

## Fernandez V. K-M Industries Holdings Co., Inc. ESOP Fiduciary Indemnification and Updated Special Tax Notice

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### **Case Law Developments - - K-M Industries Overview**

In the September Legal Update, we reported the Ninth Circuit's decision in Johnson v. Couturier, 2008 WL 4443085 (9<sup>th</sup> Cir., July 27, 2009), in which the Court of Appeals examined the extent to which an ERISA fiduciary may be indemnified by an ESOP sponsor and have its legal fees advanced. A month later, in the unrelated case of Fernandez v. K-M Industries Holding Co., Inc., 2009 WL 2579643 (N.D. Cal., August 21, 2009), the District Court for the Northern District of California again addressed the ESOP fiduciary indemnification issue, and relied on Couturier in its decision. The recent decision follows nine months after this District Court examined the duties and scope of liability of a successor trustee in relation to a breach or other omission of its predecessor (covered in the January 2009 issue of the *ESOP Report*).

#### **Relevant Facts**

In the case at hand, the family that founded Kelly-Moore Paint Company entered into two stock purchase and sale transactions in 1998 and 1999 that resulted in an ESOP owning 42% of the business's holding company, K-M Industries. In both transactions, the founder, Mr. Moore, served as the

sole trustee of the ESOP. By 2003, Mr. Moore's health began to fail and a trust company was appointed as successor trustee of the ESOP. ESOP participants brought suit against K-M Industries, the former shareholders and the successor trustee. The participants alleged that (i.) the ESOP overpaid for the K-M Industries stock in 1998 and 1999 because the selling shareholders failed to disclose complete and accurate information about asbestos claims, and (ii.) when the successor trustee became aware of this problem, it breached its fiduciary duty to the ESOP participants by failing to properly investigate the matter and seek a remedy for the alleged overpayment. The participants settled with all but the successor trustee in May 2009. The settlement provides that if the participants are successful in their claim that the successor trustee breached its fiduciary duty, the amount they collect will be offset by any amount the settling defendants are required to pay in indemnification to the successor trustee. If the settling defendants are not required to indemnify the successor trustee, the successor trustee will have to pay any judgment against it on the merits of the successor trustee breach

action out of its own pocket.

As previously reported, the successor trustee was unsuccessful in getting the case dismissed on summary judgment. The decision at issue denied the successor trustee's claim for indemnification. The merits of the participants' claim against the successor trustee would now be expected to proceed to trial.

#### **Successor Trustee's Claim for Indemnity**

The successor trustee sought indemnification from (i.) the selling shareholders on the basis of terms and conditions in the 1998 and 1999 purchase and sale agreements, and (ii.) the employer (K-M Industries) on the basis of its 2003 engagement agreement with the successor trustee. The trustee sought to rely on language in the purchase and sale agreement through which the sellers agreed to indemnify the ESOP for any breach of their representations or warranties. In addition, the contractual language in the successor trustee's engagement agreement was fairly standard language and basically indemnified the trustee for losses, damages and other expenses incurred in connection with the performance of services, except to the extent the trustee was found to be grossly negligent or to have acted with willful misconduct.

At the heart of the indemnification issue is ERISA §410(a), which provides that "any provision in an agreement or instrument which purports to relieve a fiduciary from responsibility or liability for any responsibility, obligation, or duty under... [ERISA] shall be void as against public policy." K-M Industries asserted that the successor trustee's claim for indemnification under the engagement agreement was void under ERISA §410(a) and the selling shareholders argued that the indemnification language in the purchase and sale agreement did not apply to the indemnification sought.

## **Court's Denial of Employer Indemnification**

Relying on Couturier, the District Court stated that the rationale underlying the Couturier decision supports the conclusion in this case that indemnification agreements between an ESOP fiduciary and plan sponsor are invalid any time an ESOP and its participants would bear the burden of indemnification, whether directly or indirectly. Although the ESOP in K-M Industries only owned 42% of the outstanding stock of the holding company and K-M Industries was not in liquidation mode, the District Court believed that if the plan sponsor indemnified the successor trustee, the ESOP participants would ultimately pay for the indemnification as a result of a reduction in the per share value of K-M Industries stock owned by the ESOP. It is unclear from the opinion whether the district court conducted a rigorous inquiry to determine that a material impact on the share value would result. Attempts by the successor trustee to distinguish the facts from the facts in Couturier were summarily dismissed.

The District Court also rejected the successor trustee's claim for indemnification from the selling shareholders on the basis of the purchase and sale agreement. The District Court determined that the indemnification agreed to in those documents was for the ESOP, not the trustee. This District Court was not inclined to acknowledge that any amounts recovered by the trustee would have gone to the ESOP rather than the trustee.

### **Lessons of K-M Industries**

K-M Industries reinforces the decision of the Ninth Circuit Court of Appeals in Couturier and reminds us that standard indemnification practices and arrangements of employers and ESOP fiduciaries must be examined, at least for ESOP companies resident in one of the states in the 9<sup>th</sup> Circuit. Although Couturier involved a 100% ESOP owned company that was in the process of liquidation, K-M Industries involved an ESOP which only owned 42% of the stock of a company that had ongoing operations. Thus, employers and fiduciaries must address this indemnification issue in an even broader context than the Couturier case suggested. It is unclear whether the issues in this case will be appealed and, if appealed, whether the Ninth Circuit will support the expansion of its holding in Couturier. With the possibility of employer provided indemnification becoming very problematic in an ESOP company in the 9<sup>th</sup> Circuit, the need for fiduciary insurance (in addition to D&O coverage) is expanded.

## **Regulatory Developments - - Updated Special Tax Notice Issued Overview**

Internal Revenue Code §402(f) requires a qualified plan administrator to provide a tax notice to any participant or beneficiary who is entitled to an eligible rollover distribution within a prescribed time period before the distribution or direct rollover. In 2002, the IRS issued a "safe harbor" notice that could be used to satisfy this requirement. On September 5, 2009, the IRS released Notice 2009-68 which provides updated safe harbor notices that may be used after December 31, 2009. The IRS released two forms of notices - - one relating to distributions from a designated Roth account and the other relating to distributions other than from a designated Roth account.

In addition to addressing Roth accounts, the new safe harbor notices incorporate a number of law changes including the: (a.) requirement that direct rollovers of accounts between \$1,000 and \$5,000 that are mandatory cash outs be directly rolled over to an IRA; (b.) availability of direct rollovers to non-spousal beneficiaries; and (c.) consequences of distributions to reservists and nonresident aliens.

Section 402(f) notices are to be given no less than 30 days (subject to waiver) and not more than 90 days or, if the plan so provides, 180 days, before an eligible rollover distribution is made. Plan administrators may customize the safe harbor explanations by omitting provisions that do not apply to their plans, or they can create their own form provided such form complies with the requirements of Code §402(f). The form of Special Tax Notice previously issued by the IRS as a safe harbor notice will no longer provide safe harbor protection after the end of 2009.

### **Action Required**

Plan administrators should review Notice 2009-68 and update their §402(f) notices, along with their distribution forms and procedures, between now and December 31, 2009. They should make sure their notices, forms and procedures are in compliance with the requirements of Code §402(f). If the new, safe harbor notices (or customizations thereof) will be used, they must be put in place no later than December 31, 2009.

*The author of the Legal Update is a members of The ESOP Association's Advisory Committee on Legislative and Regulatory Issues. The author reviewed this article with Committee Chair, Laurence A. Goldberg, Sheppard, Mullin, Richter & Hampton, San Francisco, CA.*

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