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Editor's Overview

It has been another busy month in the ERISA world, with a mixed bag of rulings for employers and fiduciaries. On the negative side, based on extreme facts, the Ninth Circuit blurred the lines between corporate and fiduciary conduct for ESOP-owned companies, and created risk that such companies may not be able to offer corporate indemnification to ERISA fiduciaries.

Fortunately, the other cases discussed this month offer more positive news. The Sixth Circuit held it will enforce reasonable limitations provisions set forth in benefit plans, including provisions setting forth when the claim for benefits accrues. In another case, a district court ruled that ERISA § 404(c) provides a defense to prohibited transaction claims, even when the fiduciary allegedly knew the directions it received were improper.

Finally, our Rulings, Filings and Settlements of Interest section notes the Seventh Circuit's recent ruling consolidating four appeals to decide whether *LaRue* has changed the rules for certifying class claims involving 401(k) and other defined contribution plans. This section also includes a discussion of recent significant settlements in three "stock drop" cases (*Countrywide*, *General Electric* and *Tyco*) and rulings in other stock drop and fee cases, as well as Judge Posner's views on *Glenn v. MetLife*.

Ninth Circuit Bars ESOP-Owned Company from Advancing Defense Costs of Officers Accused of ERISA Fiduciary Breach by Paying Excessive Compensation

by Robert Rachal and Aaron Reuter

In *Johnson v. Couturier*, 2009 WL 2216805 (9th Cir. July 27, 2009), the Ninth Circuit addressed two issues of importance to companies owned by Employee Stock Ownership Plans (ESOPs). One is whether an ESOP fiduciary's setting of his executive compensation as a corporate officer is subject to ERISA fiduciary duties. The other is whether ERISA precludes use of the company's assets to pay defense costs under corporate indemnification agreements. The Ninth Circuit answered both questions in the affirmative. However, as discussed below, the reach of these rulings may be limited by the extreme facts (*e.g.*, the CEO/fiduciary set his compensation at approximately two-thirds of the company's total value) at issue in this case.

Plaintiff participants in the Noll Manufacturing Corporation ESOP brought suit against former president, Clair R. Couturier, Jr., and two other directors, attorney David R. Johanson and financial advisor Robert E. Eddy, for allegedly breaching their fiduciary duties under ERISA by awarding $34.8 million (approximately two-thirds of the company's value) to Couturier in a buyout compensation package. The defendants also served as ESOP trustees. Under various indemnification agreements executed between 2001 and 2005, defendants sought advancement of their defense costs from Noll, which had become wholly owned by the ESOP in 2001. On August 10, 2007, the successor to Noll was purchased for approximately $61 million. After bank debt, executive compensation and other expenses were satisfied, about $15.8 million remained — $5 million of which was distributed to participants in January 2008. Nearly $10.8 million remained, at least partly in escrow, to be distributed to participants once remaining legal costs (potentially including defendants' claimed advances) were deducted. Concluding that plaintiffs were likely to prevail on the merits of their claims, and that these funds were functionally the same as plan assets, the district court issued a preliminary injunction preventing the advancement of defense costs to defendants.

The Ninth Circuit affirmed. The court first rejected defendants' contention that determining Couturier's compensation was a business decision not subject to ERISA. The court observed that while corporate pay decisions were not typically subject to ERISA scrutiny:

Where, as here, an ESOP fiduciary also serves as a corporate director or officer, imposing ERISA duties on business decisions from which that individual could directly profit does not to us seem an unworkable rule. To the contrary, our holding merely comports with congressional intent in establishing ERISA fiduciary duties as ‘the highest known to the law. To hold otherwise would protect from ERISA liability obvious self-dealing, as Plaintiffs allege occurred here, to the detriment of the plan beneficiaries.

On enjoining the payment of defense costs, the court stated that plaintiffs were likely to succeed in proving that defendants had breached their fiduciary duties by approving Couturier’s buyout package of $34.8 million (approximately 65% of the company’s total assets as of June 2004). Because of the apparent self-dealing and overt conflict of interest, the court believed that, as trustees, defendants should have protested this excessive compensation, and as directors pursued removal of Couturier as an ESOP trustee. The court also found that ERISA preempted state contract law regarding the advancement of defense costs. The court reasoned that the indemnification agreements, which relieved liability in the absence of deliberate wrongful acts or gross negligence, were in conflict with ERISA’s requirement that a fiduciary act in accordance with the “prudent man” standard of care codified at 29 U.S.C. § 1104(a)(1)(B). Thus, the court held that application of state law, with respect to these indemnification agreements, was preempted by ERISA.

The court's reasoning would appear to negate application of corporate indemnification agreements to *any* claim of ERISA fiduciary breach; however, later in the opinion, the court made clear that the problem with these indemnification agreements was that they were effectively funded with plan assets. Specifically, defendants argued that ERISA § 410(a) did not apply to bar these agreements because the defense costs were being advanced from corporate, not ESOP, assets. *See* 29 C.F.R. § 2509.75-4 (permitting indemnification from corporate but not plan assets). The court disagreed, finding that here the advance would be effectively from plan assets, as the company had been sold and the proceeds were being held to distribute to the ESOP participants. Thus, any advancement of defense costs would have directly reduced the funds available to be distributed to the participants. The court reasoned that, had the advancement occurred, the ESOP participants would have paid defendants' defense costs as long as defendants had not violated the terms of their indemnification agreements by engaging in deliberate wrongful acts or gross negligence. The court found that this would have been an impermissible result under ERISA § 410(a), as it would have used plan assets to relieve a fiduciary of liability for a fiduciary breach.

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Courts are divided over whether the setting of executive compensation is subject to ERISA fiduciary duties in ESOP-owned companies. Because of the extreme facts present here, the *Johnson* decision is not terribly surprising, and it ultimately may be read in light of, and limited to, these types of extreme circumstances in which an ERISA fiduciary appears to be looting the ESOP-owned company for his personal profit.

There are good reasons why the same “extreme facts” limitations ought to apply to the indemnification ruling. The Ninth Circuit cited to, and distinguished (not rejected), the Department of Labor’s guidance (29 C.F.R. § 2509.75-4) that permits the use of company assets to pay indemnification. In the extreme circumstances present here, where the company was sold and the assets were being held to be distributed to the participants, the *Johnson* court found that advancing defense costs from these funds was “tantamount” to using plan assets to pay indemnification. There are good grounds for arguing that this rule should not apply to ESOP-owned companies that are going concerns, including all of the policy reasons why indemnification agreements are permitted, and the potential adverse consequences if such agreements were effectively rendered worthless in ESOP-owned companies.   Unfortunately one district court has already ignored these limitations to conclude *Johnson* bars indemnification even when the company is a going concern that was only owned 42% by an ESOP.   *See Fernandez v. K-M Industries Holding Co.*, No. C 06-7339 (N.D. Cal. Aug. 21, 2009). In light of these risks, it also is worth noting that ESOP fiduciaries can acquire ERISA fiduciary insurance to protect themselves from the uncertainties attendant on corporate indemnification.

Sixth Circuit Ruling May Signal Prospects for Accelerating Limitations Period on Benefits Claims

By Russell L. Hirschhorn & Anthony Cacace

In *Rice v. Jefferson Pilot Financial Ins. Co.*,2009 WL 2581298 (6th Cir. Aug. 24, 2009), the Sixth Circuit concluded that plaintiff’s long-term disability benefit claim was barred by the plan’s three-year limitations period and that plaintiff’s claim accrued, as the plan provided, when proof of loss was required to be provided. Plaintiff Jerry Rice was a participant in the long-term disability benefit plan administered by the defendant Jefferson Pilot Financial Insurance Co. The plan provided that an employee was eligible for long-term disability benefits if he was disabled for more than 180 days (the “Elimination Period”). The plan also provided that “no legal action may be brought more than three years after proof of claim is required to be given” and that proof of claim must be provided within ninety days after the end of the Elimination Period.

On May 22, 2002, Rice claimed that he could no longer work because he was disabled. Rice applied for long-term disability benefits in October 2002. The plan denied his claim and two appeals, the last of which was on September 24, 2003. In November 2003, Rice commenced a lawsuit against the plan, contending that the plan improperly denied his claim for benefits. The parties agreed to stay the litigation so that Rice's claim could be re-adjudicated by the plan. On April 20, 2005, the plan again denied Rice's claim for benefits. Neither party asked the court to re-open the litigation. Instead, on June 8, 2007, Rice filed a second lawsuit against the plan again alleging that the plan improperly denied him his benefits.

The Sixth Circuit ruled that Rice had waived any argument that his claim did not accrue until April 20, 2005 (when the plan denied his claim after remand) because he had not made the argument during the proceedings before the district court. Even if he had not waived the argument, however, the court concluded that his claim was barred by the plan's three-year limitations period, which accrued, according to the terms of the plan, 270 days after the onset of his disability (the Elimination Period plus an additional 90 days to file a proof of claim). Because Rice alleged that he became disabled on May 22, 2002, the Sixth Circuit ruled that his claim accrued on February 16, 2003 and the three-year limitations period expired on February 16, 2006. In reaching this conclusion, the court "emphasized the freedom of parties to contract for the details of ERISA claims" and observed that its decision was in harmony with decisions from several other circuits.

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The Sixth Circuit's decision is significant in that it joins a growing number of authorities that have permitted employee benefit plans to prescribe not only the limitations period for a benefits claim but also the date when the claim accrues. The Second Circuit's decision in *Burke v. Price Waterhouse Coopers LLP Long Term Disability Plan*, 2009 WL 1964972 (2d Cir. July 9, 2009), which was discussed in our August Newsletter, ruled to that effect as well. Historically, some courts have held that the claim would ordinarily accrue only from the time the participant exhausted his claim for benefits. *Rice* and *Burke* indicate that, through effective plan draftsmanship, claims may be deemed to accrue in a more timely fashion.

District Court Applies ERISA Section 404(c) To Reject Prohibited Transaction Claims Against Plan's Directed Trustee

by Charles Seemann

In *Tullis v. UMB Bank, N.A.*, 2009 WL 2435084 (N.D. Ohio Aug. 11, 2009), a district court granted summary judgment dismissing prohibited-transaction claims against UMB Bank, which served as a plan's directed trustee, after UMB executed investment instructions with knowledge of potential fraud by an investment intermediary. Plaintiffs were two plan participants who appointed an investment advisor (Davis) and his firm (Capital) to manage plaintiffs' defined-contribution plan accounts. After regulators launched an investigation into Capital for allegedly fraudulent activities, UMB sued both Capital and Davis on the plan's behalf, alleging that "several investments were improper, severely declined in value immediately after being purchased, or simply never took place."

When plaintiffs learned of the fraud, they sued UMB under fiduciary-duty and prohibited-transaction theories, based on their contention that UMB "continued to accept and honor allegedly forged investment directives from Davis without consulting or warning the plaintiffs." In dismissing the case, the district court relied on ERISA § 404(c), which absolves fiduciaries of liability for losses resulting from participant direction of investments. The court found the UMB trust agreement and related instruments provided the participants adequate investment control, and conferred on plaintiffs the sole power to "establish, monitor and police limitations and restrictions" on their investments.

After concluding that Section 404(c) applied, the court rejected plaintiffs' contention that UMB had a duty to decline investment instructions in light of Davis' suspected malfeasance:

[A]lthough several prohibited transactions may have occurred, [UMB] simply did not cause the plan to engage in those transactions. As Plaintiffs' agent, Mr. Davis caused the plan to engage in transactions used for the benefit of a party-in-interest, Mr. Davis himself. Plaintiffs exercised individualized control over their own assets and selected Mr. Davis as their agent, and therefore ... [UMB] cannot be held liable for breach that occurs as a result of such individualized control.

The court also rejected plaintiffs' contention that Department of Labor regulations required UMB to decline transactions instituted by Davis, noting that the applicable provision gave UMB the option to decline, but did not requireit.

Plaintiffs also argued that UMB had a fiduciary obligation, as the directed trustee, to decline directions it suspected were improper. While the court acknowledged such a duty, it held that Section 404(c) still precluded recovery, since plaintiffs, through their agent, had directed the challenged transactions.

Finally, the court rejected plaintiffs' argument that UMB's knowledge of potential misconduct by David triggered an affirmative duty to inform plaintiffs of potential problems with investments initiated by Davis. After reviewing authorities recognizing a duty to disclose, the court concluded that any disclosure duty only arises after a participant inquiry. Finding no evidence of such inquiry, the court held that UMB's failure to warn plaintiffs did not prevent application of Section 404(c) to defeat plaintiffs' claims.

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Although there are likely to be further proceedings (plaintiffs have filed a motion for reconsideration), as it stands the *Tullis* decision is significant in two principal respects. First, the *Tullis* court held that Section 404(c) operated to defeat an alleged violation of ERISA's prohibited-transaction provisions, which typically are treated as establishing strict liability for violators. In addition, the decision read Section 404(c) in tandem with ERISA § 403(a)(1), which requires directed trustees such as UMB to follow only "proper" directions, and concluded that Section 404(c) controlled to preclude a finding of liability.

Rulings, Filings and Settlements of Interest

- On August 17, 2009, the Seventh Circuit ordered the consolidation of four appeals (*Howell v. Motorola, Inc.*, 7th Cir., No. 07-3837; *Lingis v. Dorazil*, 7th Cir., No. 09-2796; *Spano v. Boeing Co.*, 7th Cir., No. 09-3001; *Beesley v. Int'l Paper Co.*, 7th Cir., No. 09-3018) to address whether and how *LaRue* impacts class certification of claims involving 401(k) and other defined contribution plans.
- In *Shanehchian v. Macy's, Inc*., 2009 U.S. Dist. LEXIS 71997 (S.D. Ohio Aug. 14, 2009), the district court denied defendants' motion to dismiss stock drop claims brought against Macy's. In so ruling, the court determined that plaintiff's allegations that defendants made material misrepresentations regarding the company's sales growth to artificially inflate its stock price, and that the plan suffered losses when the "truth" was made public, were sufficient to withstand a motion to dismiss.
- *Alvidres v. Countrywide Financial Corp.*, No. 07 Civ. 05810 (C.D. Cal.) is the first ERISA stock drop class action lawsuit involving the subprime mortgage crisis to reach a settlement. On August 31, 2009, the district court preliminarily approved a settlement featuring a $55 million cash payment from Countrywide Financial Corp. The plaintiffs alleged that Countrywide failed to prudently and loyally manage the plan's investment in the company stock fund, failed to monitor its fiduciaries, and failed to provide plan participants with complete and accurate information regarding Countrywide stock. The plaintiffs' complaint withstood Countrywide's motion to dismiss and the plaintiffs' class was certified in April 2008.
- In *Cavalieri v. General Electric Co.*, No. 05 Civ. 00315 (N.D.N.Y.), the court approved a settlement of plaintiffs' ERISA stock-drop class action lawsuit valued at $40 million. Plaintiffs, on behalf of a class of 318,000 current and former participants of General Electric's 401(k) plan, alleged that GE imprudently invested over two-thirds of the plan's assets in company stock, breached its fiduciary duties by continuing to offer the company stock fund as an investment option even when it was imprudent to do so, and failed to convey the true operating condition of the company to plan

participants. The salient terms of the settlement were as follows: (i) a $10 million cash payout to former plan participants (former plan participants constitute approximately one quarter of the entire class); (ii) $30 million worth of structural changes to benefit current participants of the plan, including the implementation of investment education programs, fiduciary training, and additional investment options and Roth contributions; and (iii) $10 million dollars in attorneys' fees.

- In *Overby v. Tyco International Ltd.*,No. 02 Civ. 1357 (D.N.H.) and, No. 02 MDL 1335 (D.N.H.), after seven years of litigation, Tyco agreed to pay approximately $70.5 million to settle a class action lawsuit brought on behalf of 58,000 participants of seven of Tyco's retirement plans. Plaintiffs sued Tyco, alleging that it breached its fiduciary duties by maintaining the plans' investments in the company stock fund amidst an ongoing accounting fraud within the company. On August 10, 2009 the plaintiffs sought preliminary approval of the settlement agreement, which requires Tyco to pay $70.2 million to class members, and payments of $100,000 from Tyco's former CEO and $225,000 from Tyco's former CFO.
- In *Tibble v. Edison Int'l*, 2009 WL 2382340 (C.D. Ca. July 16, 2009) and 2009 WL 2382348 (C.D. Ca. July 31, 2009), on motions for summary judgment, the court addressed prohibited transaction and fiduciary breach claims arising from revenue sharing for a plan that provided the employer would pay administrative costs. The court held the revenue sharing did not constitute prohibited transactions (reading the plan to not prohibit such revenue sharing), but held there was a genuine issue whether the fiduciaries improperly considered revenue sharing (and the benefit it conferred on the employer) when selecting certain mutual funds. The court also rejected defendants' Section 404(c) defense, concluding that it is not a defense to the imprudent or disloyal selection of investment options. Finally, the court concluded that unitizing the employer stock fund was not imprudent, as it permitted faster execution of trades and also lowered fund volatility.
- In *Marrs v. Motorola, Inc.*, 2009 WL 2477650 (7th Cir. Aug. 14, 2009), the Seventh Circuit, per Judge Posner, provided a road map laying out its interpretation of the scope — and limits — of *Glenn*'s impact on how courts should treat a "conflicted" plan administrator's decision. The case arose from Motorola's decision to amend its disability income plan to place a two-year limit on benefits received under the plan, which previously had no such limitation. Against this backdrop, Judge Posner concluded that a conflict of interest existed because Motorola was both payor and plan administrator. Judge Posner went on to explain that, under *Glenn*, it is not the mere existence of a conflict of interest that will negate deference to the plan administrator's interpretation: it is the *gravity* of the conflict, as inferred from the circumstances, which is critical. From Judge Posner's perspective, the likelihood

that the conflict influenced the decision is the decisive consideration in whether to afford deference to the plan administrator’s interpretation. Applying this standard, Judge Posner concluded that there were no indications that the plan administrator labored under a conflict of interest serious enough to affect his decision.

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