

***THE AFTERMATH OF ENRON-  
Retirement Plan Issues***

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# **THE AFTERMATH OF ENRON- Retirement Plan Issues By Noel C. Ice**

## **ARTICLE 1 THE ENRON ALLEGATIONS- IN BRIEF**

### **1.1 Participant Direction of Investments.**

ENRON had a 401(k) Plan. Plan Participants were allowed to invest their elective deferrals in ENRON stock, subject to the already existing limits of ERISA<sup>1</sup> §407(b)(2)(B) applicable to 401(k) plans that invest in qualifying employer securities, [reproduced and discussed below](#). Alternatively, ENRON participants could invest in some 20 other investment options.

### **1.2 Employer Match With Company Stock.**

The employer matched elective deferrals with company stock. It did not have to do this, except perhaps to make it easier to pass the ADP<sup>2</sup> test to the extent that the match encouraged participant's to make elective 401(k) deferrals.

### **1.3 Were the Employees “Forced” to Invest in Company Stock?**

In a sense, employees were “forced” to invest the employer’s match in company stock; however, until recently, everyone was “forced” to invest in whatever the trustee invested in. The only case where participants are not, in effect, “forced” to invest as the trustee sees fit is in the case of plans that are specifically designed to allow participant direction of investment, a feature that is more common of late than previously, due to the protection that the trustee receives under ERISA §404(c), discussed below, when it is the participant, rather than the trustee, making the decisions. Even if participant direction of investment is allowed, the permitted investments are usually limited in number to a dozen or two mutual funds. In an Employee Stock Ownership Plan, as well as in a traditional stock bonus plans, you could say that employees were/are “forced” to invest money contributed by the company in company stock.

### **1.4 The Plan Investment in ENRON Stock Was at One Time Over a Billion Dollars.**

Plan investments in ENRON stock were not negligible. In January of 2001, the value of ENRON stock in the company’s retirement plans was **\$1.3 billion**.

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<sup>1</sup> All references herein to “ERISA” are to The Employee Retirement Income Security Act of 1974, as codified in 29 U.S.C. §1001, et seq., and as amended, unless otherwise indicated.

<sup>2</sup> The 401(k) annual deferral percentage test.

## **1.5 Questions for Consideration.**

Questions for consideration: Who was hurt in the ENRON debacle as a result of employer misrepresentations and concealment of material facts? Were the misrepresentations and concealment of material facts the cause of the company's bankruptcy? What about the plan participants who profited—whose 401(k) accounts purchased the stock when it was low, and sold it at a profit before all of the facts were disclosed? Is it fair that they should keep the profits?

## **ARTICLE 2 ERISA §404(c)**

### **2.1 ERISA §404(c) In Brief.**

Under ERISA §404(c), a **fiduciary is relieved from investment liability** if the participants are given a reasonable choice of investments, and the opportunity to change them at appropriate periodic intervals (“no less frequently than within any three month interval”). In the case of ENRON, it just so happened that during the eleven day blackout period ENRON stock declined by 40%. The provisions of DOL Reg. §2550.402c-1(b), but a part of the 404(c) regs., contain elaborate rules designed to protect the participant in those cases where the trustee seeks to use 404(c) to escape or limit investment responsibility. These regulations are reproduced in a separate Article which is devoted to §404(c). Employers are not required to avail themselves of ERISA 404(c), but ENRON attempted to do so, in the case of the non-matching contributions. The key to 404(c) protection is giving the participants the power to direct their investments themselves, so that it is not the trustee's duty to do so.

#### **2.1(a) The Blackout Period.**

From October 29, 2001 to November 13, 2001 there was a blackout period during which the company was switching investment providers. The blackout period was very short, only 11 days. Blackout periods can last for a month or more, simply because the logistics of moving from one investment provider to another can be quite involved, as you will know if you have ever moved from one “daily” plan to another. Note that if the ENRON plan was not one that provided frequent (in this case “daily”) participant investment directives, the blackout period would not even have been an issue.

#### **2.1(b) Was the Problem a Failure of Legislation, or a Failure to Tell the Truth, In Breach of Existing Statutes?**

One more important fact: It is alleged, and the evidence in support of the allegations look pretty strong on the surface, that ENRON employees were misled about the value of their stock. Need I say more? My own opinion is that what went wrong in the ENRON case had less to do with the statutory and regulatory framework having failed, and more to do with the fact that the truth of the companies finances was concealed. This fooled some of the best financial analysts on Wall Street, and perhaps if reforms are necessary they ought to be directed toward the securities laws, rather than ERISA. As you can see by DOL Reg. §2550.402c-1(b), set forth in the footnote, there are quite elaborate protections built

into the 404(c) regulations, but no matter how comprehensive, they are liable to be ineffective against outright fraud.

## **2.2 The Statute Its Own-Self.**

ERISA §404(c)(1)<sup>3</sup> provides:

### **(c) Control over assets by participant or beneficiary.**

(1) In the case of a pension plan which provides for individual accounts and permits a participant or beneficiary to exercise control over the assets in his account, if a participant or beneficiary exercises control over the assets in his account (as determined under regulations of the Secretary)—

**(A) such participant or beneficiary shall not be deemed to be a fiduciary by reason of such exercise, and**

**(B) no person who is otherwise a fiduciary shall be liable under this part for any loss, or by reason of any breach, which results from such participant's or beneficiary's exercise of control.**

The statute seems simple enough, but in practice the matter is very different. First of all, there are now elaborate regulations<sup>4</sup> to contend with, but even they do not give us the examples we need to feel secure under the statute.

ERISA §404(c) is certainly not going to protect a fiduciary from fraud or even from failure to disclose material facts.

## **2.3 The Regulations.**

DOL Reg. §2550.404c-1(c)(2) provides:

**(2) Independent Control.** Whether a participant or beneficiary has exercised independent control in fact with respect to a transaction depends on the facts and circumstances of the particular case. However, **a participant's or beneficiary's exercise of control is not independent in fact if:**

(i) The participant or beneficiary is subjected to improper influence by a plan fiduciary or the plan sponsor with respect to the transaction;

(ii) **A plan fiduciary has concealed material non-public facts** regarding the investment from the participant or beneficiary, *unless the disclosure of such information by the plan fiduciary to the participant or beneficiary would violate any provision of federal law or any provision of state law which is not preempted by the Act*; or

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<sup>3</sup> See footnote 5 for the full text of DOL Reg. §2550.402c-1(b).

<sup>4</sup> DOL Reg. §2550.404c-1.

- (iii) The participant or beneficiary is legally incompetent and the responsible plan fiduciary accepts the instructions of the participant or beneficiary knowing him to be legally incompetent.

§2550.404c-1(c)(2)(ii), first clause, pretty much disposes of any 404(c) defense in the ENRON case, I would think, unless, perhaps, the last clause applies, which I doubt.

DOL Reg. §2550.402c-1(b), reproduced in a footnote below,<sup>5</sup> is designed to ensure that before a fiduciary can be relieved of investment responsibility by reason of a participant's election to

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<sup>5</sup> DOL Reg. §2550.402c-1(b) provides:

**(b) ERISA section 404(c) plans.**

(1) **In general.** An "ERISA section 404(c) plan" is an individual account plan described in section 3(34) of the Act that:

- (i) Provides an opportunity for a participant or beneficiary to exercise control over assets in his individual account (see paragraph (b)(2) of this section); and
- (ii) Provides a participant or beneficiary an opportunity to choose, from a broad range of investment alternatives, the manner in which some or all of the assets in his account are invested (see paragraph (b)(3) of this section).

**(2) Opportunity to exercise control.**

(i) A plan provides a participant or beneficiary an opportunity to exercise control over assets in his account only if:

(A) Under the terms of the plan, the participant or beneficiary has a reasonable opportunity to give investment instructions (in writing or otherwise, with an opportunity to obtain written confirmation of such instructions) to an identified plan fiduciary who is obligated to comply with such instructions except as otherwise provided in paragraphs (b)(2)(ii)(B) and (d)(2)(ii) of this section; and

(B) The participant or beneficiary is provided or has the opportunity to obtain sufficient information to make informed decisions with regard to investment alternatives available under the plan, and incidents of ownership appurtenant to such investments. For purposes of this subparagraph, a participant or beneficiary will not be considered to have sufficient investment information unless—

(1) the participant or beneficiary is provided by an identified plan fiduciary (or a person or persons designated by the plan fiduciary to act on his behalf):

- (i) an explanation that the plan is intended to constitute a plan described in section 404(c) of the Employee Retirement Income Security Act, and Title 29 of the Code of Federal Regulations Section 2550.404c-1, and that the fiduciaries of the plan may be relieved of liability for any losses which are the direct and necessary result of investment instructions given by such participant or beneficiary;

- (ii) a description of the investment alternatives available under the plan and, with respect to each designated investment alternative, a general description of the investment objectives and risk and return characteristics of each such alternative, including information relating to the type and diversification of assets comprising the portfolio of the designated investment alternative;
- (iii) identification of any designated investment managers;
- (iv) an explanation of the circumstances under which participants and beneficiaries may give investment instructions and an explanation of any specified limitations on such instructions under the terms of the plan, including any restrictions on transfers to or from a designated investment alternative, and any restrictions on the exercise of voting, tender and similar rights appurtenant to a participant's or beneficiary's investment in an investment alternative;
- (v) a description of any transaction fees and expenses which affect the participant's or beneficiary's account balance in connection with purchases or sales of interests in investment alternatives (e.g., commissions, sales loads, deferred sales charges, redemption or exchange fees);
- (vi) the name, address, and phone number of the plan fiduciary (and, if applicable, the person or persons designated by the plan fiduciary to act on his behalf) responsible for providing the information described in paragraph (b)(2)(i)(B)(2) upon request of a participant or beneficiary and a description of the information described in paragraph (b)(2)(i)(B)(2) which may be obtained on request;
- (vii) in the case of plans which offer an investment alternative which is designed to permit a participant or beneficiary to directly or indirectly acquire or sell any **employer security (employer security alternative)**, a description of the procedures established to provide for the confidentiality of information relating to the purchase, holding and sale of **employer securities**, and the exercise of voting, tender and similar rights, by participants and beneficiaries, and the name, address and phone number of the plan fiduciary responsible for monitoring compliance with the procedures (see subparagraphs (d)(2)(ii)(E)(4)(vii), (viii) and (ix) of this section); and

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- (viii) in the case of an investment alternative which is subject to the Securities Act of 1933, and in which the participant or beneficiary has no assets invested, immediately following the participant's or beneficiary's initial investment, a copy of the most recent prospectus provided to the plan. This condition will be deemed satisfied if the participant or beneficiary has been provided with a copy of such most recent prospectus immediately prior to the participant's or beneficiary's initial investment in such alternative;
  - (ix) subsequent to an investment in an investment alternative, any materials provided to the plan relating to the exercise of voting, tender or similar rights which are incidental to the holding in the account of the participant or beneficiary of an ownership interest in such alternative to the extent that such rights are passed through to participants and beneficiaries under the terms of the plan, as well as a description of or reference to plan provisions relating to the exercise of voting, tender or similar rights.
- (2) the participant or beneficiary is provided by the identified plan fiduciary (or a person or persons designated by the plan fiduciary to act on his behalf), either directly or upon request, the following information, which shall be based on the latest information available to the plan:
- (i) a description of the annual operating expenses of each designated investment alternative (e. g., investment management fees, administrative fees, transaction costs) which reduce the rate of return to participants and beneficiaries, and the aggregate amount of such expenses expressed as a percentage of average net assets of the designated investment alternative;
  - (ii) copies of any prospectuses, financial statements and reports, and of any other materials relating to the investment alternatives available under the plan, to the extent such information is provided to the plan;
  - (iii) a list of the assets comprising the portfolio of each designated investment alternative which constitute plan assets within the meaning of 29 CFR 2510.3-101, the value of each such asset (or the proportion of the investment alternative which it comprises), and, with respect to each such asset which is a fixed rate investment contract issued by a bank, savings and loan association or insurance company, the name of the issuer of the contract, the term of the contract and the rate of return on the contract;

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- (iv) information concerning the value of shares or units in designated investment alternatives available to participants and beneficiaries under the plan, as well as the past and current investment performance of such alternatives, determined, net of expenses, on a reasonable and consistent basis; and
  - (v) information concerning the value of shares or units in designated investment alternatives held in the account of the participant or beneficiary.
- (ii) A plan does not fail to provide an opportunity for a participant or beneficiary to exercise control over his individual account merely because it—
- (A) Imposes charges for reasonable expenses. A plan may charge participants' and beneficiaries' accounts for the reasonable expenses of carrying out investment instructions, provided that procedures are established under the plan to periodically inform such participants and beneficiaries of actual expenses incurred with respect to their respective individual accounts;
  - (B) Permits a fiduciary to decline to implement investment instructions by participants and beneficiaries. A fiduciary may decline to implement participant and beneficiary instructions which are described at paragraph (d)(2)(ii) of this section, as well as instructions specified in the plan, including instructions—
    - (1) which would result in a prohibited transaction described in ERISA section 406 or section 4975 of the Internal Revenue Code, and
    - (2) which would generate income that would be taxable to the plan;
  - (C) Imposes reasonable restrictions on frequency of investment instructions. **A plan may impose reasonable restrictions on the frequency with which participants and beneficiaries may give investment instructions.** In no event, however, is such a restriction reasonable unless, with respect to each investment alternative made available by the plan, it permits participants and beneficiaries to give investment instructions **with a frequency which is appropriate in light of the market volatility to which the investment alternative may reasonably be expected to be subject, provided that—**
    - (1) At least three of the investment alternatives made available pursuant to the requirements of paragraph (b)(3)(i)(B) of this section, which constitute a broad range of investment alternatives, permit participants and beneficiaries to give investment instructions **no less frequently than once within any three month period**; and
    - (2)
      - (i) At least one of the investment alternatives meeting the requirements of paragraph (b)(2)(ii)(C)(1) of this section permits participants and beneficiaries to give investment instructions with regard to transfers into the investment alternative as frequently as participants and beneficiaries are permitted to give investment instructions with respect to any

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- investment alternative made available by the plan which permits participants and beneficiaries to give investment instructions more frequently than once within any three month period; or
- (ii) With respect to each investment alternative which permits participants and beneficiaries to give investment instructions more frequently than once within any three month period, participants and beneficiaries are permitted to direct their investments from such alternative into an income producing, low risk, liquid fund, subfund, or account as frequently as they are permitted to give investment instructions with respect to each such alternative and, with respect to such fund, subfund or account, participants and beneficiaries are permitted to direct investments from the fund, subfund or account to an investment alternative meeting the requirements of paragraph (b)(2)(ii)(C)(1) as frequently as they are permitted to give investment instructions with respect to that investment alternative; and
- (3) With respect to transfers from an investment alternative which is designed to permit a participant or beneficiary to directly or indirectly acquire or sell any **employer security (employer security alternative)** either:
- (i) All of the investment alternatives meeting the requirements of paragraph **(b)(2)(ii)(C)(1)** of this section must permit participants and beneficiaries to give investment instructions with regard to transfers into each of the investment alternatives as frequently as participants and beneficiaries are permitted to give investment instructions with respect to the **employer security alternative**; *or*
- (ii) Participants and beneficiaries are permitted to direct their investments from each **employer security alternative** into an income producing, low risk, liquid fund, subfund, or account as frequently as they are permitted to give investment instructions with respect to such **employer security alternative** and, with respect to such fund, subfund or account, participants and beneficiaries are permitted to direct investments from the fund, subfund or account to each investment alternative meeting the requirements of paragraph (b)(2)(ii)(C)(1) as frequently as they are permitted to give investment instructions with respect to each such investment alternative.
- (iii) Paragraph (c) of this section describes the circumstances under which a participant or beneficiary will be considered to have exercised independent control with respect to a particular transaction.

direct the investments in the participant's account, the fiduciary must give the participants the opportunity to make well-informed investment choices.

### **ARTICLE 3**

## **INVESTING IN STOCK THAT IS CONSISTENTLY DECLINING IN VALUE? -SOME RUMINATIONS**

Before proceeding on to a more detailed discussion of the law, I would like us to ruminate for a moment about the case where a fiduciary, any fiduciary, whether plan trustee or trustee of any other trusts, invests in a stock that is declining in value. What would the value of the ENRON stock have been if the employer had told the truth?

### **3.1 Stop-Loss Orders.**

Consider a stock that is declining each day *for legitimate reasons*. (There are plenty of viable, blue-chip corporations whose stock has fluctuated, during relatively short periods, by a lot more than the 40% dive that ENRON stock took during the blackout period.) Let us say that our imaginary trustee sits back and watches the stock go down and down, and does nothing. Is the trustee liable? Don't you think that, put the way I just put it, a jury is likely to think so? But consider that if the trustee had offered the stock on the market at any point in time, someone would have paid what it was presumably worth at the time. If the stock is publicly traded, and the market is efficient and has available to it all of the material information, isn't the price at which the stock is trading on any particular day (whether or not it has been declining everyday for the last month) its value? And if so, how can anyone be faulted for holding on to it? Is the efficient market presumption correct?

Some fiduciaries, particularly in probate estates, give instructions to automatically sell any securities that depreciate below a set amount (say, 10%). This gives some protection against losing everything as a stock slowly crashes in value. However, query whether such an order is in itself prudent. Many investment advisors say that it is a mistake to automatically sell whenever a stock is declining in value. I suppose the appropriate thing to do is to take each case on its merits, and perhaps instruct the broker to inform the fiduciary whenever a stock declines by more than a stated percentage, rather than to automatically sell it (assuming the fiduciary power to sell is delegable in the first place). On the other hand, if the stock is rapidly declining, there may be no time for consultation, in which case, an automatic sell order might be the surest way to limit the bleeding.

### **3.2 Questions for Consideration.**

Viewing all of the owners of ENRON stock in the aggregate, who was hurt, and who was helped by any company misrepresentations? I would assume that if ENRON had stated publicly that it was operating a shell game, the stock would have gone down; it just would have gone down earlier. Perhaps, if the company had been more forthcoming, something could have been done earlier to fix the problem, assuming it was fixable. But maybe it wasn't.

If the stock keeps going down, can we just say that anyone who buys it must be a fool? Perhaps the buyers are just persons who can afford to speculate. And what about the poor suckers on whom we fob off this stock? They are going to suffer the loss if the trust does not. And who are these buyers? Presumably, if our assumption is that they must be fools is correct, the buyers are not sophisticated institutional investors, they are just stupid individuals, perhaps day traders. Public policy should definitely favor sticking them, rather than you or I. Right? Is this just a case of whose ox gets gored?

These are all legitimate questions and concerns, worthy of serious consideration, if we wish to put the policy issues involved into a proper context. If we have problems understanding these issues where there is no fraud, then consider what the issues will be, if in addition, and as alleged in ENRON, we have one of the biggest frauds in history.

Bear in mind, as we proceed through this outline, that, from one perspective, the worst of the ENRON pension disaster may not have been that the retirement plan was heavily invested in ENRON stock, but that the stock was overvalued as a result of failure to disclose facts that a truly efficient market would consider material.

Does ENRON primarily represent a failure of the pension plan laws, or of the securities laws?

## **ARTICLE 4**

### **QUALIFIED PLANS (OTHER THAN ESOPS) THAT INVEST IN QUALIFYING EMPLOYER SECURITIES –THE LAW**

Although investing in the stock of the employer sounds like a prohibited transaction, and would be if it were not for an exemption, the law has permitted such investments for as long as companies have provided retirement plans, and a specific exception has been in the law from the date ERISA was enacted in 1974. And why not? If an employer is not required by law to provide for the retirement of its employees—and in the United States it is not— then why prohibit what is voluntary anyway? Well, the truth is that we prohibit a lot of things that arguably could be similarly analyzed, and the reason for such prohibitions is that self-dealing and the like can lead to such conflicts of interest and abuses that, given the tax benefits afforded qualified plans, the government has a right to place limits on such behavior and has a clear interest in protecting assets that are designed to provide for an employee's retirement. Nevertheless, ERISA §408(b) specifically permits certain non pension defined contribution, or individual account, plans subject to Title I of ERISA to invest in “qualifying employer securities” and “qualifying employer real property.”

Interestingly, the type of plan that receives the greatest legislative subsidy in the form of tax breaks is the Employee Stock Ownership Plan, or ESOP. An ESOP is simply a company profit-sharing plan that permits, and in some cases requires, investment in company stock. But the plan does not have to be an ESOP to be able to invest in employer securities. The employer can invest up to 10% of the assets of your average profit-sharing or 401(k) plan with no special plan language permitting such investments, and the employer is free to invest up to 100% of employer nonelective contributions in employer stock if the plan so provides.

#### **4.1 Special Exemption From Prohibited Transaction Rules For Employer Securities.**

Can a rollover IRA as a source to finance a new business venture of the IRA owner? Usually not. If a person uses an IRA to invest in a business in which the person has a significant interest, or loans it money, the IRA could be involved in a prohibited transaction, and would be disqualified. The effect of disqualification would be that the IRA would cease to be an IRA and would be entirely includible in your gross income in the year in which the prohibited transaction takes place.<sup>6</sup> This is a significantly worse penalty than that which normally applies to a qualified plan, where a 15% excise tax under IRC §4975(a) is the usual penalty for engaging in a prohibited transaction that is not egregious. However, a **profit sharing plan can legally acquire securities from the company that sponsors it, if certain conditions are met.** (This should be true, even if IRA rollover money is used for this purpose.)

Investing in employer stock, particularly if acquired from a disqualified person, could violate ERISA §406 (self-dealing), perhaps ERISA §407 (diversification) if the investment was sufficiently disproportionate, and also IRC<sup>7</sup> §4975. Nevertheless, there is an exception under ERISA and under the IRC that allows certain eligible individual account plans to invest up to 100% of the trust fund in “qualifying employer securities.”<sup>8</sup> Employer securities are defined in

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<sup>6</sup>“If, during any taxable year of the individual for whose benefit any individual retirement account is established, that individual or his beneficiary engages in any transaction prohibited by section 4975 with respect to such account, such account ceases to be an individual retirement account as of the first day of such taxable year.” IRC §408(e)(4).

<sup>7</sup>All references herein to the “IRC” are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

<sup>8</sup>ERISA §407(d)(5) defines “qualifying employer security” as follows:

- (5) The term “**qualifying employer security**” means an employer security which is-
  - (A) **stock**,
  - (B) **a marketable obligation** (as defined in subsection (e)), **or**
  - (C) **an interest in a publicly traded partnership** (as defined in section 7704(b) of the Internal Revenue Code of 1986), but only if such partnership is an existing partnership as defined in section 10211(c)(2)(A) of the Revenue ERISA of 1987 (Public Law 100-203).

ERISA 407(e) defines marketable obligation:

**(e) Marketable obligations.** For purposes of subsection (d)(5), the term “**marketable obligation**” means a bond, debenture, note, or certificate, or other evidence of indebtedness (hereinafter in this subsection referred to as “obligation”) if --

(1) such obligation is acquired --

(A) on the market, either (i) at the price of the obligation prevailing on a national securities exchange which is registered with the Securities and Exchange Commission, or (ii) if the obligation is not traded on such a national securities exchange, at a price not less favorable to the plan than the offering price for the obligation as established by current bid and asked prices quoted by persons independent of the issuer;

(B) from an underwriter, at a price (i) not in excess of the public offering price for the obligation as set forth in a prospectus or offering circular filed with the Securities and Exchange Commission, and (ii) at which a substantial portion of the same issue is acquired by persons independent of the issuer; or

ERISA §407(d)(5), reproduced at Section 4.2 below. A profit sharing plan (but not an IRA or SEP) can be an eligible individual account plan if it expressly allows for the investment in qualifying employer securities in excess of the 10% limitation otherwise applicable. The exception under ERISA is found in §408(e), and the exception under the IRC is found at §4975(d)(13), which cross references ERISA.

ERISA §§406 and 408, in pertinent part, are worth reviewing here:

**ERISA §406(a) provides,**

**Except as provided in §408:**

(1) A fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he knows or should know that such transaction constitutes a direct or indirect-

(A) Sale or exchange, or leasing, of any property between the plan and a party in interest;

\* \* \*

(E) Acquisition, on behalf of the plan, of any employer security or employer real property in violation of 407(a).

ERISA §408(b) provides:

408(b). The prohibitions provided in §406 shall not apply to any of the following transactions:

408(e). Sections 406 and 407 shall not apply to the acquisition or sale by a plan of **qualifying employer securities** (as defined in §407(d)(5)) or acquisition, sale or lease by a plan of **qualifying employer real property** (as defined in §407(d)(4))-

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(C) **directly from the issuer**, at a price not less favorable to the plan than the price paid currently for a substantial portion of the same issue by persons independent of the issuer;

(2) immediately following acquisition of such obligation --

(A) not more than 25 percent of the aggregate amount of obligations issued in such issue and outstanding at the time of acquisition is held by the plan, and

(B) at least 50 percent of the aggregate amount referred to in subparagraph (A) is held by persons independent of the issuer; and

(3) immediately following acquisition of the obligation, not more than 25 percent of the assets of the plan is invested in obligations of the employer or an affiliate of the employer.

(1) if such acquisition, sale, or lease is for **adequate consideration** (or in the case of a marketable obligation, at a price not less favorable to the plan than the price determined under §407(e)(1)),

(2) if **no commission** is charged with respect thereto, and

(3) if-

(A) the plan is an **eligible individual account plan** (as defined in §407(d)(3)), or

(B) in the case of an acquisition or lease of qualifying employer real property by a plan which is not an eligible individual account plan, or of an acquisition of qualifying employer securities by such plan, the lease or acquisition is not prohibited by §407(a).

Act Sec. 407(b)(1) Subsection (a) of this section shall not apply to any acquisition or holding of qualifying employer securities or qualifying employer real property by an eligible individual account plan.

(2) CROSS REFERENCES.-

(A) For exemption from diversification requirements for holding of qualifying employer securities and qualifying employer real property by eligible individual account plans, see section 404(a)(2).

(B) For exemption from prohibited transactions for certain acquisitions of qualifying employer securities and qualifying employer real property which are not in violation of 10 percent limitation, see section 408(e).

(C) For transitional rules respecting securities or real property subject to binding contracts in effect on June 30, 1974, see section 414(c).

The IRC<sup>9</sup> contains a similar exemption in §4975(d)(13), by cross-referencing the ERISA §406 and 408(e) exemptions. It too is worth reviewing:

(d) EXEMPTIONS.—The prohibitions provided in subsection (c) shall not apply to—

<sup>9</sup>All references herein to the “IRC” are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

\* \* \* \*

(13) any transaction which is exempt from section 406 of such Act by reason of section 408(e) of such Act (or which would be so exempt if such section 406 applied to such transaction)<sup>10</sup>

May we rely on the statute and take it literally? ERISA Opinion Letter No. 75-89 gives every indication that the statute means what it says.

**Although an investment in company stock is not prohibited on its face, plan fiduciaries are still required to make sure that the investment is prudent in respects other than lack of diversification.** For that reason, many employers have a policy that allows employees to direct the investment of their accounts in employer stock, and further restricting the plan's holding in employer stock to the accounts of those who so direct. ENRON allowed participant directed investments in employer stock, but it also had a policy of matching 401(k) contributions with ENRON stock. This has been referred to as "requiring the investment in ENRON stock," but it was really a requirement that the employer match elective deferrals with employer stock, which it did not have to make in the first place. Of course, the employer benefited by offering the match. Among other things it made its annual deferral percentage testing easier to pass.

#### **4.2 ERISA §407-Definition of Employer Security.**

ERISA §407 (29 USC §1107) provides in part:

**Limitation with respect to acquisition and holding of employer securities and employer real property by certain plans.**

**(a) Percentage limitation.** Except as otherwise provided in this section and section 414 [29 USC §1114]:

- (1) A plan may not acquire or hold—
  - (A) any employer security which is not a qualifying employer security, or
  - (B) any employer real property which is not qualifying employer real property.
- (2) A plan may not acquire any **qualifying employer security** or qualifying employer real property, if immediately after such acquisition the aggregate fair market value of employer securities and employer real property held by the plan **exceeds 10 percent of the fair market value of the assets of the plan.**

\* \* \* \*

**(b) Exception.**

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<sup>10</sup>IRC §4975(d)(13).

(1) **Subsection (a) of this section shall not apply to any acquisition or holding of qualifying employer securities or qualifying employer real property by an eligible individual account plan.**

(2)

(A) If this paragraph applies to an **eligible individual account plan, the portion of such plan which consists of applicable elective deferrals (and earnings allocable thereto) shall be treated as a separate plan—**

(i) **which is not an eligible individual account plan, and**

(ii) to which the requirements of this section apply.

(B)

(i) This paragraph shall apply to any eligible individual account plan **if any portion of the plan's applicable elective deferrals<sup>11</sup> (or earnings allocable thereto) are required to be invested** in qualifying employer securities or qualifying employer real property or both—

(I) pursuant to the terms of the plan, or

(II) at the direction of a person **other than the participant** on whose behalf such elective deferrals are made to the plan (or a beneficiary).

(ii) **This paragraph shall not apply to an individual account plan for a plan year if, on the last day of the preceding plan year, the fair market value of the assets of all individual account plans maintained by the employer equals not more than 10 percent of the fair market value of the assets of all pension plans (other than multiemployer plans) maintained by the employer.**

(iii) This paragraph shall not apply to an individual account plan that is an employee stock ownership plan as defined in section 4975(e)(7) of the Internal Revenue Code of 1986.

(iv) This paragraph shall not apply to an individual account plan if, pursuant to the terms of the plan, the portion of any employee's applicable elective deferrals which is required to be invested in qualifying employer securities and qualifying employer real property for any year **may not exceed 1 percent of the employee's compensation** which is taken into account under the plan in determining the

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<sup>11</sup>In other words, 401(k) elective deferrals cannot be invested in employer securities except to the extent permitted by ERISA §407(b)(2)(B).

maximum amount of the employee's applicable elective deferrals for such year.

- (C) For purposes of this paragraph, the term “applicable elective deferral” means any elective deferral (as defined in section 402(g)(3)(A) of the Internal Revenue Code of 1986) which is made pursuant to a qualified cash or deferred arrangement as defined in section 401(k) of the Internal Revenue Code of 1986.

(3) Cross references.

- (A) For exemption from diversification requirements for holding of qualifying employer securities and qualifying employer real property by eligible individual account plans, see section 404(a)(2) [29 USC §1104(a)(2)].
- (B) For exemption from prohibited transactions for certain acquisitions of qualifying employer securities and qualifying employer real property which are not in violation of 10 percent limitation, see section 408(e) [29 USC §1108(e)].
- (C) For transitional rules respecting securities or real property subject to binding contracts in effect on June 30, 1974, see section 414(c) [29 USC §1114(c)].

\* \* \* \*

**(d) Definitions.** For purposes of this section—

(1) The term “**employer security**” means a security issued by an employer of employees covered by the plan, or by an affiliate of such employer. A contract to which section 408(b)(5) [29 USC §1108(b)(5)] applies shall not be treated as a security for purposes of this section.

(2) The term “employer real property” means real property (and related personal property) which is leased to an employer of employees covered by the plan, or to an affiliate of such employer. For purposes of determining the time at which a plan acquires employer real property for purposes of this section, such property shall be deemed to be acquired by the plan on the date on which the plan acquires the property or on the date on which the lease to the employer (or affiliate) is entered into, whichever is later.

(3)

- (A) The term “**eligible individual account plan**” means an individual account plan which is (i) a profit-sharing, stock bonus, thrift, or savings plan; (ii) an employee stock ownership plan; or (iii) a money purchase plan which was in existence on the date of enactment of this Act [enacted Sept. 2, 1974] and which on such date invested primarily in qualifying employer securities. Such term excludes an individual retirement account or annuity

described in section 408 of the Internal Revenue Code of 1986 [26 USC §408].

(B) Notwithstanding subparagraph (A), a plan shall be treated as an eligible individual account plan with respect to the acquisition or holding of qualifying employer real property or qualifying employer securities only if such plan explicitly provides for acquisition and holding of qualifying employer securities or qualifying employer real property (as the case may be). In the case of a plan in existence on the date of enactment of this Act [enacted Sept. 2, 1974], this subparagraph shall not take effect until January 1, 1976.

(C) The term “eligible individual account plan” does not include any individual account plan the benefits of which are taken into account in determining the benefits payable to a participant under any defined benefit plan.

(4) The term “qualifying employer real property” means parcels of employer real property—

- (A) if a substantial number of the parcels are dispersed geographically;
- (B) if each parcel of real property and the improvements thereon are suitable (or adaptable without excessive cost) for more than one use;
- (C) even if all of such real property is leased to one lessee (which may be an employer, or an affiliate of an employer); and
- (D) if the acquisition and retention of such property comply with the provisions of this part (other than section 404(a)(1)(B) [29 USC §1104(a)(1)(B)] to the extent it requires diversification, and sections 404(a)(1)(C), 406 [29 USC §§1104(a)(1)(C), 1106 ], and subsection (a) of this section).

(5) The term “**qualifying employer security**” means an employer security which is—

- (A) stock,
- (B) a marketable obligation (as defined in subsection (e)), or
- (C) an interest in a publicly traded partnership (as defined in section 7704(b) of the Internal Revenue Code of 1986), but only if such partnership is an existing partnership as defined in section 10211(c)(2)(A) of the Revenue Act of 1987 (Public Law 100-203).

After December 17, 1987, in the case of a plan other than an eligible individual account plan, an employer security described in subparagraph (A) or (C) shall be considered a qualifying employer security only if such employer security satisfies the requirements of subsection (f)(1).

(6) The term “employee stock ownership plan” means an individual account plan—

- (A) which is a stock bonus plan which is qualified, or a stock bonus plan and money purchase plan both of which are qualified, under section 401 of the Internal Revenue Code of 1986 [26 USC §401], and which is designed to invest primarily in qualifying employer securities, and
- (B) which meets such other requirements as the Secretary of the Treasury may prescribe by regulation.

(7) A corporation is an affiliate of an employer if it is a member of any controlled group of corporations (as defined in section 1563(a) of the Internal Revenue Code of 1986 [26 USC §1563(a)], except that “applicable percentage” shall be substituted for “80 percent” wherever the latter percentage appears in such section) of which the employer who maintains the plan is a member. For purposes of the preceding sentence, the term “applicable percentage” means 50 percent, or such lower percentage as the Secretary may prescribe by regulation. A person other than a corporation shall be treated as an affiliate of an employer to the extent provided in regulations of the Secretary. An employer which is a person other than a corporation shall be treated as affiliated with another person to the extent provided by regulations of the Secretary. Regulations under this paragraph shall be prescribed only after consultation and coordination with the Secretary of the Treasury.

(8) The Secretary may prescribe regulations specifying the extent to which conversions, splits, the exercise of rights, and similar transactions are not treated as acquisitions.

(9) For purposes of this section, an arrangement which consists of a defined benefit plan and an individual account plan shall be treated as 1 plan if the benefits of such individual account plan are taken into account in determining the benefits payable under such defined benefit plan.

**(e) Marketable obligations.** For purposes of subsection (d)(5), the term “marketable obligation” means a bond, debenture, note, or certificate, or other evidence of indebtedness (hereinafter in this subsection referred to as “obligation”) if—

- (1) such obligation is acquired—
  - (A) on the market, either (i) at the price of the obligation prevailing on a national securities exchange which is registered with the Securities and Exchange Commission, or (ii) if the obligation is not traded on such a national securities exchange, at a price not less favorable to the plan than the offering price for the obligation as established by current bid and asked prices quoted by persons independent of the issuer;
  - (B) from an underwriter, at a price (i) not in excess of the public offering price for the obligation as set forth in a prospectus or offering circular filed with the Securities and Exchange

- Commission, and (ii) at which a substantial portion of the same issue is acquired by persons independent of the issuer; or
- (C) directly from the issuer, at a price not less favorable to the plan than the price paid currently for a substantial portion of the same issue by persons independent of the issuer;
- (2) immediately following acquisition of such obligation—
    - (A) not more than 25 percent of the aggregate amount of obligations issued in such issue and outstanding at the time of acquisition is held by the plan, and
    - (B) at least 50 percent of the aggregate amount referred to in subparagraph (A) is held by persons independent of the issuer; and
  - (3) immediately following acquisition of the obligation, not more than 25 percent of the assets of the plan is invested in obligations of the employer or an affiliate of the employer.
- (f)
- (1) Stock satisfies the requirements of this paragraph if, immediately following the acquisition of such stock—
    - (A) no more than 25 percent of the aggregate amount of stock of the same class issued and outstanding at the time of acquisition is held by the plan, and
    - (B) at least 50 percent of the aggregate amount referred to in subparagraph (A) is held by persons independent of the issuer.

\* \* \* \*

(Sept. 2, 1974, P.L. 93-406, Title I, Subtitle B, Part 4, §407, 88 Stat. 880; Dec. 22, 1987, P.L. 100-203, Title IX, Subtitle D, Part II, Subpart D, §§9345(a)(1), (2), (b), 101 Stat. 1330; Dec. 19, 1989, P.L. 101-239, Title VII, Subtitle H, Part V, Subpart C, §7881(l)(2), (3), Subpart D, §§7891(a)(1), 7894(e)(2), 103 Stat. 2443, 2445, 2450; Nov. 8, 1990, P.L. 101-540, §1, 104 Stat. 2379; Aug. 5, 1997, P.L. 105-34, Title XV, Subtitle B, §1524(a), 111 Stat. 1071.)

You can see that ERISA §407(b)(2)(B) already contains built in limits applicable to 401(k) plans, for plan years beginning after 1998. These were added as a part of the Taxpayer Relief Act of 1997, PL 105-34. These limitations would not apply to employer matching contributions, which is why ENRON could invest those accounts in its own stock without any percentage limits. Interestingly, I can find no IRC corollary to this rule.

In effect, ERISA §407(b)(2)(B) requires that the portion of a plan which would otherwise be an eligible individual account plan (EIAP) that “consists of applicable elective deferrals and earnings” will be treated as if it were not an EIAP, if the elective deferrals or earnings “are **required to be invested** in qualifying employer securities or qualifying employer real property or both” either pursuant to the plan’s terms or “at the direction of someone other than the participant.”

## ARTICLE 5

### THE ECONOMICS OF ESOPS FROM THE PERSPECTIVE OF THE REMAINING SHAREHOLDERS

#### 5.1 General Remarks.

This is a one issue Article. I am not going to be discussing valuation in general, because, among other reasons, I am not particularly well-versed in the subject. I have but one observation to make, and I think that it is a very important one that I fear people do not pay enough attention to. I could be wrong, but I think that this issue is more like a forest than a tree.

The valuation of company stock is a tricky business. Appraisers maintain that it is a science, but I am not sure that it is even an art. Sometimes I think that there is no sense to it at all. Nevertheless, we do our best to establish a reasonable value by taking into account the obvious at least. In the case of publicly traded stock, like ENRON, we have a market that, if it is efficient, is supposed to establish value. But we know that even publicly traded stock is very unstable, and that its valuation fluctuates wildly, even when the accounting is not fraudulent. In a closely held business one would think that value would be even more speculative, and yet we are called upon routinely to give it a value for tax purposes, and in that case we have to look at the basics, even if the public does not appear to be doing so in the case of marketable securities.

ESOPs receive generous tax benefits, and those benefits are directly tied to the value of the stock that an ESOP receives by purchase or by employer contribution. For this reason it is reasonable to hold the employer and other fiduciaries to a high standard in valuing the stock contributed, even if one wants to argue that the stock is a “gift from the employer to the employees.”

#### 5.2 The One Example I Want You to Think About—“And Would it Have Been Worth it, After All . . .”.

Here is my oversimplified example, constructed, admittedly, to make a point: Let us imagine a company whose only asset is \$10 million cash, and no liabilities. I own five shares and you the other five. Initially, I want to sell my stock to the company for \$5 million.<sup>12</sup> Had I done that, you would now own 100% of a company with no debt and \$5 million cash as its only asset. Presumably your stock would be worth \$5 million, the same as before.<sup>13</sup>

However, after talking to an ESOP lawyer I decide that there would be certain tax advantages in forming an ESOP to purchase my shares, and I convince you to go along with the idea. **What are your shares now worth?** Are you in the same position now as previously?

The company could contribute \$5 million cash to the ESOP to purchase my stock; or, in what amounts to economically much the same thing, the ESOP will more likely borrow the \$5 million, and the company will guaranty the debt.

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<sup>12</sup> To make the example easy to understand, I have ignored the issue of minority discounts. I could have structured the example so as to avoid this problem, but it would complicate the math without adding to my point. We could have multiple shareholders, none of which is in control.

<sup>13</sup> Again, I am ignoring a control premium.

In either case, you now you still own half the company. The ESOP owns the other half. How is that different from the way things stood prior to the sale? What is different is that the company is now more or less \$5 million poorer. Is this any different than if there had been a redemption of the stock instead? Of course. If the deal had been structured as a redemption, you would have owned all of the company afterwards; now you only own half; the ESOP owns the other half of the stock.

If the company pays \$5 million to the ESOP and the ESOP pays \$5 million to the bank to pay off the debt that the company has guaranteed, then how much is left in the company at the end of the day? \$5 million, the same as if the transaction had been structured as a redemption. The only difference is that if the transaction had been structured as a redemption, you would own all the stock. As it is, you now own only half. Was this a good deal for you? If you still own half the shares, but the company is worth \$5 million, your five shares are arguably now only worth \$2.5 million, because the company, which is now once again debt free, only has \$5 million in assets, of which you and the ESOP are each 50% owners.

But how can that be, since the ESOP trustee just got through paying \$5 million for its five shares? This raises other issues. If the ESOP paid \$5 million for \$2.5 million worth of stock, then it is not the only one that got (I am searching for a word) shafted in the transaction.

Okay, I am fully cognizant of the fact that I have oversimplified the problem and the issues, but I did so to make a point that I think is sorely in need of being made. After you have grasped the example, which illustrates a number of fundamental issues, we can proceed to make excuses, some of them good ones, for the outcome. Before doing that, let us distill the essence of the transaction just described.

A gratuitous —arguably, and arguably not gratuitous— transfer of \$5 million was made to the employees of the company. That is economic point one. That transfer dilutes the value of the company. (In those cases where the ESOP acquires its stock by purchase of treasury shares, the dilution is in the remaining shareholder equity, but the economic result is similar.) Previously you owned half of a company with \$10 million in assets, and now you own half of a company with \$5 million in assets. The \$5 million that disappeared was transferred to the employees. It is almost that simple.

But if I got \$5 million by selling my stock to the ESOP, and if the ESOP now has \$5 million worth of stock, then even if you only have \$2.5 million in stock, we have still manufactured \$2.5 million. Not. In order for the transaction to square, the ESOP's stock would have to be worth \$2.5 million, your stock \$2.5 million, and my stock \$5 million. My stock was worth more, because I was the only one that understood what was really going on.

Now when the ESOP shareholders come into court complaining that they paid \$5 million for stock that was only worth \$2.5, believe it or not, they might lose, and the reason is only indirectly related to the fact that the \$2.5 million that they actually got was a gift; so why should they complain? The reason that the ESOP shareholders may very well lose is that it is apparently appropriate to value the stock to be sold to the ESOP without taking into account the obligation of the company to fund the ESOP or to take into account the company's liability on the ESOP note. Why this is the case is not all that clear to me, but that is because I am not an expert on appraisals, I am just a simple person who looks at the most extreme *reducto absurdum* example I can think of and then asks "what is going on here?"

I promised to consider the other side of the argument, and I will do so somewhat hesitatingly now. First, as presaged above, the ungrateful employees have nothing to complain about. After all they received a freebie, a gift. Why, they are no different from the ENRON employees whose accounts were matched with company stock. So what that the stock was manipulated and inflated, if it was a gift. Generally, under ERISA, that gift argument will not get you very far. If it was a good argument, then it would be open season for all noncontributory plans, and no one would have standing to complain about anything. However, ESOPs are a special case. There is abundant evidence that ESOPs are not subject to all of the rules applicable to other defined contribution plans, and there are cases holding that it is appropriate to value the stock based on its value the day before the transaction. If this is true, and if my analysis is even remotely accurate, then an ESOP can be, as we suspected, a better than average deal for the company. And if it is good for the company, then it is good for the non ESOP shareholders.

Furthermore, it is not true that the transfer to the ESOP is entirely a gift, though in my example, and from your perspective as the non-selling shareholder, it may resemble one. Presumably, there is some value to the company arising out of its ability to offer its employees ESOP benefits. Perhaps they will take a pay cut (ha!); or, more realistically, an employee who has to choose between two jobs paying more or less the same, will choose to work for the one with the ESOP. In any case, there is some value to the company in offering its employees benefits under an ESOP; the question is “what is that value worth?” In the example I gave earlier, if the value were \$2.5 million, then we really would have manufactured it, and both I and you would walk away with \$5 million apiece, and the ESOP employees get a \$2.5 bonus created out of thin air and a tax deduction—or would it be one half of 7.5 million, in which case you were still shafted, just less so (these numbers can be very tricky).

The value of the tax deduction is important. The company will get a tax deduction of \$5 million. This has real value, even more so if the stock it contributed was only worth \$2.5 million. But if we really are able to sell \$2.5 million worth of stock to the employees and take a \$5 million deduction for it, this transaction may be economically viable after all, which, in turn, would make the stock more valuable. So if we take that deduction into account, maybe the stock the employees got is worth more than \$2.5 million. Now you see it, now you don't.

Finally, there is the possibility that after a couple of years, and before the ESOP debt is paid, you decide that you really don't want the ESOP anymore, so you terminate it before having allocated all of those shares to the employees. That would be slick. In making the decision to terminate the ESOP, you will have to take into account that you are no longer the only shareholder, however.

Is the point I am making so obvious that it is virtually never mentioned because any idiot would already realize it? That would explain the fact that I have only heard the issue alluded to briefly a couple of times. If I am right, and that the effect of the ESOP on the value of the stock can be significant and that it need not be considered as a valuation factor under present law, then I now know the secret, after all these years, that ESOPs are so popular. In your experience, have you found the point I am making to be typically and prominently raised as the main selling point when an ESOP is being proposed? It should be, because it makes the ESOP a much, much better deal for the company, as the Dairy Fresh directors only belatedly discovered. Whether or not it is also a good deal for the shareholders left behind depends on just how good that deal is for the company, because the remaining shareholders will definitely have their shares diluted, and so the value to the company better compensate for it.

### 5.3 Case Law.

#### 5.3(a) In General.

Surprisingly, there is little case law on the issue of factoring the ESOP transaction itself, and the company's obligations attendant thereto, into the valuation process. But it has come up on occasion. I found a few cases on the subject: *Hooker Industries, Inc.*, TC Memo 1982-357; *Eyler v. CIR.*, 78 AFTR 2d 96-5207, 88 F.3d 445, 7<sup>th</sup> Cir., 7/02/1996; and *Dairy Fresh Corp. v. Poole*, 108 F. Supp. 2d 1344 (2000).

#### 5.3(b) Dairy Fresh Corp. v. Poole.

This last case is very interesting. I will quote from it at length, since the opinion says it all. Briefly, however, what happened was that a company worth \$5.8 million (the day before the ESOP transaction), set up a \$5.2 million ESOP. In order to do this, it borrowed \$5.2 million and issued stock to the ESOP, stock which was supposed to be worth \$5.2 million. Prior to the ESOP transaction, the stock was worth \$40 share. Stop. How many shares, expressed as a percentage of all the shares, must a company that is presently worth \$5.8 million issue, if it is to issue \$5.2 million worth of stock. Presumably something approaching 100%. Right?

If the company had been worth exactly \$10 million, and there were 10 shares outstanding, which are all owned by you, and the company was going to give \$9 million in treasury stock to the employees' ESOP, it would stand to reason that the company would issue 90 more shares. The ESOP would own \$9 million worth, and you would own \$1 million. If \$9 million in equity is being transferred to the ESOP, it has to come from somewhere. Where else is going to come from if not from the value of your stock?

Well, the attorney for the company, being a reasonable guy, and not knowing what the law apparently would have allowed him to get away with, figured (how could he be so stupid?) that (1) either issuing additional shares would dilute the value of the existing stock on the front end, or that (2) the \$5.2 million liability that did not exist before the transaction would have to be taken into account in valuing the newly issued shares on the back end. Either way the transaction is viewed, the company would have to issue approximately ten times as many shares to the ESOP as were then outstanding, and the per share value would be approximately one-tenth of what it was before the transaction.

After the company CEO finally figured out what the attorney had done, it was too late. So the company tried to undo the transaction, and value the stock that went to the ESOP at ten times its real(?) value, as is apparently permitted, and which the poor benighted attorney did not realize. The court said that there are conservative valuation methods and ones not so conservative, and the fact that a conservative method was chosen does not make it a mistake of fact that can be undone retroactively. Apparently, a conservative valuation would have been at \$4 share, and, using another method—the method that allows one to value the shares without considering the ESOP—the value would have been \$40. Is there something wrong with this picture?

Members of the Dairy Fresh Board of Directors intended that the ESOP would borrow \$5.2 million from SouthTrust Bank, N.A. to purchase newly issued shares of Dairy Fresh stock and that the shares purchased would have a value of \$5.2

million. (Pretrial Order at PP 8, 10) This transaction was accomplished, in part, through a document issued by Dairy Fresh in its capacity as Plan Administrator, entitled "Direction to Trustee of Dairy Fresh Employees Stock Ownership Plan," which states:

Pursuant to the terms and provisions of the Dairy Fresh Employees Stock Ownership Plan ("the Plan"), Dairy Fresh Corporation, as Plan Administrator of the aforesaid Plan, does hereby direct AmSouth Bank, N.A., as Trustee of the Plan to enter into that certain Loan Agreement between the Plan, SouthTrust Bank of Alabama, N.A., Dairy Fresh Corporation, and the Individual Guarantors, to purchase 1,247,002 shares of the voting common stock of Dairy Fresh Corporation from said corporation for a purchase price of \$5,200,000.00, such purchase price having been determined in accordance with an independent appraisal as required by the appropriate regulations and the Plan.

Neiswender [the attorney for the Company] obtained an independent appraisal of Dairy Fresh from Gene Dilmore of Realty Researchers, Inc., a stock valuation firm. On December 16, 1988, Dilmore concluded that the market value of Dairy Fresh's 148,756 outstanding shares was \$5,820,431, or **\$39.13 per share**. (Secretary's Ex. 7) Based on Dilmore's valuation report, Neiswender calculated the number of shares to be issued and the price per share, taking into consideration the issuance of new shares. **Neiswender subtracted \$5.2 million [the amount of the debt], the value of stock sold to the ESOP, from Dilmore's valuation figure, then divided the result by the number of shares outstanding to arrive at a price per share of \$4.17.** (Neiswender Dep. at 135-36) Neiswender then divided the total amount to be paid by the ESOP (\$5.2 million) by the price per share (\$4.17) to determine that the ESOP would purchase 1,247,002 shares.<sup>14</sup>

Neiswender deliberately chose a conservative approach to arrive at the number of shares to be issued and the price per share. (Id. at 123-24) He felt that a more aggressive, or generous, valuation, would make the transaction susceptible to attacks from the Plan participants as well as the Department of Labor and the Internal Revenue Service. (Id.) The valuation formula Neiswender used was in line with a 1983 Department of Labor opinion Neiswender had seen regarding leveraged transactions which held that an ESOP should receive a dollar's worth of equity in the company for every dollar paid. (Id. at 124)

Closing on the ESOP transaction took place on December 30, 1988. Burt, as president of Dairy Fresh, signed the direction that instructed the trustee to purchase the stock on behalf of the ESOP. (Burt Aug. 22, 1997 Dep. at 117) Burt understood that the direction authorized the trustee to purchase 1,247,002 shares for **\$5.2 million** dollars.<sup>15</sup>

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<sup>14</sup> So was the stock worth \$39 a share, or \$4, a ten times difference?

<sup>15</sup> *Dairy Fresh Corp. v. Poole*, 108 F. Supp. 2d 1344 (2000).

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**Note that if the \$40 value had been used, the purchase price would have been \$50 million, rather than \$5 million, using the same number of shares.** Presumably, the \$5 million contribution would have been maintained by issuing 90% less shares. If that had been done, the shareholders who previously owned 100% of the company, would now own around half of it (instead of one-tenth). The ESOP (through company contributions) would have paid \$5.2 million for half the stock in a company that was only worth \$5.8 million before the transaction and which is now \$5.2 million poorer, presumably. Go figure.

If you are still not convinced that something is wrong with this picture, consider that if you were the only shareholder of a company whose only asset was \$5 million cash, and the company contributed the cash to an ESOP, what would the company be worth now? What would the ESOP be worth? What would the ESOP be worth if it used the \$5 million to purchase all of your stock? At that point the ESOP would own all of the stock in a company with no assets. Are you getting the picture?

The opinion continues by analyzing the effect on shareholders:

The ESOP transaction had both positive and negative effects on the pre-ESOP shareholders. The most obvious disadvantage was the dilution of the value of the stock held by pre-ESOP shareholders. For example, Morrison, the majority shareholder, became a minority shareholder. However, there were also definite benefits to the pre-ESOP shareholders, especially Morrison. As previously noted, the transaction provided Morrison, Burt, Tidmore, and York each with a significant amount of cash in repayment of their loans to the company and extinguished their potential liability on company debts. For Morrison, in particular, the ESOP's creation provided financial liquidity, eliminated personal liability on the corporation's debts and also eliminated some potential adverse tax consequences related to his personal loan to the corporation.

Maintenance of the ESOP is not without cost to the company. When a participant retires or separates from service, he has the right to sell his shares of Dairy Fresh stock to the company. (Plan Doc. §7.11) This is referred to as the “put” option, and is mandated by law. Because Dairy Fresh is required to purchase these shares, it incurs costs in servicing the “put” option. If, as Dairy Fresh seeks, the number of shares are reduced, then the costs of servicing the “put” option will also decrease.<sup>16</sup>

\* \* \* \*

The mistake, according to Dairy Fresh, was Neiswender's failure to take the appraisal's pre-transaction value per share (\$39.13) and divide that amount into **\$5.2 million** to determine the number of shares to issue. Dairy Fresh reads the phrase “determined in accordance with” to mean that Neiswender was not permitted to take any other factors into account to determine the price per share

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<sup>16</sup> *Id.*, 1350.

and was required to use the price per share determined by the independent appraiser. Such an interpretation is too restrictive. The direction does not say that the price per share was “determined by” an independent appraisal, only that it was “in accordance with an independent appraisal.” The “in accordance with” language encompasses what Neiswender did, that is, used the appraised price as a starting point to determine the value per share taking into consideration the issuance of new stock.

Dairy Fresh expends much energy attempting to prove that Neiswender should have used a different, less conservative method of valuation. In so doing, Dairy Fresh simply proves that--right or wrong--**Neiswender used a valuation formula that is favored by some and disfavored by others**. The issue in this case is not whether Neiswender's valuation was the preferred method but whether it was “in accordance with the independent appraisal”. Since the starting point for Neiswender's formula was based on the independent appraisal, it can be considered “in accordance with” it. Consequently, Dairy Fresh operated under no mistake of fact when it relied on Neiswender's valuation.<sup>17</sup>

The court concluded:

In summary, the Court finds that Victor Poole did not breach his fiduciary duty by refusing to obey Dairy Fresh's directive to follow a revised allocation schedule. However, Dairy Fresh, as Administrator, violated its fiduciary duty to the Dairy Fresh ESOP by issuing such directive and by bringing and maintaining this action. Similarly Poole, as Trustee, violated his fiduciary duty to the Dairy Fresh ESOP by initially failing to defend against and by failing to investigate the claims of Dairy Fresh against the ESOP. Accordingly, the motion for summary judgment filed by the Secretary is GRANTED. The motion for summary judgment filed by Dairy Fresh Corporation is DENIED.<sup>18</sup>

Well, now at least I hope you have a feel for the importance of this issue. I suspect that, after ENRON, if the “valuation formula that is favored by some” produces a value ten times larger than the valuation “disfavored by others” that the difference in the two approaches will invite more scrutiny than formerly.

## ARTICLE 6 BREACH OF DUTY

### 6.1 Wrongs?

We start by looking for a breach of a fiduciary duty. That means we must first tag someone as a fiduciary and then identify the duty that was breached. Whether and the extent to which nonfiduciaries can be held liable is beyond the scope of this outline.

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<sup>17</sup> *Id.*, 1358

<sup>18</sup> *id.*, 1361.

In the ENRON case, the duties alleged to have been breached are fairly obvious. It is clear by now that there is a duty not to lie and mislead. Some the finer points that will undoubtedly be a part of the ensuing ENRON litigation include the following, none of which I have the time to adequately explore here:

- When is a person who is **not** a fiduciary liable to the plan, and on what grounds?
- When is a person who **is** a fiduciary liable **to a plan participant or beneficiary, rather than to the plan**, and on what grounds? (This is in some ways much more interesting than the preceding bulleted question.)
- When is the employer a fiduciary, and when is it merely a settlor? In other words, what activities of the employer are fiduciary functions, and which are settlor type functions for which no fiduciary duty is owed?
- Admitting that it is now established that there is a duty not to lie, under what circumstances is the employer under a duty to affirmatively communicate or disclose essential information? And how does one disclose relevant inside information without violating the securities laws? And what is a real insider doing on the trust committee anyway?
- What is the reach of the so-called duty of the named fiduciary to “monitor” the plan?
- If the Plan requires that an account be invested primarily in employer securities, when should the fiduciary violate that requirement? See [ERISA 404\(a\)\(1\)\(D\)](#), discussed below. And when should/may the fiduciary ignore the participant’s direction in a participant directed account?

## **6.2 What’s a Trustee to Do?**

What is a trustee or other fiduciary supposed to do if the plan requires that plan assets be invested in qualifying employer securities, but it nevertheless appears imprudent to follow the terms of the plan?

ERISA §404(a) (29 USC §1104) provides:

### **(a) Prudent man standard of care.**

(1) Subject to sections 403(c) and (d) [29 USC §1103(c) and (d)], 4042 [29 USC §1342], and 4044 [29 USC §1344], a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and—

(A) for the exclusive purpose of:

(i) providing benefits to participants and their beneficiaries;

and

(ii) defraying reasonable expenses of administering the plan;

(B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like

capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;

- (C) by diversifying the 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; and

(D) **in accordance with the documents and instruments governing the plan *insofar as such documents and instruments are consistent with the provisions of this title and title IV.***

(2) In the case of an eligible individual account plan (as defined in section 407(d)(3) [29 USC §1107(d)(3)]), **the diversification requirement of paragraph (1)(C) and the prudence requirement (only to the extent that it requires diversification) of paragraph (1)(B) is not violated by acquisition or holding of qualifying employer real property or qualifying employer securities** (as defined in section 407(d)(4) and (5) [29 USC §1107(d)(4) and (5)]). [Emphasis added.]

Note that 404(a)(1)(D) requires that the terms of the plan document and other governing instruments be followed “insofar as such documents and instruments are consistent with the provisions of this title.”

### **6.3 Remedies?**

Had I world enough and time, I would love to write an outline devoted entirely to remedies under ERISA. But I don't. The subject is a fascinating, frustrating, and complicated one. Particularly as the cases cannot truly be reconciled, at least not with a straight face. I am frequently amused to read U.S. Supreme court cases where the Justices—or more likely their clerks—write the majority opinion in a typical 5 to 4 case, by citing dozens of other Supreme Court cases as cases which inexorably lead to the conclusion reached, as if anyone holding a contrary opinion must be a complete dolt. Then one reads the minority opinion in which 4 out of 5 Justices concurred, citing dozens of other Supreme Court cases as cases which inexorably lead to the conclusion reached, as if anyone holding a contrary opinion must be a complete dolt. I suppose it would be an affront to the dignity of the Court to frankly admit that the prior opinions are irreconcilable, and that basically the courts are making it up as they go along, and all to frequently changing the law, on a case by case basis, such that it is really just anybody's guess as to what the law actually is. If we admitted that, I suppose we would lack the pretext to argue with conviction, or to even get out of bed to go to the law office in the morning, so perhaps it is best that we continue to harbor the delusion that the cases merely interpret the law (rather than making it), and that the conclusions reached are logical, consistent, and foreseeable, even though this is clearly not the case where ERISA is concerned.

One thing we can say, is that we start with two sections of ERISA that can potentially be invoked as a remedy for a fiduciary breach, 502 and 409. In retrospect, these sections could have been more precise. It is safe to say that much.

#### **6.3(a) ERISA 502.**

§502(a) provides:

- (a) Persons empowered to bring a civil action. A civil action may be brought -
  - (1) by a participant or beneficiary --
    - (A) **for the relief provided for in subsection (c)** of this section,<sup>19</sup> or
    - (B) **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;
  - (2) by the Secretary, or by a participant, beneficiary or fiduciary for appropriate relief under section **409** [29 USCS 1109];
  - (3) by a participant, beneficiary, or fiduciary (A) to enjoin any act or practice which violates any provision of this title or the terms of the plan, or (B) to obtain other appropriate equitable relief (i) to redress such violations or (ii) to enforce any provisions of this title or the terms of the plan;
  - (4) by the Secretary, or by a participant, or beneficiary for **appropriate relief** in the case of a violation of 105(c) [29 USCS 1025(c)];
  - (5) except as otherwise provided in subsection (b), by the Secretary (A) to enjoin any act or practice which violates any provision of this title, or (B) to obtain other appropriate equitable relief (i) to redress such violation or (ii) to enforce any provision of this title;
  - (6) by the Secretary to collect any civil penalty under subsection (c)(2) or (i) or (I);
  - (7) by a State to enforce compliance with a qualified medical child support order (as defined in section 609(a)(2)(A) [29 USCS 1169(a)(2)(A)]);
  - (8) by the Secretary, or by an employer or other person referred to in section 101(f)(1), (A) to enjoin any act or practice which violates subsection (f) of section 101 [29 USCS 1021(f)], or (B) to obtain appropriate equitable relief (i) to redress such violation or (ii) to enforce such subsection; or
  - (9) in the event that the purchase of an insurance contract or insurance annuity in connection with termination of an individual's status as a participant covered under a pension plan with respect to all or

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<sup>19</sup> The relief under §502(c), provide in §502(a)(1)(B), can be expensive for the employer, but is not going to be much help to a plaintiff, since all it does is provide civil penalties.

any portion or the participant's pension benefit under such plan, by the Secretary, by any individual who was a participant or beneficiary at the time of the alleged violation, or by a fiduciary, to obtain appropriate relief, including the posting of security if necessary, to assure receipt by the participant or beneficiary of the amounts provided or to be provided by such insurance contract or annuity, plus reasonable prejudgment interest on such amounts. [Emphasis added.]

**6.3(b) ERISA 409.**

ERISA §409, referred to in 502(a)(2) above, provides:

29 USC §1109 **Liability for breach of fiduciary duty.**

- (a) 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 title 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 411 of this Act [29 USC §1111].
- (b) No fiduciary shall be liable with respect to a breach of fiduciary duty under this title if such breach was committed before he became a fiduciary or after he ceased to be a fiduciary. [Emphasis added.]

(Sept. 2, 1974, P.L. 93-406, Title I, Subtitle B, Part 4, §409, 88 Stat. 886.)

The problem for the private litigant is that these two sections have been narrowly construed, and generally do not afford compensatory or consequential, much less punitive, damages. See *Massachusetts Mutual Life Ins. Co. v. Russell*.<sup>20</sup> Just how broadly *Russell* should be interpreted is a matter on which the circuits do not appear to be in agreement.<sup>21</sup>

Other cases have granted individual relief for breach of fiduciary duty. Prominent among them was *Variety Corp. v. Howe*,<sup>22</sup> where the employer was held liable for misleading the

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<sup>20</sup> *Massachusetts Mutual Life Ins. Co. v. Russell*, 105 S. Ct. 3085 (1985).

<sup>21</sup> *Farr v. U.S. West Communications, Inc.*, 151 F. 3d 908 (9<sup>th</sup> Cir. 1998). *Muse v. IBM*, 103 F. 3d 490 (6<sup>th</sup> Cir. 1996). *Shea v. Esenten*, 107 F. 3d 625 (8<sup>th</sup> Cir. 1997). *Degan v. Ford Motor Co.*, 869 F. 3d 889 (5<sup>th</sup> Cir. 1989). *McLeod v. Oregon Lithoprint Inc.*, 46 F. 3d 956 (9<sup>th</sup> Cir. 1995). *Simmons v. Southern Bell*, 940 F. 2d 614 (11<sup>th</sup> Cir. 1991).

<sup>22</sup> *Variety Corp. v. Howe*, 116 S. Ct. 1065 (1996). Contrast *Variety* with *Mertens v. Hewitt Associates*, 113 S. Ct. 2063 (1993).

employees about the likelihood that medical benefits would be retained following the spin-off of a bound to fail subsidiary.

This outline will not attempt to analyze the emerging body of law in this area, other than to note that it is extremely difficult to reconcile all the cases. In some cases ERISA gives employers and other fiduciaries more protection than they frankly deserve, and I would expect that after ENRON we are going to see this area clarified both judicially and legislatively, probably in favor of the wronged plan participant. **For an up-to-date comprehensive article on the subject, see “The Duty to Inform and Fiduciary Breaches: The ‘New Frontier’ in ERISA Litigation,” by Howard Shapiro and Robert Rachel, presented as part of the course materials for the ABA’s ENRON Teleconference held in the spring of 2002.**

### **6.3(c) RICO.**

Racketeering? Yes, why not throw that in too. The ENRON plaintiffs are alleging violations of RICO §1962(a), (c) and (d). Where is Elliot Ness when you need him?

### **6.3(d) Civil Conspiracy and Common Law Negligence.**

The ENRON plaintiffs are also claiming civil conspiracy and common law negligence. Have we left anything out?

## **6.4 Fiduciary Decisions and Nonfiduciary Decisions.**

It is important to distinguish between “settlor functions,” which are nonfiduciary in nature, from fiduciary decisions. As a general rule, plan design is a settlor function; and hence, it would ordinarily not be a fiduciary breach to provide that the plan will invest solely or partly in employer securities.<sup>23</sup> Nevertheless, one of the claims in *Tittle, et. al. v. Enron Corp., et. al.*, is that Ken Lay, Skilling and Causey, as fiduciaries, violated ERISA duties of loyalty and care, and that ENRON violated the same duties both as a fiduciary and as a knowing participant, and that Arthur Andersen did the same as a knowing participant, by inducing and mandating the investments in ENRON stock.

## **ARTICLE 7 POLICY QUESTIONS**

- Should we prohibit plans from investing in employer stock altogether?
- If we did so, would most employees be better off, or worse off?
- What about ESOPs? Do we want to limit or prohibit investment in employer stock, unless we name the plan an ESOP? How silly is that? Why should we force an employer who

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<sup>23</sup> See *Curtiss-Wright Corp. v. Schoonejongen*, 514 U.S. 73, *Lockheed Corp. v. Spink*, 517 U.S. 882 (1996), and *Hughes Aircraft Co. v. Jacobson*, 525 U.S. 432 (1999). But see *Arakelian v. National Western Life Ins. Co.*, 680 F. Supp. 400 (D.D.C. 1987). *Moench v. Robertson*, 62 F. 3d 553 (3<sup>rd</sup> Cir. 1995), *cert. den.*, 516 U.S. 115 (1996).

presently has a profit sharing plan that is designed to invest in employer stock, to rename the plan, and add a bunch of surplus language, so that it will technically be an ESOP, all to avoid a new restriction in profit sharing plans investing in employer securities, which restriction is not going to apply to ESOPs?

In my humble opinion (IMHO) it is already the case that there are way too many statutory plans that resemble one another in every respect, save that they are created under a different section of the Internal Revenue Code. There is already little enough difference between a nonleveraged ESOP and a profit sharing or stock bonus plan designed to invest in employer stock, other than a number of picky details that the average participant would never notice. Take a profit sharing plan that has mandatory employer contributions; call it a money purchase pension plan, and presto, it will be one, being thereby subject to §§412 and 417, but otherwise not all that different from what it was before. Practically the only difference left these days between a 403(b)(7) plan and a 401(k) plan is in the name. Your response may be to make the differences between these plans greater, thereby justifying them. My response is to do away with about half of these separate categories, thereby dispensing with separate sets of rules and regulations the preservation of which serves no appreciable public purpose difference. I would start with the distinction between 401(k) and 403(b)(7) plans, if anybody cares to know.

- If we allow plans to invest in employer stock, should we prohibit employees from directing their own account balances in employer stock? Perhaps, since some of them obviously do not know what is good for them, says the elitist.
- Should we allow the highly compensated to invest in employer stock (because they can afford to lose it), and deny the nonhighly compensated that right because big brother knows what's best?
- Perhaps, in light of ENRON, the emphasis should be on forcing employers and their auditors to tell the truth, rather than mandating restrictive plan design rules on honest employers.
- If the employees of a company are required to limit their investments in employer stock, should employees of other companies be limited in their ability to invest in the stock of other employers?

For example, if employees of IBM are required to limit their investment in IBM stock to no more than 10% of their account balances, would not the same policy concerns apply to employees of General Motors who want to invest their profit sharing accounts in IBM stock? And why is it, for heaven's sake, that it is much less likely for an employee of GM to want to do this than it is for an employee of IBM? After all, if IBM goes under, then the employee loses both a job and his or her retirement savings. This would explain the policy distinction, but not the reason there is a problem to begin with, other than the fact that employees, if left unsupervised, behave doubly irrationally. Nevertheless, the fact is that they do. The statistical evidence is overwhelming that employees prefer to invest disproportionately in the stock of their employers, no matter how illogical. It is indeed an absurd world in which we live, and psychology trumps reason repeatedly.

- If we permit plans to invest in employer stock, should we put percentage limits in place? Is this to protect blue collar workers? Tell them that. Where do you think organized labor is on this issue?

Actually, the unions have been quite vocal in opposing such limits. According to an April 22, 2002 Los Angeles Times Article by Peter Gosselin, "Top labor leaders quietly refused to support the most stringent congressional proposal, one that would have taken an important first step toward affording 401(k) accounts the same protections that have long applied to traditional pensions." "[O]fficials conceded they also were influenced by internal polls showing that union members are deeply enamored of their 401(k)s, often to a greater extent than they are of their financially more important and far less risky union-won pensions." "Our people just value their ability to make their own personal decisions. They trust their own investment decisions more than they do anybody else's," said Jerry Shea, chief policy advisor to ALF-CIO President John J. Sweeney." Take that, do-gooders of the big brother wing of the political spectrum. The same article states that the Bush administration estimates that the government "will provide" (or if you prefer, "lose") "\$60 billion in tax breaks this year underwriting 401(k) accounts, compared with \$53 billion on traditional pensions."

- And there is the legitimate fear, not to be overlooked, that if an employer is prohibited from, say, matching 401(k) contributions with employer stock, the employer might just respond with something like, "Okay, we won't match 401(k) contributions anymore." That is one way to cure the problem, kill the goose. Perhaps the union leaders understand this better than their congressional counterparts. IMHO, reforms are necessary and could be effective, but only if proper consideration is given to the issues raised above. At the end of the day, after Congress has responded to the ENRON debacle, the test should be whether rank and file employees will be better off; else the reforms designed to address one problem will have failed in the ultimate purpose for which the private pension plan system was created.

## ARTICLE 8

### THIRD PARTY REPORTS ON THE ENRON SCANDAL

There are two very informative reports produced by the government in response to the ENRON debacle. One is a "Report by the Department of the Treasury on Employer Stock in 401(k) Plans," published February 28, 2002. The PDF version of the Treasury report can be retrieved from <http://216.239.35.100/search?q=cache:12q31FwagWQC:www.house.gov/jct/x-1-02.pdf+JCX-1-02&hl=en> The other is "Background Information Relating to the Investment of Retirement Plan Assets in Employer Stock," prepared by the Staff of the Joint Committee of Taxation, published February 11, 2002 (JCX-1-02). The PDF version of the Joint Committee report can be retrieved from <http://www.house.gov/jct/x-1-02.pdf>. These give background information about qualified plans that invest in employer stock. The Treasury report, surprisingly, takes a very strong position against "arbitrary caps" on plan investments in employer stock. The Joint Committee report describes almost two dozen separate bills introduced to regulate employer plan investment in company stock.

Another interesting survey is the “EBRI Survey on Company Stock in 401(k) Plans.” Go to <http://www.ebri.org/>.

Finally, some of the course materials from the spring ABA seminar entitled “After ENRON: Employer Securities in Qualified Plans,” are quite good.