Sulyma*, 140 S. Ct. 768 (Feb. 26, 2020) *Jander v. Retirement Plans Committee of IBM*, 140 S. Ct. 592 (Jan. 14, 2020), remanded to the Second Circuit
- ESOP Case Filings and Settlements to Watch and Recent Decision in *Foster v. Adams and Associates* Case No. 18-cv-02723-JSC.(N.D. Cal. July 6, 2020).
- Recent Discovery Orders Against the U.S. Department of Labor
- EBSA Enforcement Trends and Recent Executive Orders and Potential Limits on EBSA Enforcement; ERISA Industry Committee Recommendations regarding the Pandemic

ERISA Fiduciaries

- “Named fiduciary” - ERISA requires every employee benefit plan to identify at least one.
 - Authority to control and manage the plan (e.g., make all benefit-and investment-related decisions, appoint and direct Trustee)
 - Typically the employer sponsor of the plan
 - A plan may have multiple named fiduciaries – fiduciary duties allocated among them.
- Trustee – ERISA requires a plan to hold assets in a trust maintained by a Trustee.

Trustee

- Discretionary vs. Directed
 - Discretionary – Exclusive authority to manage and control plan assets, fiduciary to the plan
 - Directed – Subject to the direction of the Named Fiduciary, fiduciary as to matters it has actual authority (which may be limited)

Trustee as Named Fiduciary in ESOP

- Can be the Board or an ESOP Committee
- Majority of ESOPs name Trustee as the Named Fiduciary
- Institutional Trustee
 - More common (e.g., bank trust department, independent financial adviser)
- Individual Outside vs. Individual Internal
 - Individual outside Trustee more prevalent in larger companies
 - Smaller companies tend to have an individual (i.e., CEO, CFO or other officer) or a Committee act as Trustee
 - Internal Trustee may have conflicts of interest

ERISA Fiduciary Duties

1. Duty of loyalty
 2. Prudence
 3. Diversify plan investments
 4. Follow terms of plan document
- ESOP named fiduciaries have the same fiduciaries as above, but with special considerations.

ERISA Fiduciary Duties

Duty of Loyalty

- Discharge duties with respect to a plan solely in the interest of the participants and beneficiaries and for the exclusive purpose of providing benefits to participants and their beneficiaries; and defraying reasonable expenses of administering the plan
- When there is a conflict between the interests of the ESOP participants and the interests of another party, the Trustee should make the decisions solely in the interests of the ESOP

ERISA Fiduciary Duties

Prudence

- Act with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.

ESOP fiduciary should:

- Understand basic ESOP rules
- Read ESOP plan document, valuation
- Understand operations
- Maintain level of ESOP knowledge
- Know when to hire an expert

ERISA Fiduciary Duties

Diversify Plan Investments

- Diversify investments of the plan so as to minimize the risk of large losses, unless under the circumstances, it is clearly prudent not to do so.

ESOP fiduciary should:

- Ensure participants are permitted to diversify their accounts
- Ensure plan assets are prudently invested - diversify out of company stock if necessary
- Ensure non-company stock investments are prudent

ERISA Fiduciary Duties

Follow Terms of Plan Document

- Act in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of ERISA.

ESOP fiduciary must:

- Understand ESOP plan provisions so as to follow their terms
- Take corrective action when ESOP inconsistent with law

ERISA Prohibited Transactions

- Purpose – exclusive benefit of participants
- Governed by ERISA § 406

Prohibited Party in Interest Transactions

- ERISA § 406(a)
 - Prohibits “party in interest” transactions
 - A fiduciary is a party in interest
 - Causing the plan to acquire any employer security or employer real property in violation of ERISA § 407

Prohibited Self-Dealing and Conflicts of Interest

- ERISA § 406(b) prohibits transactions that involve any type of self-dealing or conflicts of interest by the plan fiduciary
 - Deal with plan assets in his own interest or for his own account (aka “self-dealing”);
 - Act in a transaction involving a plan on behalf of a person whose interests are adverse to the interest of the plan, its participants or beneficiaries (in other words, representing an adverse party to the plan in a transaction); or
 - Receive any consideration for his own personal account from any party dealing with the plan in connection with a transaction involving plan assets (aka “kickbacks”)

Role Independent Fiduciary – Resolve Conflicts of Interest

- Evolving role - increased fiduciary scrutiny, recent pension scandals means independent fiduciaries (IFs) used more frequently
- Relieve other ESOP fiduciaries from conflicts of interest
- Insulate other ESOP fiduciaries from liability
- IF duty is solely to ESOP participants and beneficiaries

Role of Independent Fiduciary – Valuation of Employer Stock

- ESOP fiduciary must ensure ESOP trust pays no more than FMV for company stock
- Valuation is used to determine the FMV of company's stock
 - At the time the ESOP first purchases the stock
 - Annually
- ESOP fiduciary – not appraiser – ultimately decides whether ESOP is paying a justifiable price
- Must critically evaluate the appraisal, including:
 - Data provided to appraiser
 - Whether appraiser has sufficient expertise
 - Appraiser's methods
 - Discounts properly applied
 - Comparison companies used were truly comparable
- Hiring IF can resolve conflicts or fill in lack of expertise on part of ESOP fiduciary

Recent Case About ESOP IF Fiduciary Duties

Acosta v. Vinosky (W.D. Va 8/2/2019)

- Court held ESOP Independent Trustee (IF) breached duties of prudence and loyalty and committed a prohibited transaction by causing ESOP to overpay for founding shareholder's company stock. Shareholder and IF were jointly and severally liable.
- Facts:
 - IF contacted less than 6 week before transaction
 - IF hired appraiser less than month before transaction
 - IF's due diligence was rushed, cursory; settled on price before reviewing appraisal; no negotiation
- At issue: Process, valuation methodology, assumptions used by IF's financial adviser. IF overlooked indications that financial adviser's was predisposed to reaching a predetermined value, and settled on a purchase price before reviewing the final appraisal.

Intel Corp. Investment Policy Comm. v. Sulyma

Decided: February 26, 2020

Issue: What is “actual knowledge” under ERISA’s 3-year statute of limitations (ERISA section 413(a)(2)(A), 29 U.S.C. § 1113)

- Plaintiff alleged Intel imprudently invested plan assets
- Documents and website available about plan’s asset allocation and investment strategy; the Plaintiff stated he did not read this information
- District court dismissed as time-barred
- Ninth Circuit reversed, holding Plaintiff had no “actual knowledge”

Intel Corp. Investment Policy Comm. v. Sulyma

The Ninth Circuit held that the phrase “actual knowledge” means that “the plaintiff is actually aware of the facts constituting the breach, not merely that those facts were available to the plaintiff.” The Court noted that the plain and unambiguous meaning of actual knowledge means knowledge “existing in fact or reality,” as distinguished from constructive or imputed knowledge.

The Supreme Court affirmed, holding that a plaintiff does not necessarily have actual knowledge of the information contained in disclosures that he receives but does not read or cannot recall reading. To satisfy the actual knowledge requirement, the plaintiff must “in fact have become aware of that information.”

Intel Corp. Investment Policy Comm. v. Sulyma

The Court concludes its opinion by clarifying that nothing in the opinion precludes any of the “usual ways” of proving actual knowledge including “inference from circumstantial evidence.” The Supreme Court instructed that, for purposes of ruling on a motion for summary judgment, a court should not adopt a plaintiff’s version of the facts if the record “blatantly” contradicts the plaintiff’s denial of knowledge.

Finally, the Supreme Court emphasizes that its opinion does not preclude defendants from arguing that evidence of “willful blindness” supports a finding of actual knowledge.

Jander v. Retirement Plans Committee of IBM

IBM's announcement of the sale of its microelectronics division caused the stock price to fall 7%

Plaintiffs alleged fiduciaries could have made an earlier announcement that would have mitigated losses to stock fund

District Court dismissed on the grounds that plaintiffs failed to allege that a prudent fiduciary in the fiduciary's position would not have viewed the earlier disclosure as more likely to harm the stock fund than help it

Second Circuit reversed

Jander v. Retirement Plans Committee of IBM

The Supreme Court remanded noting that petitioners argued that ERISA imposes no duty on an ESOP fiduciary to act on inside information. The government's briefs argued that an ERISA-based duty to disclose inside information that is not otherwise required to be disclosed by the securities laws would conflict at least with objectives of the complex insider trading and corporate disclosure requirements imposed by the federal securities laws. The remand stated:

“The Second Circuit did not address these arguments, and, for that reason, neither shall we.”

The case remains pending in the Second Circuit.

ESOP Case Filings to Watch

***Ferrell Companies, Inc. v. GreatBanc Trust Co., et al.*, 2:20-cv-02229 (D. Kan., Filed May 4, 2020)**

The complaint, arising out of a failed acquisition, alleges (i) that trustee GreatBanc Trust Company attempted to thwart its removal by replacing the Board of Directors of an ESOP sponsor that was attempting to terminate GreatBanc and (ii) that financial advisor Houlihan Lokey intentionally interfered with GreatBanc's fiduciary contract and breached its own confidentiality agreement.

ESOP Case Filings to Watch

***Gamino v. KPC Healthcare Holdings, Inc., et al.*, Case 5:20-cv-01126 (C.D. Cal., Filed June 1, 2020)**

The complaint alleges fiduciary violations of the prudence obligations and prohibited transaction based on the acquisition of employer securities for greater than adequate consideration. The complaint further seeks the \$110 per day penalty under ERISA section 104 for failure to disclose the ESOP valuation report as a plan document.

ESOP Case Filings to Watch

***Szalanski v. Arnold, et al.*, 3:19-cv-940 (W.D. Wis., Filed Nov. 15, 2019)**

The complaint frames allegations that are typically framed as shareholders' derivative allegations – Board of Directors conflicts and self-interest with employment rights and stock appreciation rights – to assert an ERISA fiduciary violation against ESOP Trustee GreatBanc Trust Company which approved an asset sale in its shareholder capacity. The allegations raise the issue regarding how an ESOP Company Board of Directors should monitor its ESOP's independent trustee.

ESOP Case Filings to Watch

***Lee v. Argent Trust Company*, 5:19-cv-00156, 2019 U.S. Dist. LEXIS 132066 (W.D.N.C. Aug. 7, 2019). Appeal Pending in the Fourth Circuit (Case No. 19-2485)**

The Western District of North Carolina held that a post-transaction drop in ESOP value from \$198 per share of company stock to \$65 per share did not indicate an ERISA fiduciary violation and suggested the analogy of a home *purchased* pursuant to a mortgage was applicable to a leveraged ESOP purchase. The District Court rejected a motion for reconsideration in late November in light of the Fourth Circuit decision in *Brundle v. Wilmington Trust, N.A.* and an appeal to the Fourth Circuit is currently pending. Briefs have been filed by a number of amicus parties in support of the district court decision, including by the American Society of Appraisers.

ESOP Settlements Watch

Wilmington Trust Settlement with the DOL Announced April 30, 2020

The Secretary of Labor announced on April 30, 2020 that it has reached an agreement with Wilmington Trust, N.A. requiring Wilmington Trust to pay a combined \$80 million to 21 different ESOPs for which it served as trustee plus \$8 million in penalties to the federal government. In addition, the settlement requires Wilmington to reimburse the plan sponsors of ESOPs for an unspecified amount legal costs and expenses advanced in connection with the Secretary's investigations and litigation. The settlement involved 3 pending cases in federal district court (*Scalia v. Wilmington Trust, N.A.* (Graphite Sale ESOP), Civil Action No. 17-CV-1755 (N.D. Ohio); *Scalia v. Wilmington Trust, N.A.* (HCMC Legal, Inc.), Civil Action No. 17-CV-6325 (S.D.N.Y.); *Scalia v. Wilmington Trust, N.A.* (Stargate Apparel, Inc. ESOP), Civil Action No. 19-CV-2793 (S.D.N.Y.) in addition to 18 further investigations where litigation had not yet been filed. The details of the settlement allocation have been sealed to date and the ESOP community will need to piece the details together when 2020 Form 5500s are filed during 2021.

ESOP Recent Decision

Foster v. Adams and Associates, Inc., Case No. 18-cv-02723-JSC.

N.D. Cal.) July 6, 2020.

Held: breach of the duty to monitor a fiduciary requires a predicate breach by the fiduciary. The Northern District of California joins the Second Circuit in finding that a monitoring claim is a derivative claim. *Rinehart v. Lehman Bros. Holdings Inc.*, 817 F.3d 56, 68 (2d Cir. 2016) ("Plaintiffs cannot maintain a claim for breach of the duty to monitor ... absent an underlying breach of the duties imposed under ERISA by the Plan Committee Defendants.") (internal quotation marks and citation omitted).

In *Adams*, this required an analysis of the actions of the deceased trustee in order for the allegations of monitoring violations to be considered. While there was sufficient factual questions on the withholding of information in the monitoring rule the Court also found that "no reasonable trier of fact could find the Director Defendants were acting as fiduciaries for purposes of the ESOP transaction; instead, their liability on this claim must be evaluated as non-fiduciaries."

Recent Discovery Orders Against the DOL

***Scalia, Secretary of Labor v. Heritage, et al.*, 1:18-cv-155 (D. Haw.)**

- Discovery in private plaintiff ERISA cases and those brought by the U.S. Department of Labor (“DOL”) are similar. Plaintiff does not typically have personal knowledge of the alleged ERISA violation(s).
- DOL ERISA actions, however, arise out of investigations by the DOL’s Employee Benefits Security Administration (“EBSA”). EBSA gathers considerable factual information, such as plan-related documents, transactional documents, e-mails, and conducts numerous interviews of investigation targets, that are discoverable in litigation.
- While certain of the DOL’s investigatory materials are privileged under a number of governmental privileges, such as investigatory files, deliberative process, and informant privileges, the underlying facts are discoverable.

Recent Discovery Orders Against the DOL

***Scalia, Secretary of Labor v. Heritage, et al.*, 1:18-cv-155 (D. Haw.)**

- Governmental privileges must be supported by a detailed declaration from senior agency staff explaining how the withheld material fits into the decision-making or investigative process. *Cal. Native Plant Soc’y*, 251 F.R.D. 408 (N.D. Cal. 2008).
- The DOL is obligated to produce facts relevant to the claims and defenses in a lawsuit. Governmental privilege does not protect “facts and evidence” from disclosure. *F.T.C. v. Warner Communications Inc.*, 742 F.2d 1156, 1161 (9th Cir. 1984). Only factual material that “is so interwoven with the deliberative material that it is not severable” may be encompassed by the privilege. *U.S. v. Fernandez*, 231 F.3d 1240, 1247 (9th Cir. 2000).
- Even if properly asserted, qualified privileges can be overcome if defendant’s need for the materials and the interest in accurate fact-finding outweighs the government’s interest in non-disclosure. *F.T.C. v. Warner Commc’ns Inc.*, 742 F.2d 1156, 1161 (9th Cir. 1984); *N. Pacifica, LLC v. City of Pacifica*, 274 F. Supp. 2d 1118, 1122 (N.D. Cal. 2003).

Recent Discovery Orders Against the DOL

***In Scalia, Secretary of Labor v. Heritage, et al.*, 1:18-cv-155 (D. Haw.) [Dkt. 237, July 21, 2020]:**

- The Court awarded \$63,509.25 in fees and \$1,801.20 in costs against the Secretary of Labor in favor of two defendants following a 14-month discovery dispute over the Secretary of Labor's failure to produce documents and provide sufficient privilege logs and declarations supporting the assertion of governmental privileges.
- Despite the Secretary of Labor's continued failings in discovery and being compelled to produce thousands of pages of documents previously withheld, the Court failed to find a waiver of governmental privileges and held that an award of attorneys' fees and costs was appropriate and proper.
- With respect to the Secretary of Labor's continued assertions of privilege in certain redactions, the Court determined that defendant's need for the materials and the interest in accurate fact-finding did not outweigh the government's interest in non-disclosure.

EBSA Enforcement Trends

2019 EBSA Enforcement Program Results (DOL Fact Sheet)

- The DOL has been actively promoting its enforcement results and announced that in its most recent fiscal year ended September 30, 2019, EBSA recovered in excess of \$2.5 billion in direct payment to plans, participants and beneficiaries.
<https://www.dol.gov/sites/dolgov/files/EBSA/about-ebsa/our-activities/resource-center/fact-sheets/ebsa-monetary-results.pdf>
- It appears that \$510M of these recoveries are from informal complaint resolutions (such as participants asking when is my check going to arrive, how do I update my address, etc.) outside of enforcement contexts. Of the remaining \$2 billion, the DOL does not break down the recoveries between litigation and investigations.

EBSA Enforcement Trends

2019 EBSA Enforcement Program Results (DOL Fact Sheet)

- EBSA closed 1,146 civil investigations with 770 of those cases (67%) resulting in monetary results for plans or other corrective action.
- EBSA referred 89 cases for litigation.

EBSA Enforcement Trends

Executive Orders 13891 and 13892, Issued in October 2019, direct:

- Federal Agencies to stop reliance on guidance that goes beyond a statute or notice and comment regulations (which have the force of law, if consistent with the governing statute).
- Federal agencies must establish a single, searchable toolbar that links to all of the already issued guidance. Additionally, the website must note that the guidance does not have the force and effect of law, unless as authorized by law or incorporated into a contract.

EBSA Enforcement Trends

DOL Website Guidance

In response to the Executive Orders, and in accordance with Office of Management and Budget directives, the DOL has announced on its website that it “is undertaking a detailed and comprehensive review of guidance documents issued by Department agencies to determine whether such guidance aligns with the law and Administration policy and otherwise serves an appropriate and useful purpose. Guidance which is outdated, superseded, invalid, unhelpful, confusing, redundant, outside the Department's appropriate role, or contrary to law or policy is being rescinded or modified.”

EBSA Enforcement Trends

Recent Executive Orders and Potential Limits on EBSA Enforcement

There has been speculation that these Executive orders may limit future case filings on topics such as the adequate consideration standard for purchases of ESOP shares of company and cause the DOL to consider returning to their proposed regulations on adequate consideration issued 31 years ago in 1988 to issue final regulations. EBSA has listed 205 documents in the DOL guidance website as “non-binding Guidance Documents” pursuant to the directive in Executive Order 13891. The 1988 proposed regulations issued by the Department of Labor and never finalized have not been identified to date by EBSA as “non-binding Guidance Documents”.

What About the Pandemic?

July 17, 2020 ERISA Industry Committee Letter to Congressional Leadership sets forth a wish list of legislative proposals on ERISA litigation matters , including requests that Congress act to address the following:

Prevent abusive “stock drop” lawsuits, if the plaintiff cannot prove that the volatility of the investment was due to a cause other than COVID-19;

Prevent abusive “imprudent investment” lawsuits, if the plaintiff cannot prove that the volatility of the investment was due to a cause other than COVID-19; and

Prevent abusive ERISA disclosure lawsuits, by requiring plaintiffs to demonstrate actual harm in a case based on failure to provide an ERISA-required disclosure or respond to a document request in a timely manner.

Arbitration

Individual Arbitration Provisions in Plan Documents

Dorman v. Charles Schwab Corp.

- ◆ The Ninth Circuit recently modified its position on the enforceability of arbitration agreements to ERISA claims of breach of fiduciary duty on behalf of the plan under ERISA Section 502(a)(2). The Court found an arbitration provision in the plan document was enforceable against the plaintiff.
- ◆ This decision may encourage plan sponsors to amend plan documents to include arbitration provisions like the one in *Dorman*
- ◆ Plan document stated "Any claim, dispute or breach arising out of or in any way related to the Plan shall be settled by binding arbitration"

Individual Arbitration Provisions in Plan Documents

Dorman v. Charles Schwab Corp.

- ◆ Plaintiff agreed to be bound to the arbitration clause because he participated in the plan while the arbitration clause was in effect
- ◆ Class action claims of plan-wide breach of fiduciary duty applied to the scope of the arbitration provision because the claims were asserted under ERISA and alleged that plan fiduciaries breached their duties to the plan on the whole.
- ◆ The *Dorman* court applied the reasoning of *Lamps Plus* and other recent Supreme Court pro-employer arbitration cases

Individual Arbitration Provisions in Plan Documents

Dorman v. Charles Schwab Corp

- ◆ Pitfalls of arbitration -- generally cannot be appealed, arbitrators may not have ERISA expertise, tendency to find middle ground

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David has helped hundreds of corporations' form ESOPs and create effective employee ownership through other equity incentives during the past 35 years. David defends ERISA fiduciary actions in federal courts throughout the U.S. in a wide range of controversies covering ERISA fiduciary responsibilities, ESOP valuation disputes, disclosure obligations, investment issues, and tax matters. He has extensive experience in negotiating ESOP, ERISA, and other issues with government regulatory agencies and in representing ERISA fiduciaries in litigation. and is actively involved in defending regulatory and enforcement actions by the IRS and the U.S. Department of Labor. Recognized nationally for his experience and expertise in the ESOP and executive compensation field, David is a past chair (1993-1995 and 2005-2007) of the legislative and regulatory advisory committee of The ESOP Association.



Mr. Wilkes is a partner with The Wagner Law Group, and the Practice Group Leader for ERISA Fiduciary and Investment Management Law practices. He represents Plan Sponsors, Investment Advisers, Broker Dealers, Trustees and other financial service providers on ERISA and related Securities Law matters. In addition, he leads the firm's Independent Fiduciary practice, where The Wagner Law Group serves as the independent ERISA fiduciary for a variety of ESOP, transactional, and Prohibited Transaction Exemption matters.