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## Feature

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### New Trust Protects Fiduciaries of Distressed Companies



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In 2012, Iowa-based Dahl's Foods Inc. was ranked in the top 100 of the largest majority employee-owned companies in the U.S.<sup>2</sup> Two years later, it filed for chapter 11 protection in the U.S. Bankruptcy Court for the Southern District of Iowa. At the time of its bankruptcy filing, Dahl's was 97 percent owned by its employee stock ownership plan (ESOP).<sup>3</sup>

In its bankruptcy, Dahl's sold substantially all of its assets and used the proceeds to fund its chapter 11 reorganization plan. At the time it filed its reorganization plan on Aug. 17, 2015, it had approximately \$1 million available to distribute to approximately 900 participants in its ESOP — an average recovery of \$1,000 per participant.<sup>4</sup>

The *Dahl's* case is remarkable for yielding even a modest financial recovery for ESOP participants. Unfortunately, recoveries in situations like these are the exception rather than the rule. In the vast majority of instances, a distressed company's stock loses most, if not all, value post-bankruptcy. Thus, equityholders, such as ESOP participants, receive little or, most likely, no recovery on their ownership interests due to the absolute priority rule in bankruptcy, which provides that equity is last in line to get paid.

As a consequence, employees of failing or bankrupt ESOP companies are left holding the proverbial "empty bag." These employees are often left to seek recourse by commencing Employee Retirement Income Security Act (ERISA) fiduciary breach litigation against plan administrators, company officers

and directors, and other ESOP fiduciaries. ESOP fiduciaries now have a new weapon in their arsenal to help prevent or defend against ERISA fiduciary breach litigation. This article discusses ESOPs in general; the U.S. Supreme Court's unanimous decision in *Fifth Third Bancorp v. Dudenhoeffer*, which held that fiduciaries of ESOPs are not entitled to a "presumption of prudence" when deciding whether to buy, sell or hold company stock; recent ESOP litigation against bankrupt companies; and a new ESOP protection trust designed to protect both employees and fiduciaries in the event of a catastrophic decline in the value of company stock, the primary trigger of ERISA "stock drop" litigation.

#### ESOPs

An ESOP is an employer-sponsored retirement-benefit plan that allows a company's employees to hold an ownership interest in the company. ESOP proponents believe that ESOPs are an effective way to encourage employee productivity by providing employees with a direct vested interest in the well-being and longevity of the corporate enterprise. In addition, the ESOP serves as both an economic tool that "expands the national capital base among employees" and a "technique of corporate finance."<sup>5</sup> To qualify as an employee-benefit plan, the ESOP must meet the standards set forth under 26 U.S.C. § 401 and be set up as an individual account plan that "is designed to invest primarily in qualifying employer securities" and "meets such other requirements as the Secretary of the Treasury may prescribe by regulation."<sup>6</sup>

Companies may offer employees the right to participate in standalone ESOPs or ESOPs that are a part of a general 401(k) plan offering. A company

1 This article represents the views of the authors, and such views should not necessarily be imputed to StockShield, LLC, Simmons Legal PLLC, or their respective affiliates and clients.

2 National Center for Employee Ownership, "Top 100: The 2012 Employee Ownership 100, America's Largest Majority Employee-Owned Companies," *ESOP Facts* (October 2012).

3 See *In re Dahl's Foods Inc.*, Case No. 14-02689, Dkt. No. 592 (Bankr. S.D. Iowa Nov. 9, 2014).

4 *Id.* See also Patt Johnson, "Dahl's Employees Could See Stock Plan Payments," *Des Moines Register* (Sept. 1, 2015), available at [www.desmoinesregister.com/story/money/2015/09/01/dahls-des-moines-bankruptcy-creditors/71537078/](http://www.desmoinesregister.com/story/money/2015/09/01/dahls-des-moines-bankruptcy-creditors/71537078/) (unless otherwise indicated, all links in this article were last visited on Sept. 24, 2015).

5 See *Donovan v. Cunningham*, 716 F.2d 1455, 1458 (5th Cir. 1983); *Edgar v. Avaya Inc.*, 503 F.3d 340, 346 (3d Cir. 2007).

6 See 29 U.S.C. § 1107(d)(6); 26 U.S.C. § 401.

sets up an ESOP by drafting and executing a written instrument that, among other items, names one or more fiduciaries that “jointly or severally shall have authority to control and manage the operation and administration of the plan.”<sup>7</sup> The company also establishes a trust to hold the ESOP’s assets<sup>8</sup> and may then distribute tax-deductible contributions to the plan through outright stock transfers or cash to be used to purchase company stock to be held as an ESOP asset.<sup>9</sup> Further, some ESOPs are leveraged ESOPs that borrow money to invest in company stock. According to the National Center for Employee Ownership, there are 6,908 ESOPs in the U.S. with 13.8 million participants and \$232 billion in company stock.<sup>10</sup>

## ESOP Fiduciaries Are Not Entitled to Presumption of Prudence

Congress established ERISA in 1974 to protect the beneficiaries of qualified employee-retirement plans such as ESOPs.<sup>11</sup> With that goal in mind, Congress requires fiduciaries of ERISA benefit plans to act “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.”<sup>12</sup> Generally, benefit-plan fiduciaries must diversify investments to minimize the risk of large losses, unless it would be imprudent to do so.<sup>13</sup> Since ESOPs are designed to invest primarily in employer stock, Congress carved out for ESOP fiduciaries an exemption from the diversification requirement: “[T]he diversification requirement ... and the prudence requirement (only to the extent that it requires diversification) ... is not violated by acquisition or holding of qualifying employer real property or qualifying employer securities.”<sup>14</sup>

Given this exemption for ESOPs under ERISA, prior to June 25, 2014, a number of federal courts concluded that ESOP fiduciaries had the benefit of a special “presumption of prudence” when their decisions of buying, holding or selling employer stock were challenged by plan participants and beneficiaries.<sup>15</sup> On June 25, 2014, the Supreme Court sounded the death knell to the presumption of prudence. In *Fifth Third Bancorp v. Dudenhoeffer*,<sup>16</sup> the Court concluded that ESOP fiduciaries are subject to the same duty of prudence as other ERISA fiduciaries and are not entitled to any special presumption:

Section 1104(a)(2) makes no reference to a special “presumption” in favor of ESOP fiduciaries and does not require plaintiffs to allege that the employer was, e.g., on the “brink of collapse.” It simply modifies the duties imposed by § 1104(a)(1) in a precisely delineated way. Thus, aside from the fact that ESOP

fiduciaries are not liable for losses that result from a failure to diversify, they are subject to the duty of prudence like other ERISA fiduciaries.<sup>17</sup>

Therefore, ESOP fiduciaries are subject to the same fiduciary standards set forth under the common law of trusts.<sup>18</sup> ESOP fiduciaries thus have a duty to periodically monitor ESOP investments and take action to protect ESOP beneficiaries against the risk of large losses.<sup>19</sup> In light of *Dudenhoeffer*, ESOP fiduciaries are at increased risk of being sued for breach of fiduciary duty, especially when all signs indicate that the employer is headed toward bankruptcy and the ESOP is likely to suffer catastrophic losses.

## ESOP Litigation Against Bankrupt Companies *RadioShack Corp.*

The most common way that ESOP beneficiaries can seek to recoup losses in the event of bankruptcy of the employer is by seeking recompense from fiduciaries of the subject ESOP. On Nov. 26, 2014, a class action was filed on behalf of participants and beneficiaries of certain employee-benefit plans provided to employees of RadioShack Corp.<sup>20</sup> The RadioShack employee-benefit plans, including a 401(k) plan with an ESOP component, invested in (among other equities) RadioShack stock.<sup>21</sup> The plaintiffs, who were RadioShack employees, sued the company and certain of its officers, directors and benefit plan committee members that were fiduciaries of the RadioShack employee-benefit plans given that they exercised discretionary authority or control over management of the plans or plan assets.<sup>22</sup>

The RadioShack employees alleged that the plan fiduciaries breached their fiduciary duties owed to them because, although they knew or should have known that the RadioShack stock was an imprudent investment for the RadioShack employee-benefit plans, they failed to take action to protect the RadioShack employees’ retirement savings from loss.<sup>23</sup> The RadioShack employees bolstered their argument by pointing to facts revealing that troubled RadioShack suffered continuous net losses, including a decline in stock value, over a multi-year period.<sup>24</sup> Nearly two months after commencement of the class-action litigation against the plan fiduciaries, RadioShack filed for bankruptcy protection on Feb. 5, 2015.<sup>25</sup> The litigation is ongoing.

## *Eastman Kodak Co.*

On Jan. 19, 2012, Eastman Kodak Co. filed for chapter 11 protection in the U.S. Bankruptcy Court for the Southern District of New York.<sup>26</sup> Eight days later, the administrators and fiduciaries of Kodak’s savings and investment plan (SIP) and ESOP, plus BNY Mellon Financial Corp. (as the successor trustee of the SIP), found themselves embroiled in ERISA litigation.<sup>27</sup> The ESOP and SIP were administered by a committee comprised of Kodak’s “chief financial officer,

7 See 29 U.S.C. § 1102(a).

8 *Id.* § 1103(a).

9 See, e.g., *Donovan*, 716 F.2d at 1459.

10 See “A Statistical Profile of Employee Ownership,” National Center for Employee Ownership (updated March 2015), available at [www.nceo.org/articles/statistical-profile-employee-ownership](http://www.nceo.org/articles/statistical-profile-employee-ownership).

11 See, e.g., *St. Vincent Catholic Med. Ctrs. Ret. Plan v. Morgan Stanley Inv. Mgmt. Inc.*, 712 F.3d 705, 715 (2d Cir. 2013) (noting that “ERISA’s central purpose is to protect beneficiaries of employee-benefits plans.”); *Kopp v. Klein*, 722 F.3d 327, 334 (5th Cir. 2103) (same).

12 See 29 U.S.C. § 1104(a)(1)(B).

13 *Id.* § 1104(a)(1)(C).

14 *Id.* § 1104(a)(2).

15 See, e.g., *White v. Marshall & Ilsley Corp.*, 714 F.3d 980, 989 (7th Cir. 2013); *Quan v. Computer Sciences Corp.*, 623 F.3d 870, 882 (9th Cir. 2010); *Moench v. Robertson*, 62 F.3d 553, 571 (3d Cir. 1995).

16 134 S. Ct. 2459 (2014).

17 *Id.* at 2461 (syllabus).

18 See, e.g., *Tibble v. Edison Int’l*, 135 S. Ct. 1823 (2015).

19 *Id.* at 1828-29.

20 See *Singh v. RadioShack Corp., et al.*, Case No. 14-vc-00959, Class Action Complaint, Dkt. No. 1 (N.D. Tex. Nov. 26, 2014).

21 *Id.*

22 *Id.*

23 *Id.*

24 *Id.*

25 See *In re RadioShack Corp.*, Case No. 15-10197 (Bankr. D. Del. Feb. 5, 2015).

26 See *In re Eastman Kodak Co.*, Case No. 12-10202 (Bankr. S.D.N.Y. Jan. 19, 2012).

27 See *Gedek v. Perez, et al.*, Case No. 12-cv-06051 (W.D.N.Y. Jan. 27, 2012).

general counsel, director of human resources, treasurer and director of ‘Worldwide Total Compensation.’”<sup>28</sup>

Kodak’s employees brought the putative class action against the fiduciaries of the Kodak SIP and ESOP (collectively, the “Kodak plans”), alleging that the fiduciaries of the Kodak plans “violated ERISA by failing to prudently manage the Plans’ assets ... by continuing to invest [plan] assets in Kodak stock even after it became obvious that Kodak was headed for bankruptcy and that its stock was going to plummet in value.”<sup>29</sup> As was the case with RadioShack, this litigation is ongoing.

## ESOP Protection Trust

Although Congress exempts ESOPs from the requirement that qualified benefit plans be diversified, the loss of the presumption — that ESOP fiduciaries are acting prudently in the event of a significant loss in the value of company stock — places fiduciaries in a difficult position. In the event that a company becomes distressed, insolvent or files for bankruptcy protection, plaintiff attorneys and/or the Department of Labor may now require ESOP fiduciaries to demonstrate that they acted to protect ESOP beneficiaries. Moreover, traditional fiduciary liability insurance does not provide protection against ESOP plan losses and has limited applicability where the ESOP fiduciary is held liable for violation of ERISA, which expressly permits personal liability for losses caused by a breach of fiduciary duty.

A newly invented irrevocable trust, the ESOP protection trust helps protect ESOPs against large declines in the value of company stock. A group of financially healthy participating companies pools funds together to establish the ESOP protection trust, which is managed by an independent third party. Subject to certain conditions, the ESOP protection trust injects cash into participating company ESOPs that suffer large declines in the value of company stock. By providing this loss protection to ESOPs, the protection trust has the salient benefit of providing ESOP fiduciaries with meaningful protection in the event of a significant drop in the value of company stock — which may result in lawsuits similar to those faced by fiduciaries of RadioShack and Kodak.

Affirmative investment in an ESOP protection trust may serve as evidence that ESOP fiduciaries acted prudently to mitigate the risk of large losses to the ESOP should a company become distressed, insolvent or bankrupt. In addition, loyal employees who sacrificed to help build the company are provided a safeguard against a complete “wipeout” of the value of their retirement savings invested in company stock.

## Conclusion

Although most ESOP fiduciaries fully expect their sponsoring company to remain a healthy and viable entity, the Great Recession demonstrated that such an expectation is not certain. No company is immune to the risk of financial distress, insolvency or bankruptcy. Typically, an ESOP’s holdings are concentrated in a single stock. Even though ESOP fiduciaries are not required to diversify this equity

position, the Supreme Court has made it clear that ESOP fiduciaries must be prudent and should proactively seek out ways to mitigate the risk of large losses that could result should the company experience financial distress, insolvency or bankruptcy. The ESOP protection trust<sup>30</sup> is one such way that ESOP fiduciaries can demonstrate prudence and, among other things, (1) protect the retirement benefits of ESOP participants; (2) help prevent ERISA litigation; and (3) in the event of litigation, provide an affirmative defense that the ESOP’s fiduciaries did everything in their power to protect the ESOP. **abi**

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<sup>28</sup> See *Gedek v. Perez, et al.*, 66 F. Supp.3d 368, 372, 373 (W.D.N.Y. 2014) (citation omitted).  
<sup>29</sup> *Id.* at 371.

<sup>30</sup> See generally Overview of ESOP Protection Trust, available at [esopprotectiontrust.com](http://esopprotectiontrust.com).