5-15-1983

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Recommended Citation

Margaret E. McLean Employee Stock Ownership Plans and Corporate Takeovers: Restraints on the Use of ESOPs by Corporate Officers and Directors to Avert Hostile Takeovers, 10 Pepp. L. Rev. 4 (1983)
Available at: http://digitalcommons.pepperdine.edu/plr/vol10/iss4/2

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Employee Stock Ownership Plans and Corporate Takeovers: Restraints on the Use of ESOPs by Corporate Officers and Directors to Avert Hostile Takeovers

In 1974, Congress enacted the Employee Retirement and Income Security Act (ERISA), which was designed to promote employee benefit plans and provide safeguards for the assets of the plans. An employee stock ownership plan is a device used by corporations which holds corporate stock as the primary asset of the employee benefit plan. Recently, corporate executives have seized the opportunity to use ESOPs as a defensive tactic for averting takeovers considered to be adverse to the corporation. However, provisions of ERISA, particularly relating to fiduciary duty, exclusive benefit, and prudence, seriously impede the use of an ESOP by incumbent management to avert takeovers. This article outlines and discusses ERISA and its application to corporate management utilizing an ESOP to avert a corporate takeover.

I. INTRODUCTION

Corporate takeovers involve complex issues of corporate law, securities regulation, finance and most recently, employee benefit plans. The stakes and rewards are high in the corporate takeover

1. A corporate takeover occurs when one entity seeks to assume control or management of another corporation. The initiating entity, whether an individual or a corporation, is known as a “raider.” The corporation which is the subject of the takeover is referred to as the “target” corporation. On February 7, 1983, the Securities and Exchange Commission announced the formation of a 15-member panel to render advice to Congress regarding any changes in tender offer regulations. The committee specifically analyzes regulations affecting corporate takeovers. The members of the panel include attorneys representing the four corporations involved in the Bendix-Martin Marietta takeover and merger transactions. L.A. Times, Feb. 8, 1983, Part IV at 3. See infra note 3.


(a) any plan, fund, or program which was heretofore or is hereafter established or maintained by an employer or by an employee organization, or by both, to the extent that by its express terms or as a result of surrounding circumstances such plan, fund or program—

(A) provides retirement income to employees, or

(B) results in a deferral of income by employees for periods extending to the termination of covered employment or beyond, regardless of the method of calculating the contributions made to the plan, the method of

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scenario. Recent headlines covering the Bendix-Martin Marietta-Allied-United Technology takeover, acquisition, and merger have exposed the general public to the strong personalities of corporate officers and directors as well as to the legal and financial intricacies involved in a corporate takeover. An employee stock ownership plan played an important role in the Bendix-Martin Marietta takeover attempt. The potential influence of an employee stock ownership plan may determine the future ownership and control of a corporation.\textsuperscript{3}

calculating the benefits under the plan or the method of distributing benefits from the plan.

See infra notes 36-37 and accompanying text.

3. On August 25, 1982, Bendix Corporation, a Delaware corporation headquartered in Michigan, announced its intention to purchase up to 45\% of Martin Marietta Corporation's stock. The acquisition, a combination cash and exchange tender offer by Bendix, amounted to $1.5 billion. On August 30, 1982, Martin Marietta retaliated by offering to buy Bendix shares at a price of $75.00 per share. The two-part bid for Bendix included a $75.00 per share offer for 11.9 million shares of Bendix stock. The potential purchase represented 50\% of the 23.7 million outstanding Bendix common shares. The second step was a proposal to acquire the balance of Bendix's shares in exchange for Martin Marietta stock valued at $5.00 per share.

The "Pac-Man" strategy continued. Bendix sought to acquire Marietta; Marietta sought to acquire Bendix. A "gray knight" came to Martin Marietta's aid. United Technology, acting as a Martin Marietta ally, launched a tender offer for 50.3\% of the Bendix stock at the price of $75.00 per share. To avoid potential antitrust violations, Martin Marietta and United Technology agreed to divide up Bendix if either party was successful in its takeover bid.

Bendix reacted to the Martin Marietta-United Technology alliance by increasing its tender offer price from $43.00 per share to $48.00 per share. Martin Marietta promptly rejected the offer. On September 9, 1982, Bendix rejected United Technology's offer as "grossly inadequate." Bendix increased its offering for Martin Marietta stock from 45\% to 55\%. In an attempt to merge the companies on a friendly basis, United Technology's chairman, Harry Gray, offered $85.00 per share for Bendix stock. Bendix declined the offer on September 15, 1982. On September 17, 1982, Bendix consummated the purchase of Martin Marietta stock. Seventy percent of Martin Marietta stock was purchased for approximately $1.2 billion. As a majority shareholder, Bendix demanded resignation of Martin Marietta's board of directors at a shareholders' meeting. Martin Marietta refused.

Martin Marietta's offer for Bendix stock continued. Bendix approached Martin Marietta seeking a peaceful solution to no avail. On September 22, Allied Corporation entered the corporate takeover arena with an offer to merge with Bendix at a cost of $1.9 billion. Citibank, the trustee for the Bendix employee stock ownership plan [hereinafter referred to as ESOP] withdrew the 4,479,000 shares previously tendered to Martin Marietta. This offer of ESOP shares by the trustee, Citibank, was sharply denounced by Bendix's management as not being in the best interest of the employee participants.

Martin Marietta bought 44\% of the Bendix stock on September 23, 1982. On September 24, the takeover battle which involved four major corporations ended. Allied struck a tentative agreement with Martin Marietta. Bendix, the initiator of the takeover scenario, was now controlled by Allied. This proved to be an ironic outcome for Bendix, considering it sought to be the proud owner of Martin Marietta at the onset. See generally, Wall Street Journal, August 26, through September 24, 1982; The American Lawyer, Feb. 1983, p. 35-39. Mr. Agee resigned as Chairman of Bendix effective June 1, 1983. (L.A. Times, Feb. 9, 1983, Part IV, at 1).
To avoid corporate takeovers, defensive actions may be taken before or after the initial move by the corporate raider. The decision to either succumb to or avert the takeover is made by the board of directors of the target corporation. Each company, using its investment bankers, attorneys, accountants, and public relation specialists must develop its own defense strategy and tactics. Several factors must be considered in formulating a defense strategy. These factors include the circumstances of the takeover, the particular opponent, and the opponent's individual strengths and weaknesses.

One possible defense technique for a corporation threatened by a takeover is the use of an employee stock ownership plan or employee stock ownership trust (hereinafter collectively referred to as an ESOP). ESOPs have been recognized as a possible pre-offer defense by target corporations as well.

4. The defense measures include but are not limited to:
   (a) repurchase of its corporate securities to make it less likely for the corporate raider to obtain control of the company through the tender offer;
   (b) induce friendly third parties to make open market purchases of the target company's securities;

5. See Quinn, supra note 4.

6. Id.

7. ERISA, 29 U.S.C. § 1101 defines the term "employee stock ownership plan" as follows: 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 both of which are qualified, under section 401 of the Internal Revenue Code of 1954, and which is designed to invest primarily in qualifying employee securities.... See also infra notes 55-85 and accompanying text.

8. Quinn, supra note 4, at ¶ 26,386. (The existence of an ESOP will normally provide substantial additional stock in the hands of friendly parties). See also, SEC Act Release No. 15,230, 15,235, supra note 4, in which an ESOP was noted as a possible takeover prevention tactic. This fact must be disclosed in a proxy statement. Defensive corporate charter amendments or provisions may include but are not limited to: “creation of an Employee Stock Ownership Plan which, because of its size, percentage of total outstanding securities of the issuer which it may own, voting or other provisions to be used in defense in a contested takeover attempt.” Aranow, Einhorn & Berlstein, Developments in Tender Offers for Corporate Control (1977) [hereinafter cited as Developments]. Comment, ESOP and Universal Capitalism, 31 Tax L. Rev. 289, 295 [hereinafter cited as Carlson]; Testa & Bachelder, ESOPs and TRASOPS 1979, at 131 (1979); Lipton, supra note 4, at 271.
ESOPs may be utilized prior to or during a tender offer. The tender offer is the most popular corporate takeover scheme used as compared to other possible methods, such as proxy solicitation. The target corporation may issue stock to the ESOP. This action averts a takeover in two ways. First, it dilutes the voting strength of the stock held by the offeror. Second, the issuance of stock increases the amount of stock the raider must acquire in order to obtain voting control.

An ESOP was used to avoid a corporate takeover in *Podesta v. Calumet Industries, Inc.* The District Court for the Northern District of Illinois granted a preliminary injunction to sterilize the votes of those shares which were transferred to the ESOP. The incumbent management had attempted to control the voting rights of the corporation through the adoption of the ESOP and the transfer of corporate shares thereto. Not only did the court enjoin the voting of the ESOP shares, but further found the action of the management of Calumet Industries to be a breach of their fiduciary duty.

More recently, the use of an ESOP to dodge a hostile takeover attempt was the basis of a lawsuit in *Donovan v. Bierwirth*. To avoid the takeover of Grumman Corporation by LTV Corporation, the trustees for the Grumman ESOP bought a substantial block...
of Grumman stock. The action was ostensibly for the benefit of the employee participants and beneficiaries. LTV's attempted takeover, although eventually thwarted, presents an interesting and comprehensive demonstration of the impact of the utilization of an ESOP to avoid a corporate takeover.

The purpose of this article is to familiarize the reader with the basic concepts and policy behind the Employee Retirement Income Security Act of 197417 [hereinafter referred to as ERISA] which provides the framework within which an ESOP is established and operates. Further, the establishment of an ESOP and the restrictions placed upon a corporate director and/or officer in using the ESOP as a defense technique during a proposed corporate takeover are discussed. These restrictions, specifically the fiduciary standards of "exclusive benefit"18 and "prudent man"19 set forth in ERISA severely hinder the employment of an ESOP as a potential tactic in a company's defense strategy. In conclusion, ESOPs, although a powerful resource,20 should be used exclusively for the benefit of employee participants and beneficiaries—not for the primary benefit of the corporation and its incumbent management in fending off a hostile takeover attempt.

II. EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974

A. Statutory Scheme

ERISA is a comprehensive remedial statute21 designed to offer...
employee participants and beneficiaries protection with respect to pensions and other benefits accrued during employment. From the date of its enactment, ERISA has had tremendous impact not only upon pension plan sponsors, employee participants, and beneficiaries, but also upon the multitude of individuals and institutions providing services, advice, and counsel to the plans. ERISA imposes broad uniform standards governing the operation of the employee benefit plan to assure employees that they will receive anticipated benefits at retirement or when the plan is terminated.

The purpose of ERISA is two-fold. First, it provides protection for employees against abuses related to employee benefit plans. Second, it improves the equitable nature and financial soundness of these plans. The incentive for such a comprehensive and broad-sweeping statute was spawned by the rapid growth, in size, scope, and number, of employee benefit plans offering post-

requiring the disclosure and reporting to participants and beneficiaries of financial and other information with respect thereto, by establishing standards of conduct, responsibility, and obligation for fiduciaries of employee benefit plans, and by providing for appropriate remedies, sanctions and ready access to the Federal courts.

Id. See also Eaves v. Penn, 587 F.2d 453, 457 (10th Cir. 1978); M & R Inv. Co., Inc. v. Fitzsimmons, 484 F. Supp. 1041, 1054 (D. Nev. 1980).

22. ERISA, 29 U.S.C. § 1102(7) defines a participant in an employee benefit plan:

The term "participant" means any employee or former employee of an employer, or any member or former member of an employee organization, who is or may become eligible to receive a benefit of any type from an employee benefit plan which covers employees of such employer or members of such organization, or whose beneficiaries may be eligible to receive any such benefit.

Id.

23. ERISA, 29 U.S.C. § 1102(8) defines a beneficiary of an employee benefits plan. "The term 'beneficiary' means a person designated by a participant, or by the terms of an employee benefit plan, who is or may become entitled to a benefit thereunder." Id.


25. See Fiduciary Standards, supra note 21, at 961.


employment compensation.\textsuperscript{28}

In interpreting the statutory language of ERISA, a liberal construction is required to safeguard the interests of the plan participants and beneficiaries in addition to preserving the integrity of pension plan assets.\textsuperscript{29} ERISA places restrictions on interested parties\textsuperscript{30} in administering plans.\textsuperscript{31} Enforcement of the statutory provisions is accomplished through taxation\textsuperscript{32} and civil\textsuperscript{33} or criminal sanctions.\textsuperscript{34}

Under ERISA, every employee benefit plan shall be established

\textsuperscript{28} ERISA, 29 U.S.C. § 1001(a) states Congress' findings and declaration of policy with respect to the enactment of ERISA:

The Congress finds that the growth in size, scope, and numbers of employee benefit plans in recent years has been rapid and substantial . . . that the continued well-being and security of millions of employees and their dependents are directly affected by these plans; that they are affected with a national public interest; that they have become an important factor affecting the stability of employment and the successful development of industrial relations . . .

\textit{Id.} See also Cutaiar v. Marshall, 590 F.2d 523, 529 (3d Cir. 1979).


\textsuperscript{30} An interested party is defined in ERISA, 29 U.S.C. § 1002(14) as follows:

The term "party in interest" means, as to an employee benefit plan—

(A) any fiduciary (including but not limited to, any administrator, officer, trustee, or custodian), counsel or employee of such employee benefit plan;

(B) a person providing services to such plan;

(C) an employer any of whose employees are covered by such plan;

\textit{Id.}

\textsuperscript{31} ERISA, 29 U.S.C. § 1104 states the fiduciary duties to be exercised under an employee benefit plan. \textit{See infra} notes 55-85 and accompanying text.

\textsuperscript{32} Internal Revenue Code of 1954, as amended [hereinafter cited as I.R.C.], § 4975 (West 1982).


\textsuperscript{34} ERISA, 29 U.S.C. § 1131 states the criminal penalties which may be imposed for violations of the statutory provisions under ERISA:

Any person who willfully violates any provision of part 1 of this subtitle, or any regulation or order issued under any such provision, shall upon conviction be fined not more than $5,000 or imprisoned not more than one year, or both; except that in the case of such violation by a person not an individual, the fine imposed upon such person shall be a fine not exceeding $100,000.

\textit{Id.} \textit{See generally infra} notes 198-212 and accompanying text.
and maintained pursuant to a written instrument.\textsuperscript{35} Plans are categorized either as defined benefit\textsuperscript{36} or defined contribution\textsuperscript{37} plans. The employer, as plan sponsor, bears all the investment risks in a defined benefit plan. If investment performance falls short of projected goals, larger contributions to the plan’s funding account is necessary to protect the employees’ interest.\textsuperscript{38} A defined contribution plan does not pay any fixed or determinable benefit. Benefits to participants and beneficiaries vary depending on contributions made by the employer, the employee, the investment success of the plan, and the allocations of benefits forfeited by non-vested participants who terminate employment. The risk of poor investment is shifted from the plan sponsor to the employees in a defined contribution employee benefit plan such as an ESOP.\textsuperscript{39}

Congress intended fund trustees to possess broad managerial and administrative discretion in the operation of the fund.\textsuperscript{40} This broad managerial discretion places primary responsibility for the establishment and operation of the plan, including claim procedures, upon the trustees.\textsuperscript{41}

The federal courts,\textsuperscript{42} in interpreting ERISA, should pay careful

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\item \textsuperscript{35} ERISA, 29 U.S.C. § 1102(a)(1) states: “Every employee benefit plan shall be established and maintained pursuant to a written instrument.” Id. Additionally, the plan document must include: 1.) the naming of the fiduciaries who are in control and manage plan operation; 2.) a description of any procedures for allocating responsibility among named fiduciaries and for delegation of responsibilities to others, including delegation of responsibility for asset management to an investment manager; 3.) a description of procedures for amending the plan; 4.) a description of the basis for making contributions to the plan or distributions from the plan; and, 5.) a description of procedures for establishing and carrying out a funding policy and method consistent with the requirements of ERISA. Sporn, Working with the New Rules of Fiduciary Responsibility in the 1974 Pension Reform Act, 41 J. Tax’n 263, 267 (1974); see also ERISA, 29 U.S.C. § 1102(a) & (b).
\item \textsuperscript{36} See Fiduciary Standards, supra note 21, at 961-62; 1982 PENS. & PROFIT SHARING (P-H) ¶ 9,165. ERISA, 29 U.S.C. § 1002(35) defines a “defined benefit plan” to be: “a pension plan other than an individual account plan; except that a pension plan which is not an individual account plan and which provides a benefit derived from employer contributions which is based partly on the balance of the separate account of a participant...” Id.
\item \textsuperscript{37} ERISA, 29 U.S.C. § 1002(34) defines a “defined contribution plan” as: “a pension plan which provides for an individual account for each participant and for benefits based solely upon the amount contributed to the participant’s account, and any income, expenses, gains and losses, and any forfeitures of accounts of other participants which may be allocated to such participant’s account.” Id. See generally SEC Rel. No. 3-6188, Fed. Sec. L. Rep. (CCH) ¶ 1,051.
\item \textsuperscript{38} See Professional Money Managers, supra note 24, at 523.
\item \textsuperscript{39} Id.
\item \textsuperscript{41} Sample v. Monsanto Co., 485 F. Supp. 1018, 1019 (E.D. Mo. 1980). See also ERISA, 29 U.S.C. §§ 1101-1114.
\item \textsuperscript{42} ERISA, 29 U.S.C. § 1132(e)(1) states in pertinent part: “the district courts
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attention to existing practice in the financial community and to the prescription of modern investment theory.\textsuperscript{43} Since its enactment, over three thousand lawsuits have been filed under Title 1 of ERISA.\textsuperscript{44} The courts have adjudicated questions involving a number of its most important provisions, specifically those relating to fiduciary duties of plan trustees. The reviewing court may interfere in the administration of an ESOP or any other employee benefit plan only where the trustee's actions are arbitrary, capricious or an abuse of discretion.\textsuperscript{45} Obligations of trustees and limitations on their power of investment are generally interpreted under principles applicable to trustees pursuant to the common law of trusts.\textsuperscript{46} However, the court shall adjudicate provisions of ERISA with a view toward establishing uniform standards.\textsuperscript{47} Thus, in the absence of statutory guidance and judicial precedent, the law of trusts, especially that pertaining to the requirement of even-handed treatment of beneficiaries,\textsuperscript{48} is particularly relevant.

\textbf{B. The Common Law of Trusts—Foundation for ERISA}

The provisions of ERISA addressing fiduciary standards, specifically the "exclusive benefit" and "prudent man" requirements derived therefrom, are largely based upon common law trust principles. The fiduciary responsibility standards set forth in Part 4 of Title 1 of ERISA are a codification of certain principles developed

\textsuperscript{43} Fiduciary Standards, supra note 21, at 969.

\textsuperscript{44} Gallagher, Recent Developments in Concept Relating to Fiduciary Liability, 16 F. 753, 753 (1981); see also Trudgeon, Recent Litigation Regarding Fiduciary Responsibility Under ERISA, 7 J. PENS. PLAN. & COMPLIANCE 250 (1981).

\textsuperscript{45} Morgan v. Mullins, 643 F.2d 1320, 1321 (8th Cir. 1981); see also Bueneman v. Central States Southeast and Southwest Areas Pension Fund, 572 F.2d 1208, 1209 (8th Cir. 1978); Phillis v. Kennedy, 542 F.2d 32, 54 (8th Cir. 1976); Maness v. Williams, 513 F.2d 1264, 1265 (8th Cir. 1975).

\textsuperscript{46} See infra notes 49-54 and accompanying text.


\textsuperscript{48} 3 Scott, Trusts § 183 (3d ed. 1967). See infra notes 49-54 and accompanying text.
and applied in the law of trusts. However, the fiduciary of an ESOP has more freedom and opportunity to make investment decisions than a common law trustee. In the absence of statutory provisions, precedent established under the law of trusts is particularly relevant. In addition, any interpretation under ERISA and the principles applicable to trustees under the common law of trusts must be accomplished with the objective of establishing uniform standards.

Under the principles of equity, a trustee bears an unwavering duty of complete loyalty to the beneficiary. The rule against a trustee dividing his loyalty must be enforced with uncompromising rigidity. Such strict enforcement of trustee standards severely limits any possibility of utilizing an ESOP primarily for averting a corporate takeover. The employment of an ESOP by a trustee who may also be a director conflicts directly with the primary duty of a trustee—loyalty to the beneficiary. A director has a primary loyalty to the corporation. In cases involving the use of ESOPs, courts have scrutinized the action taken and have often relied upon the initial breach of loyalty of a trustee as a basis for liability.

49. ERISA, 29 U.S.C. § 1104 deals specifically with fiduciary duties. See infra notes 118-52 and accompanying text.

50. H. REP. No. 93-533, 93d Cong., 1st Sess. 3, reprinted in 1974 U.S. CODE CONG. & AD. NEWS 4639. The trustees need not be faced with problems arising from tensions between a beneficiary and remainderman in a private trust wherein the beneficiary is concerned in high income investments and the remainderman is interested in preserving the corpus of the trust. The private trust receives its capital only at the inception of the trust. Under a pension plan, new funds are contributed regularly which frees the trustee from liquidity pressures. See Fiduciary Standards, supra note 21, at 968.

51. The Department of Labor provisions apply rules and remedies similar to those under traditional trust law governing the conduct of fiduciaries. 1974 U.S. CODE CONG. & AD. NEWS, 5076.

52. "The objectives of these provisions are to make applicable the law of trusts; . . . to establish uniform fiduciary standards to prevent transactions which dissipate or endanger plan assets, and to provide effective remedies for breaches of trust." Marshall v. Teamster Local 282 Pension Trust Fund, 458 F. Supp. 986, 990 (E.D.N.Y. 1978) (citing 1973 U.S. CODE CONG. & AD. NEWS 5186).

53. Heit v. Baird, 567 F.2d 1157, 1161 (1st Cir. 1977). In Heit, a shareholder brought a derivative action alleging that the board of directors, forewarned of a potential control contest by a minor shareholder, issued a large block of new stock. The new stock was placed in the hands of three of its seven board members. The shareholder alleged that the transactions were effected only to thwart threatened control contests and that such action by the board of directors was a violation of the Securities and Exchange Act as well as a breach of common law fiduciary duties.


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III. Establishment of an ESOP

Before discussing the manner in which an ESOP may be used to avoid a corporate takeover, it is necessary to understand how an ESOP is established. Special financial and legal aspects must be complied with for the proper set-up and operation of an ESOP.

In 1974, ERISA recognized stock bonus plans as a qualified contribution plan. ERISA marked the creation of an ESOP—"a device by which an employer corporation uses a qualified pension or profit sharing trust to obtain the use of capital funds which can be repaid out of pre-tax earnings."

An ESOP is a tax-qualified plan under which employer stock is held for the benefit of employees. Legislative history illustrates that the basic element common to all ESOPs is the classification as a qualified bonus plan designed primarily to invest in qualifying securities of an employer whose employees are covered by the plan. The stock held by the tax-exempt trust under

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55. See supra note 7. An ESOP is a stock bonus plan, or a stock bonus and money purchase pension plan, that is: (a) qualified under § 401 of the Internal Revenue Code; (b) designed to invest primarily in stock or market obligations of the employer; and, (c) designed to provide for an individual bonus or retirement account for each participant employee and for benefits based solely upon the amount contributed to the participant's account. Developments, supra note 8, at 97.

56. "Qualified" means the plan has been approved by the Internal Revenue Service. I.R.C. § 401(a) (West 1982) sets forth the requirements for a plan to qualify. Briefly:

The requirements for section 401(a) are complex and grow more so from day to day through both legislation and administrative regulation. In very rough outline, a qualified plan must not categorically exclude young, old or short service employees from participant; neither contributions nor benefits under the plan may discriminate in favor of officers, shareholders or highly compensated employees; certain minimum standards for the funding and vesting of benefits must be met; and benefits must conform to certain rules as to their maximum amount and as to their form and time of payment.

Carlson, supra note 8, at 293 n.16.

57. Carlson, supra note 8, at 293.

58. The employer stock purchased by the ESOP must be "qualified employer stock." ERISA, 29 U.S.C. § 1107(a)(1) states: "[a] plan may not acquire or hold - (A) any employer security which is not a qualifying employer security. . . ." Id.

59. ERISA, 29 U.S.C. § 1103(c)(1) and 1104(a)(1)(A) specifically state the plan must inure to the exclusive benefit of the employee participants. I.R.C. § 401(a)(2) (West 1982) also imposes the exclusive benefit rule on employee benefit plans. See infra notes 153-67 and accompanying text.

60. H. REP. No. 533, 93d Cong., 1st Sess. 3, reprinted in 1974 U.S. CODE CONG. & AD. NEWS at 5093. See also Eaves v. Penn, 587 F.2d 453, 459 (10th Cir. 1978),
the plan may be acquired through direct employee contributions\(^{61}\) or with the proceeds of a loan to the trust.\(^{62}\) Additionally, under the rules applicable to tax-qualified plans, employee benefits from an ESOP are generally not taxed until distributed or made available.\(^{63}\) The Internal Revenue Code also provides for special ten-year income averaging\(^{64}\) or tax-free rollover treatment for lump sum distributions to participants and beneficiaries.\(^{65}\) The Internal Revenue Code allows a deferral of tax on appreciation of employer securities\(^{66}\) and an estate and gift tax exclusion.\(^{67}\)

The ESOP, although flexible, is complex. A well-defined plan, with proper communication,\(^{68}\) tailored to the right company, should benefit both the employees and the sponsor corporation. Purposes for establishing an ESOP include: 1) a motivational program; 2) an employee benefit program; 3) a retirement income supplement; and 4) a corporate financing technique.\(^{69}\) A pension

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\(^{61}\) See supra note 37 and accompanying text.

\(^{62}\) An ESOP established from proceeds of a loan is known as a leveraged employee stock ownership plan. (LESOP). See Testa & Bachleder, supra note 8, at 38,042.

\(^{63}\) I.R.C. § 402(a)(1) (West 1982).

\(^{64}\) I.R.C. § 402(e)(1) (West 1982). Under the ten-year averaging method the distributee is taxed on an amount which is equal to an initial separate tax multiplied by a fraction. The numerator is the ordinary income portion of the lump sum distribution and the denominator is the total taxable amount of the lump sum distribution. Id. See generally ESOPs Tables: A Survey of Companies with Employee Stock Ownership Plans, 6 J. CORP. L., 551, 576 1981 [hereinafter cited as ESOPs Tables].

\(^{65}\) I.R.C. § 402(a)(5)(A)(ii), (D)(iv) (West 1982). See generally, Comment, How to Accomplish a Successful Tax-Free Pension Plan Rollover, 8 PEPPERDINE L. REV. 933 (1981); ESOPs Tables, supra note 64, at 577.


\(^{67}\) The Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 347 (1982) [hereinafter cited as TEFRA] was signed by President Reagan on September 3, 1982. The estate tax exclusion was modified therein. “An aggregate limit of $100,000 is placed on the estate tax exclusion for benefits payable to a beneficiary . . . of a deceased employee under a qualified plan (pension, profit-sharing, etc. plan) . . . Previously, the estate tax exclusion for such plans was unlimited. The $100,000 limit applies to estates of decedents dying after December 31, 1982.” TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982 - LAW AND EXPLANATION (CCH) (Aug. 1982) at 28.

\(^{68}\) ERISA requires the administrator of the plan to duly disclose and report to participants and beneficiaries a summary of the plan, provide additional information and report the method and distribution of benefits, inter alia. See ERISA, 29 U.S.C. §§ 1021-1025.

\(^{69}\) 1981 PENS. & PROFIT SHARING (P-H) ¶ 6,653. See generally ESOPs Tables, supra note 65. In Herald Co. v. Seawell, 472 F.2d 1018 (10th Cir. 1972), the court notes four benefits derived from an employee stock ownership trust: 1) employees have greater pride in their work; 2) employee turnover has been reduced in all phases of operation; 3) it can pin down several of the key personnel in the younger age bracket; and 4) it can help materially in production and labor relations. Additionally, the incentive for an employee to remain with the firm with an employee
plan offered by the employer and impliedly accepted by the employee by remaining in employment constitutes a contract between them, whether the plan is a public or private one, and whether or not the employee is to contribute funds to the pension fund. However, from the employee's point of view, there may be several disadvantages associated with the establishment of an ESOP by his corporate employer. Disadvantages may be: 1) an ESOP inevitably results in a high concentration of trust assets in the stock of a single corporation; 2) the employer's stock may not be a desirable investment for an employee's trust; and 3) the flexibility of a managed portfolio is lacking in an ESOP.

Additionally, management may be faced with several potential problems if an ESOP is established. Potential dilution of corporate stock is one possible disadvantage. Further, employee ownership of marginal companies, poorly managed, and in declining industries, is of dubious merit.

An ESOP must be initiated in good faith by the sponsor employer. A repurchase tender offer, if made for the purpose of funding an ESOP, or for the purpose of effectuating a valid company policy favoring ownership of stock by employees, is a proper corporate purpose. However, if the establishment of an ESOP is simply a sham to force out minority shareholders, the repurchase tender offer lacks the good faith prerequisite. Thus, the motive behind the corporation as the plan sponsor will influence any challenge to the validity of the purpose of the establishment and benefit plan was noted in Litwicki v. PPG Indus., Inc., 386 F. Supp. 296, 305 (W.D. Pa. 1973), aff'd, 505 F.2d 189 (3d Cir. 1974).

71. ERISA, 29 U.S.C. § 1104(a)(2) excuses an ESOP trustee from the obligation of diversifying investments.
72. ERISA, 29 U.S.C. § 1104(a)(2) specifically indicates that the trustee's duty to act prudently is left intact despite the fact that diversification of investment is not required. Query: is it prudent for a trustee of an ESOP to invest in a financially unsound corporation?
74. 1981 Pens. & Profit Sharing (P-H) § 6,655.
76. A "plan sponsor" is defined in ERISA, 29 U.S.C. § 1002(16)(B): "[t]he term 'plan sponsor' means (1) the employer in the case of an employee benefit plan established or maintained by a single employer. . . ." Id.
77. See supra note 9.
78. See Developments, supra note 8, at 284.
Factors to consider in determining whether a plan has been set up for the benefit of the employees include the corporate resolution of the board of directors, the timing of the establishment (i.e., was the plan set up while the firm was threatened with a hostile takeover?), and who is appointed to the fiduciary and administrative positions in the plan. Also, voting control of the ESOP shares, whether vested in the trustee or employees themselves, will be a relevant factor.

In *Weinberg v. Cameron* and *Klaus v. Hi-Shear Corporation*, the court closely examined the motive behind the establishment of the ESOP. In *Weinberg*, the ESOP was used to increase employee pension benefits, which the district court held to be in pursuit of a legitimate corporate purpose. However, the district court in *Klaus* issued an injunction against the voting of the ESOP shares because the principal motive was self-serving for the incumbent corporate management rather than a bona fide interest in promoting employee welfare.

Five types of transactions occur during the operation of an ESOP: 1) issuance of interests in the plan to participants; 2) acquisition of employer securities by the plan trustee; 3) allocation of employer securities to individual participant accounts; 4) distribution of employer securities to participants; and 5) sales of distributed employer securities to participants and beneficiaries.

In the corporate takeover setting, the second transaction listed

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79. *Id.*
80. *1980 FED. SEC. L. REP. (CCH) ¶ 97,377 (D. Hawaii March 21, 1980).*
81. *528 F.2d 225 (9th Cir. 1975).*
82. The court was presented with evidence indicating that the ESOP had the effect of giving the present managemnt an absolute lock-in on the voting of shares of the stock in trust at the time it was set up. However, the court found that the establishment of the ESOP and the sale of company shares to the ESOP was not done solely for the purpose of controlling or influencing control of the corporation. The ESOP arose out of a management effort to assist both present and retired corporate employees. The plan was designed primarily to benefit the employees, not corporate management.
83. The district court found that Hi-Shear lacked good faith in the establishment of the ESOP. The ESOP adversely affected Klaus, a minority shareholder who sought control of Hi-Shear. Hi-Shear failed to advance any compelling reason why the ESOP had to be established at a time so advantageous to those in control. The timing of the establishment of the ESOP hampered Klaus' endeavor to take over Hi-Shear. If the plan had been set up a few months later, the unfair advantage afforded Hi-Shear at Klaus' expense would not have been apparent. The injunction on voting the shares was later vacated. See generally *Klaus v. Hi-Shear Corp.*, 528 F.2d 225 (9th Cir. 1975).
85. *See supra* note 4.
above is the primary maneuver used to avert the takeover. Creative financial, legal, and corporate executives have seized the opportunity to utilize an ESOP not only for use as an employee benefit plan, but also to serve the additional task as a defense tool. As a tactic, the ESOP places substantial additional stock in the hands of friendly parties which aids incumbent management in averting a takeover.

IV. SEC CONSIDERATIONS

ESOPs deal with corporate securities for the benefit of participants and beneficiaries. ERISA alone does not govern the entire spectrum of transactions involved in the establishment and operation of an ESOP. The Internal Revenue Code requirements as well as those rules and regulations promulgated by the Securities and Exchange Commission must be followed.

Depending on the structure of a particular plan, the administrative committee, the plan trustees and the employee participants may be subject to the filing requirements of section 13(d) of the Securities and Exchange Act of 1934. A trustee of an ESOP holds beneficial ownership of the stock. Rule 13d-3(a) defines beneficial ownership. Beneficial ownership exists because the trustee will be given some independently exercisable powers, including the right to retain or dispose of securities held by the plan. In a no-action letter, the SEC stated that because an ESOP may tender significant quantities of employer stock, the tender offer rules should be observed. However, in LTV v. Grumman Corp., the district court found that Grumman's massive buying of its stock on the open market, along with its attendant press releases indicating its intention to do so was to defeat the tender offer of LTV, did not itself constitute a tender offer for pur-
poses of SEC filing requirements and reporting.\textsuperscript{92}

Additionally, if the plan beneficially owns more than ten percent of the corporation's registered equity securities, the trust and trustees must file reports under section 16(a) of the Securities and Exchange Act of 1934.\textsuperscript{93} However, exemptions from reporting requirements may be granted. Using banks as trustees, many exemptions from registration and reporting requirements, both as to the interests in the plan and the underlying employer securities, are available. The full benefit of these exemptions may be realized if the bank trustee is independent of the issuing corporation. Consequently, the trustee bank should not be controlled by the plan's administrative committee with respect to the time, price or amount of securities purchased.\textsuperscript{94}

In \textit{Weinberg v. Cameron},\textsuperscript{95} the court failed to find an SEC violation from the actions of the management of the corporation: The offer did not constitute a proxy solicitation in violation of the Securities and Exchange Act of 1934 or Hawaii state law. The company transferred shares of its stock to the ESOP which in turn allowed management to vote the shares.\textsuperscript{96}

Thus, although an ESOP is principally governed by the statutory provisions of ERISA, the plan sponsor should carefully consider and analyze the application and effect of the Securities and Exchange Commission's rules and regulations. The manner in which the plan operates through its appointed administrators appears to be a key determinant as to whether SEC rules apply.

\section*{V. Dual and Divided Loyalty—Conflict Between the Duties of Officer or Director and Trustee of an ESOP}

The dual loyalty problem arises in the corporate takeover scenario when the trustees of the ESOP are also officers and/or di-

\textsuperscript{92} Id. at 109.
\textsuperscript{93} Section 16(a) states in pertinent part: "[e]very person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of equity security (other than an exempted security) which is registered pursuant to section 12 of this title... shall file... a statement with the Commission...." Securities Exchange Act of 1934, 48 Stat. 896 (1934), 15 U.S.C. \S 78p (1971).
\textsuperscript{94} Selection of an independent trustee is advantageous because it may deter future problems arising under the fiduciary standard set forth under ERISA. \textit{ESOPs and Securities Laws, supra} note 84, at 48-49.
\textsuperscript{96} \textit{But see} Monogram Indus., Inc. v. Royal Indus., Inc., Civ. No. 76-336R, (C.D. Cal. Nov. 17 and Dec. 13, 1976), wherein the court held that an improperly motivated defensive maneuver may be preliminary enjoined as a violation of \S 14(e) of the Securities and Exchange Act of 1934 and/or as a breach of fiduciary duty. \textit{Accord} Orbanco v. Security Bank of Ore., 371 F. Supp. 125, 128 (D.C. Or. 1974) (Williams Act and its implementing regulations strictly regulate purchases by target company or its management; the policy is to guarantee full disclosure to public).
rectors of the sponsor corporation. The duties of a fiduciary of an ESOP may directly conflict with the position of a corporate officer or director. Action which may be in the best interest of the ESOP, either in the long or short run, may be adverse to corporate objectives as stated by top corporate management.

It is a well-established rule of corporate law that officers and directors are in the position of a fiduciary for corporate shareholders. Officers and directors of a corporation have a fiduciary duty to treat all shareholders, majority and minority, fairly and must always act in good faith. Coupled with the fiduciary duty placed upon officers and directors who are appointed trustees of an ESOP, the position involves the utmost in due care and good faith. Standards for the officers and directors appointed to operate an ESOP are set by the traditional common law of trusts and corporate law, plus the statutory provisions of ERISA.

Corporate management has the affirmative duty to oppose a takeover offer that it has determined to be adverse or detrimental to the interests of the corporation or its shareholders. In arriving at such a decision, however, management should be scrupu-

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97. "Officer" means: 1) the chairman of the board of directors, president, treasurer, secretary, controller and, to the extent not encompassed by the foregoing, the chief executive, operating, financial, legal and accounting officers of a corporation; 2) a vice-president or other employee who participates or has the authority to participate, other than as a director, in major policy making functions of a corporation; or, 3) any other individual designated as an officer of the corporation. RESTATEMENT OF PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE § 1.17 (Tent. Draft No. 1, 1982).

98. "Director" means any individual designated as a director by the corporation, and any individual who, in accordance with applicable law or a standard of the corporation (i.e. by-laws, corporate charter), acts in place of a director. RESTATEMENT OF PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE § 108 (Tent. Draft No. 1, 1982).

99. Treadway v. Care Corp., 490 F. Supp. 653, 657 (S.D.N.Y. 1979). See also Yasik v. Wachtel, 25 Del. Ch. 247, 176 A.2d 309 (1941). In Yasik, the court held that directors stand in a fiduciary relationship to the corporation and its shareholders. The primary duty is to deal fairly and justly. However, officers and directors of a corporation although fiduciaries do not hold title to the property of the corporation. Therefore, officers and directors are not trustees. RESTATEMENT (SECOND) OF TRUSTS § 16A, comment a (1959).

100. While the law does not demand infallibility or the impossibility of error in directors, it does require that they act as reasonable men and in good faith to their stockholders. Casson v. Bosman, 137 N.J. 532, 535, 45 A.2d 807 (1946).

101. Management has not only the right but the duty to resist by any lawful means persons whose attempt to win control of the corporation, which, if successful, would harm the corporate enterprise. Heit v. Baird, 567 F.2d 1157, 1161 (1st Cir. 1977). See also McPhail v. L.S. Starret Co., 257 F.2d 388, 394-96 (1st Cir. 1958); Cheff v. Mathes, 41 Del. Ch. 494, 199 A.2d 548 (1964).
lously fair in considering the merits of any proposal submitted to its stockholders. Strict impartiality is required by virtue of the fiduciary position. If management determines the takeover attempt is contrary to the best interests of the shareholders, then management may take any steps necessary to lawfully counter the attempted takeover.102

Courts, in analyzing actions of corporate officers, will consider whether the action taken was in accordance with sound business judgment103 and to further a valid corporate purpose.104 The issuance of shares for the purpose of defeating a takeover, as in the case of an ESOP, may be proper if such issuance will avert detrimental consequences to shareholders. The issuance, however, cannot be for the sole or primary purpose of sustaining incumbent management.105

A president or treasurer considers his primary concern to be the profitability of the enterprise. These officers may be in a particularly difficult position of divided loyalty between the ESOP and the sponsor corporation. The board of directors' primary responsibility is to the corporate shareholders. Again, the difficult position of divided loyalty is apparent.106 Although a trustee may have dual loyalties by virtue of his position in the corporation and ESOP respectively, when acting on behalf of the ESOP, primary

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102. Northwest Indus. v. B.F. Goodrich Co., 301 F. Supp. 706, 712 (N.D. Ill. 1969) (suit individually and derivatively by minority shareholders to enjoin corporation's purchase of seller's one-half interest of joint venture). See also Donovan v. Bierwirth, 680 F.2d 263, 271-72 (2d Cir. 1982). The court criticized the director's failure to fully analyze the tender offer of LTV in deciding to fend off the takeover. The trustees failed to perform a thorough investigation in ascertaining the facts with respect to the LTV pension funds, the unfunded liabilities of which were to be the principal ground for their action. No preliminary action was taken to discover if steps could be taken to protect the Grumman pension in the event of an acquisition of Grumman by LTV.

103. See Selheimber v. Manganese Corp. of Am., 224 A.2d 634 (Pa. 1966); MODEL BUS. CORP. ACT § 35. CAL. CORP. CODE § 309 (West 1977) addresses the performance of duties by a director: "[a] director shall perform the duties of a director, . . . in good faith, in a manner such director believes to be in the best interests of the corporation and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances." CAL. CORP. CODE § 309 (West 1977).

104. Treadway v. Care Corp., 490 F. Supp. 653, 658 (S.D.N.Y. 1979). The district court held that "even a transaction carried out at the 'eleventh hour' which effectively blocks a takeover attempt, but which also serves to further a valid purpose, may be permissible." Id. Accord, McPhail v. L.S. Starrett Co., 257 F.2d 388, 395 (1st Cir. 1958). In McPhail, the court failed to infer some improper ulterior or selfish purpose. Evidence indicated the directors acted in the laudable purpose of frustrating a raid by a minority shareholder. The suit was brought by a minority shareholder to enjoin the corporation from putting an employee stock ownership plan into operation. See generally Developments, supra note 8, at 197.

105. See Lipton, supra note 4.

106. 1982 PENS. & PROFIT SHARING (P-H) ¶ 20,119.
loyalty to the fund is the sole loyalty which should guide his judgment.\textsuperscript{107}

ERISA contemplates the existence and approval of fiduciary action on behalf of an employee benefit plan where dual loyalties may exist.\textsuperscript{108} ERISA recognizes that trustees, as officers of the sponsor corporation, may act on behalf of the plan in making investment decisions concerning employer stock even though there may be a potential conflict of interest.\textsuperscript{109}

An extraordinary obligation is imposed upon an individual with dual loyalties to act fairly and in the best interests of the participants and beneficiaries of an ESOP.\textsuperscript{110} A duty is imposed on the trustees to avoid placing themselves in a position where their acts as officers or directors will prevent their functioning with complete loyalties to participants of the employee benefit plan.\textsuperscript{111}

A fiduciary will act in the best interests of the participants and beneficiaries, despite dual loyalty and a potential conflict of interest, so long as: 1) he acts exclusively for the benefit of the plan;\textsuperscript{112} and 2) his actions are not violative of the proscriptions of section 1106\textsuperscript{113} of ERISA.\textsuperscript{114} Compliance with the duty of loyalty is even more difficult in the area of plan administration as compared to plan investment\textsuperscript{115} of the ESOP. The exclusive benefit rule applicable to the conduct of plan fiduciaries is unavoidable. However, an incidental benefit\textsuperscript{116} accruing to the corporation is permissible.

\begin{itemize}
\item \textsuperscript{107} Donovan v. Bierwirth, 680 F.2d 263, 271 (2d Cir. 1982).
\item \textsuperscript{109} Id.
\item \textsuperscript{110} Id. at 469. See also Withers v. Teachers' Retirement Sys. of New York, 447 F. Supp. 1248, 1256 (S.D.N.Y. 1978), aff'd mem., 595 F.2d 1210 (2d Cir. 1979) (applying common law principles of fiduciary duty).
\item \textsuperscript{111} Donovan v. Bierwirth, 680 F.2d at 271.
\item \textsuperscript{112} See infra notes 153-60 and accompanying text. See also Donovan v. Bierwirth, 638 F. Supp. at 469.
\item \textsuperscript{113} ERISA, 29 U.S.C. § 1106 deals with prohibited transactions of a fiduciary with respect to transactions with the employee benefit plan.
\item \textsuperscript{114} Donovan v. Bierwirth, 538 F. Supp. at 469.
\item \textsuperscript{115} 1982 PENS. & PROFIT SHARING (P-H) ¶ 20, 255. The trust instrument states employer securities are to be bought for the ESOP. However, the time of the purchase and sale or securities is an administrative fiduciary function. ERISA must be construed to differentiate between advocating a course of action or a solution and having the power to take the course or implement the particular solution. Curren v. Freitag, 432 F. Supp. 668, 672 (S.D. Ill. 1977).
\item \textsuperscript{116} In Culinary Workers & Bartenders Union No. 596 Health & Welfare Trust v. Gateway Cafe, Inc., 91 Wash. 2d 353, 362-63, 588 P.2d 1334, 1341 (1979), later appeal, 630 P.2d 1348 (1981), the court stated: "we do not believe a finding of violation of fiduciary duty is warranted in situations ... where there is no showing that the
\end{itemize}
The Internal Revenue Service has stated, pursuant to section 401(a), that benefits need not be exclusively for the participants and beneficiaries. Rather, transactions need only be “primarily” for the benefit of such persons. Thus, officers and directors tread a fine line between the potential conflict of interest which may arise while acting simultaneously in the corporate capacity and as an ESOP trustee. In day-to-day management, the objectives and goals of the corporation and the ESOP will generally coincide. However, when an ESOP is employed to avoid a corporate takeover, it is apparent that conflicts may arise.

VI. FIDUCIARY DUTY OF THE CORPORATE DIRECTOR AND OFFICER ACTING AS A TRUSTEE OF AN ESOP

A fiduciary of an ESOP is defined in ERISA, section 1002(21):

[A] person is a fiduciary with respect to a plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan.

Persons in charge of a profit-sharing and pension plan have a statutory fiduciary duty to uphold the purpose of the plan. Personal liability is imposed if a person responsible for enforcing the plan breaches the statutory fiduciary duty. A fiduciary not only may be exposed to personal liability for his individual breach, fiduciary's collateral interest impaired a trust fund's operation or a beneficiary's interest." Accord Schwartz v. Marien, 27 N.Y.2d 487, 492, 335 N.E. 2d 334, 338, 373 N.Y.S.2d 122, 127 (1975); Treadway Companies v. Care Corp., 490 F. Supp. 653 (S.D.N.Y. 1979). See Developments, supra note 8, at 28; see also infra notes 164-65 and accompanying text.

117. Rev. Rul. 69-494, 1969-2 C.B. 88, addresses the incidental benefit which may accrue to an entity other than the participants and beneficiaries of the plan:

The primary purpose of benefiting employees or their beneficiaries must be maintained with respect to investments of the trust fund as well as with respect to other activities of the trust. This requirement, however, does not prevent others from also deriving some benefit from a transaction with the trust. For example, a sale of securities at a profit benefits the seller, but if the purchase price is not in excess of the fair market value of the securities at the time of sale and the applicable investment requisites have been met, the investment is consistent with the exclusive-benefit-of-employees requirement.

Id. See generally Professional Money Managers, supra note 24, at 528-30.


119. Id. See ERISA, 29 U.S.C. §§ 1104(c)(1), 1104, 1106(b) & 1109. See also supra notes 33 & 34 & infra notes 198-212 and accompanying text.
but also for the breach of a fiduciary duty by a co-fiduciary.120

Fiduciary duties are set forth in ERISA, section 1104,121 which states in pertinent part:

[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,122 (B)
with 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. . . .

The fiduciary must comply with the provisions of the plan instrum-
ent to the extent it is consistent with the provisions of ER-
ISA.123 To insure that the fiduciary complies with the provisions
of the plan instrument and ERISA, the performance of the fiduci-
ary, as well as others associated with the plan, should be re-
viewed at reasonable intervals by an appointed fiduciary.124

There is no required number of fiduciaries to maintain the ESOP,
but each plan must have at least one named fiduciary who serves

120. Liability for the breach of fiduciary duty by co-fiduciary is stated in ER-
ISA, 29 U.S.C. § 1105(a):

[A] fiduciary with respect to a plan shall be liable for a breach of fiduciary
responsibility of another fiduciary with respect to the same plan in the fol-
lowing circumstances: (1) if he participates knowingly in, or knowingly
undertakes to conceal, an act or omission of such other fiduciary, knowing
such act or omission is a breach; (2) if, by his failure to comply with sec-
tion 404(a)(1) of this title in the administration of his specific responsibili-
ties which give rise to his status as a fiduciary, he has enabled such other
fiduciary to commit a breach; or (3) if he has knowledge of a breach by
such other fiduciary, unless he makes reasonable efforts under the cir-
cumstances to remedy the breach.

Id.

121. ERISA, 29 U.S.C. § 1104(a)(1) embodies the central and fundamental obli-
gation imposed on fiduciaries by ERISA. The court in Eaves v. Penn, 587 F.2d 453,
457 (10th Cir. 1978), aff'd, 426 F. Supp. 830 (W.D. Okla. 1976) commented that this
section of ERISA contains:

[a] carefully tailored law of trusts, including the familiar requirements of
undivided loyalty to beneficiaries, the prudent man rule, the rule requiring
diversification of investments and the requirement that fiduciaries
comply with the provisions of plan documents to the extent that they are
not inconsistent with the Act.


122. See DONOVAN, 538 F. Supp. at 475. In Donovan, the court questioned the
payment of $86,850 in brokerage fees when the trustees of the plan bought shares
to avert the takeover by LTV.

123. Eaves v. Penn, 587 F.2d 453, 457 (10th Cir. 1978), aff'd, 426 F. Supp. 830
(W.D. Okla. 1975).

as plan administrator. Additionally, since the assets of the plan are held in trust under an ESOP, at least one trustee must be appointed.

Fiduciaries are limited to persons who perform one or more of the functions described in ERISA section 1002(21)(A) with respect to an ESOP. There is an emphasis on the discretionary nature of the duties of the fiduciary. Persons performing ministerial duties are not fiduciaries because these individuals do not have discretionary authority or control over the management of the plan or disposition of assets. A named fiduciary must be stated in the plan instrument. The purpose of a named fiduciary is to allow employee participants and beneficiaries to obtain information and seek resolution of any dispute.

Fiduciaries include not only named fiduciaries, but any appointed fiduciaries. Section 1105(c)(1)(B) states that the instrument under which a plan is maintained may expressly provide for procedures "for named fiduciaries to designate persons other than named beneficiaries to carry out fiduciary reponsibilities.

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125. ERISA, 29 U.S.C. § 1102(16)(A) defines a plan administrator:
The term "administrator" means - (i) the person specifically so designated by the terms of the instrument under which the plan is operated; (ii) if an administrator is not so designated, the plan sponsor; or (iii) in the case of a plan for which an administrator is not designated and a plan sponsor cannot be identified, such other person as the Secretary may by regulation prescribe.

Id.

126. Interpretive Bulletins Relating to Fiduciary Responsibility, 40 Fed. Reg. 47,491 (1975) lists ministerial duties involved in the operation of an employee benefit plan. These consist of:

1) application of rules determining eligibility participation and benefits;
2) calculation of services and compensation credits for benefits;
3) preparation of employee communications materials;
4) maintenance of participants service and employment records;
5) preparation of reports required by government agencies;
6) calculation of benefits;
7) orientation of new participants and advising participants of their rights and options under the plan;
8) collection of contributions and application of contributions as provided in the plan;
9) preparation of reports concerning participant's benefits;
10) processing of claims;
11) making recommendations to others for decisions with respect to plan administration.

The Internal Revenue Services, in defining the fiduciary, within the meaning of § 4975(e)(3) of IRC of 1954, as amended, does not list persons performing ministerial duties.

127. ERISA, 29 U.S.C. § 1102(a)(1)(A). A named fiduciary must be designated so that employees may determine who is responsible for operating the plan. See generally Fiduciary Responsibility, supra note 33, at 89; and Fiduciaries Under ERISA, supra note 24, at 8.

128. Id.

sibilities (other than trustee responsibilities) under the plan."¹³⁰
The board of directors or any committee which appoints
fiduciaries should carefully review the qualifications of any per-
son selected and undertake a reasonably comprehensive and peri-
odic review of the fiduciary's performance in order to protect
against personal liability for failing to select a competent
fiduciary.¹³¹

Self-dealing¹³² is addressed in ERISA section 1106(b). “Deal-
ing” as applied to fiduciaries exists when the fiduciary possesses
the power to compromise the positions of his employer, the em-
ployee benefit fund, or both. Section 1106(b) states in pertinent
part that a fiduciary, with respect to a plan shall not:

(1) deal with the assets of the plan in his own interest or for his own
account,
(2) in his individual or in any other capacity act in any transaction involv-
ing the plan on behalf of a party (or represent a party) whose interests
are adverse to the interests of the plan or the interest of its participants or
beneficiaries. . . .¹³³

The Internal Revenue Code also prohibits fiduciaries from dealing
with the assets or income of a plan for his own account and bene-
fit.¹³⁴ Fiduciaries must guard the interests of the employees.¹³⁵

Trustees must exercise their fiduciary trust in good faith and
deal fairly with the employee participants and beneficiaries of an
ESOP.¹³⁶ Congress intended that the assets of the plan should
never inure to the benefit of the trustee/fiduciary,¹³⁷ thus forbid-

¹³⁰ Id.
¹³¹ Professional Money Managers, supra note 24, at 524.
¹³² Curren v. Freitag, 432 F. Supp. at 672.
¹³³ ERISA, 29 U.S.C. § 1106(b); see also AM. JUR. 2d New Topic Service Pen-
sion Reform Act § 133 (1975).
¹³⁴ I.R.C. § 4975(c)(1) (West 1982) states; “the term 'prohibited transaction'
means any direct or indirect . . . act by a disqualified person who is a fiduciary
whereby he deals with the income or assets of a plan in his own interests or for
his own account. . . .” Id.
¹³⁵ Under the guise of opposing what they claim to be an unfavorable take-
over, management may not attempt to manipulate the issuance or sale of stock for
the purpose of perpetrating their control over the corporation. Treadway v. Care
Corp., 490 F. Supp. 653, 657 (S.D.N.Y. 1979). See also Calhoun v. Falstaff Brewing
Co., 478 F. Supp. 357, 361 (E.D. Mo. 1979) (action brought for alleged violation of
fiduciary duties under ERISA).
206, 212 (1971).
¹³⁷ Although Congress intends a fiduciary shall discharge his duties with re-
spect to the plan solely in the interest of participants and beneficiaries, an inciden-
tal benefit to the corporation deriving from the ESOP has been recognized. See
supra note 101 and accompanying text.
ding self-dealing in assets of the fund. Additionally, the fiduciary is forbidden from granting preferences as between plan participants and beneficiaries in the allocation of contributions and distribution of benefits.

A possible conflict exists between the duties and obligations of a fiduciary and the requirement of prudent investment. Under some circumstances, the trustee’s responsibility to the plan may require him to tender the securities or sell the shares in the market. The offer by the employer of the securities held by the ESOP may be profitable as opposed to the retention of the stock in the trust. However, the trustee may have an obligation under the terms of the trust which requires him to retain the securities. Although ERISA grants trustees broad managerial and administrative discretion in the operation of the plan, the fiduciary responsibility standards imposed by common law, corporate law, and ERISA must be strictly followed.

Fiduciaries may be selected from the plan sponsor corporation or from outside service groups such as banks. According to ERISA section 1102(c)(1), any person or group of persons may serve in more than one fiduciary capacity. A person may serve both as a trustee and administrator. Even the corporation may be a fiduciary. Insofar as a corporation maintains the plan for its em-

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139. In Donovan, 680 F.2d at 274, had the trustees tendered the shares to LTV, the tender offerer, a substantial profit for the ESOP would have realized. In the Bendix-Martin Marietta takeover, when Citibank, the trustee of the Bendix ESOP, tendered the plan’s shares at the price of $85.00, there was a substantial potential profit for the ESOP. See generally supra note 3.
140. See generally supra note 3.
141. Carlson, supra note 8, at 299 n.29.
142. Taylor v. Bakery & Confectionary Union & Indus. Int’l Welfare Fund, 455 F. Supp. 816, 819 (E.N.C. 1978). See also Sample v. Monsanto Co., 485 F. Supp. 1018, 1019 (E.D. Mo. 1980). Further, the fiduciary of a pension plan has more freedom and opportunity to make investment decisions than a common law trustee. See supra note 21 and accompanying text. Additionally, in Marshall v. Teamster Local 282 Pension Trust Fund, 458 F. Supp. 986, 990 (E.D.N.Y. 1978), the court states that there is “substantial reason to believe that Congress did not intend to compel the courts to rely exclusively on the common law when drawing the contours of ERISA’s fiduciary standards.” Id.
143. In Cutaiar v. Marshall, 590 F.2d 523, 529 (3d Cir. 1979), the court accepted the Secretary of Labor’s argument that a per se violation of § 1106(b)(2) was present. Identical trustees of two employee benefit plans, whose participants and beneficiaries were not identical, effected a loan between the plans. The loan was not exempt under the provisions of ERISA, 29 U.S.C. § 1108. Fiduciary misconduct need not be shown before the act is violated, and harm to the participants and beneficiaries inflicted. Accord Eaves v. Penn, 587 F.2d 433 (10th Cir. 1978).
144. ERISA, 29 U.S.C. § 1002(9) states: “The term ‘person’ means an individual, partnership, joint venture, corporation, mutual company, joint-stock company, trust, estate, unincorporated organization, association or employee organization.” Id.
ployees, and administers the plan through its directors, officers, and employees, it will be considered a fiduciary subject to liability under ERISA.\textsuperscript{145}

Officers and directors of the corporation may be designated fiduciaries under an ESOP. In \textit{Eaves v. Penn},\textsuperscript{146} the Court of Appeals for the Tenth Circuit found the officers and directors of the plan sponsor to be fiduciaries under ERISA.\textsuperscript{147} The fiduciary status resulted by virtue of the officer and director activities in recommending, designing, and implementing an amendment to transform a profit sharing plan to an ESOP.\textsuperscript{148} Members of the board of directors of a sponsor corporation will be designated fiduciaries\textsuperscript{149} if duties and responsibilities with respect to the plan involve the obligations stated in ERISA section 1002(21)(A).\textsuperscript{150} However, it is disadvantageous to name a board of directors as the trustee of an ESOP because of the potential conflict of interest and dual loyalty to the employee benefit plan and the corporation.\textsuperscript{151}

Plan trustees and administrators are fiduciaries of an ESOP.\textsuperscript{152}

\textsuperscript{145} 1982 \textit{Pens. \& Profit Sharing (P-H)} ¶ 20,072.
\textsuperscript{146} 587 F.2d 453, 458-59 (10th Cir. 1978).
\textsuperscript{147} \textit{Id.} at 459. In \textit{Marshall v. DeKeyer}, 485 F. Supp. 629, 640-41 (W.D. Wis. 1979), the court held:

\begin{quote}
[O]fficials of a company which sponsors a plan are themselves fiduciaries to the extent that they retain authority for selection and retention of plan fiduciaries because, to that extent, they have retained 'discretionary authority or discretionary control respecting management of the plan'... While it is indeed contemplated under ERISA that a corporation, as an entity, may be a plan fiduciary, the analysis does not end there. Individuals within the corporation who exercise the type of authority or control described in section 3(21)(A) of ERISA will themselves be fiduciaries with respect to the plan.
\end{quote}

\textit{Id.} at 640-41.

\textsuperscript{148} In \textit{Eaves v. Penn}, 587 F.2d 453, 457-59 (10th Cir. 1978), the defendant, an officer and director, recommended, designed and implemented an amendment in the corporation's profit sharing plan to an ESOP. The court held that the structure of ERISA itself requires that an individual making an investment decision be a fiduciary. An ESOP fiduciary, just as a fiduciary in other plans, is governed by the "solely in the interests" and "prudence" tests stated in ERISA, 29 U.S.C. §§ 1104(a)(1)(A) and 1104(a)(1)(B).

\textsuperscript{150} 1982 \textit{Pens. \& Profit Sharing (P-H)} ¶ 20,119. It is disadvantageous to name a board of directors as trustee of an ESOP because of the potential conflict of interest and dual loyalties to the employee benefit plan and the corporation.

\textsuperscript{151} \textit{Id.}

\textsuperscript{152} \textit{Freund v. Marshall \& Isley Bank}, 485 F. Supp. 629, 634-35 (W.D. Wis. 1979) (action brought for alleged violations of fiduciary duties). In \textit{Freund}, the district court noted that the fiduciary's state of mind is not determinative of fiduciary status under ERISA. \textit{Id.} at 635.
A plan administrator has discretionary authority as to the maintenance and operation of the ESOP. Thus, the fiduciary duty is an all-encompassing duty. As a subpart thereof, the “exclusive benefit” and “prudent man” requirements must be defined and analyzed because these requirements strictly govern an officer or director in utilizing an ESOP to avert a takeover.

VII. EXCLUSIVE BENEFIT REQUIREMENT—IS THE USE OF AN ESOP TO AVERT A CORPORATE TAKEOVER FOR THE EXCLUSIVE BENEFIT OF EMPLOYEE PARTICIPANTS?

The exclusive benefit rule subjects the fiduciary to an additional requirement which allows only those actions and investments designed for the exclusive benefit of the participants and beneficiaries of an ESOP. Thus, when an ESOP is used as a defense tactic to avoid a takeover, the court will grant relief upon the showing that such action was not for the exclusive benefit of the employee benefit plan, but rather, for the primary benefit of the corporation and incumbent management.

The exclusive benefit requirement for employee benefit plans is stated in ERISA sections 1103(c)(1) and 1104(a)(1)(A). Section 1103(c)(1) states in pertinent part: “[t]he assets of a plan shall never inure to the benefit of any employer and shall be held for the exclusive purposes of providing benefits to participants in the plan and their beneficiaries...” Section 1104(a)(1)(A) states that the fiduciary shall act solely in the interest of the participants and beneficiaries “for the exclusive purpose of (i) providing benefits to participants and their beneficiaries. . . .”153 Provisions of the Internal Revenue Code, specifically sections 401154 and 503, also address the exclusive benefit concept.155 Usually, the terms and conditions of the trust agreement establishing the ESOP will provide that the plan shall inure only to the exclusive benefit of participants and beneficiaries.156 The exclusive benefit rule

153. In Talarico v. United Furniture Workers Pension Fund, 479 F. Supp. 1072, 1081 (D. Neb. 1979), the district court stated that in carrying out the obligations imposed on employee benefit plan trustees, the trustee's actions must be designed to protect the plan and its participants and beneficiaries. Thus, trustees must exercise their discretion to serve the interests of all participants of the plan. Accord Eaves v. Penn, 587 F.2d 453 (10th Cir. 1978). In Eaves, the trustee of an ESOP was bound by the exclusive benefit and prudent man requirements of ERISA in determining whether to invest plan funds in employer securities.

154. See supra note 56.

155. The aspect of the exclusive benefit requirement under the Internal Revenue Code will be deemed to have been met if the fiduciary meets the prudent man rule of the labor provisions (Title I of ERISA). H.R. No. 533, 93d Cong., 1st Sess. 3 (1973), reprinted in 1974 U.S. CODE & CONG. AD. NEWS 4639, 5083.

156. Rev. Rul. 69-494, 1969-2 C.B. 88. The term “exclusive” is thus transmitted to
heightens the fiduciary standard, since the fiduciary of an ESOP must pay special attention to ascertain not only that the investment is sound, but also that the choice of investment is solely for the benefit of participants.\textsuperscript{157} Plan trustees must always discharge their duties and administer the ESOP with the exclusive benefit rule in mind.\textsuperscript{158}

Legislative history concerning the exclusive benefit standard indicates that while an ESOP may be able to acquire employer securities, the acquisition must be for the sole benefit of the participants and beneficiaries.\textsuperscript{159} Commentators have stated that the existence of an ESOP may present corporate management with a desire to manipulate the ESOP's holdings contrary to the best interests of the participants.\textsuperscript{160} The trust may be perceived by management as an extension of the corporation. Therefore, the ESOP may be manipulated primarily to further corporate objectives rather than the promotion of employee welfare.\textsuperscript{161}

The exclusive benefit rule may be absolute in that no other indirect benefit may inure to other entities or interests. The primary benefit requirement does not, however, preclude others from deriving some benefit from a transaction of the ESOP.\textsuperscript{162} Where a legitimate business purpose for the transaction exists, even though the transaction may assist the target corporation's management to defeat a tender offer, the transaction will be

\begin{itemize}
  \item 1) the cost must not exceed fair market value at the time of purchase,
  \item 2) a fair return commensurate with the prevailing rate must be provided,
  \item 3) sufficient liquidity must be maintained to permit distributions in accordance with the terms of the plan; and
  \item 4) the safeguards and diversity to which a prudent investor would adhere must be present.
\end{itemize}

\textit{Id.} See supra note 117 and accompanying text.

\textsuperscript{157} 1982 PENS. & PROFIT SHARING (P-H) \S 20,252.

\textsuperscript{158} In Donovan, 680 F.2d at 271, the good faith intention of the trustees alone did not satisfy the exclusive benefit requirement of ERISA.

\textsuperscript{159} Because the fiduciary duty stated in ERISA, 29 U.S.C. \S 1104(a)(1) is made subject to the language of \S 1103(c) and (d), congressional intent is that assets of an employee benefit plan should never inure to the benefit of any employer. These two sections expressly forbid the employer from self-dealing in fund assets. See supra note 155. Since assets of the employee benefit plans are to be held for the exclusive benefit of participants and beneficiaries, plan assets are generally not to inure to the benefit of the employer. See Winpisinger v. Aurora Corp. of Ill. Precision Castings Div., 456 F. Supp. 559, 565 (D.C. Ohio 1978).

\textsuperscript{160} Carlson, supra note 8, at 300.

\textsuperscript{161} Id.

\textsuperscript{162} Developments, supra note 8, at 28.
valid. When trust funds are invested in employer securities, a full disclosure must be made stating the reasons for such an arrangement. The conditions under which the investments are made should be stated so that a determination may be made, if necessary, as to whether the trust serves any purpose other than constituting a part of a plan for the exclusive benefit of employees.

In *Ma-Tran Corp. v. Commissioner* and *Feroletto Steel Co.*, the Tax Court found that the assets of the employee benefit plan were not utilized for the exclusive benefit of the participants and beneficiaries. In *Ma-Tran Corp.*, the assets of a profit sharing trust were lent at a low interest rate to the employer. It was also held that other assets were not profitably invested and the plan was not administered in the best interests of the employees.

The transaction in *Feroletto Steel Co.* violated the exclusive benefit rule. Applying the exclusive benefit test, the Tax Court held that the plan's sponsor, not the employee participants, was the main beneficiary. The return of the investment was less than the prevailing interest rate at the time of the transaction. The policy of ERISA to safeguard the plan's assets for the benefit of the recipients was not the primary purpose of the transaction.

The exclusive benefit rule and the prudent man rule, as subparts of the fiduciary standard set forth in ERISA, impose strict limitations upon the use of an ESOP to thwart a potential corporate takeover. An officer or director of a corporation acting as a trustee of the ESOP will face the difficult task of attempting to act solely on behalf of employee participants while simultaneously acting as a corporate officer or director.

VIII. THE PRUDENT MAN REQUIREMENT

The officer or director of a corporation appointed as a fiduciary of an ESOP must act according to the statutory fiduciary standards outlined in ERISA, and must also act in a prudent manner.

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163. *Id.*
164. Additionally, I.R.C. Reg. § 1.401(1)(b)(J)(ii) (West 1982) and Reg. 1.6033(i)(a) set forth reporting requirements for the trust. Every employer trust qualified under I.R.C. § 401(a) (West 1982), and exempt from federal income taxation under § 501(a), shall file an annual return. The return, Form 990-P, must include the information required by Reg. 1.401-1 1969-2 C.B. 88.
165. "Since the merits of an act may be judged under unfavorable circumstances, conscientious fiduciaries should meticulously document why they have taken specific actions. They should give a reasonably good idea of the alternatives that have been considered and the reasoning that has led to the ultimate decision." *Professional Money Managers, supra* note 24, at 522.
166. 70 T.C. 158 (1978).
The prudent man requirement is yet another hurdle which must be overcome before an ESOP may be employed to avert a corporate takeover.

The prudent man requirement is set forth in ERISA section 1104(a)(1)(B). The prudence rule of ERISA is a standard built upon certain aspects of traditional trust law. Section 1104(a)(1)(B) states that a fiduciary shall discharge his duties “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.”

Legislative history indicates that the prudent man rule must be interpreted bearing in mind the special nature and purpose of employee benefit plans. To the extent that a fiduciary meets the prudent man rule of the labor provisions of Title I of ERISA, the fiduciary will be deemed to meet the aspects of the exclusive benefit requirement under Title II of ERISA (the Internal Revenue Code provisions).

In *Eaves v. Penn*, the court enunciated the two-fold duty under the prudent man requirements of ERISA: “[1.] to act in his relationship to the plan’s fund as a prudent man in a similar situation and under like conditions would act; and [2.] to act consistently with the principles of administering the trust for the exclusive purposes” of benefiting the participants and beneficiaries.

The primary consideration in the prudent man analysis is whether the fiduciary has investigated and analyzed all relevant factors before acting. Additionally, inquiry must be made to determine if the decision was impartial and primarily for the benefit

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169. *Id.* The first statement of the requirement that trustees invest the assets under their control as would “men of prudence, discretion and intelligence” was in the case of Harvard College v. Amory, 26 Mass. 446, 461 (1830). Compare this standard with the sound business judgment rule, *supra* note 103.
171. *See supra* note 155.
172. 587 F.2d 453 (10th Cir. 1978).
of employees. The trustee of an employee benefit plan breaches the duty of due care by making an investment unless he makes an investigation regarding the soundness of the investment. Where the transaction is significant, prudence requires the fiduciary to make a thorough investigation, especially if any party in interest is involved.

The affirmative obligation on the part of the fiduciary to exercise prudence requires careful evaluation in order to guarantee the preservation of the trust corpus. Preservation of the ESOP's corpus includes the responsibility to make an independent inquiry into the merits of a particular investment rather than relying solely upon the advice of others. The case of *In Re Talbot's Estate*, held that it is a matter of common prudence for a trustee to request expert advice on investments. Further, consultation with other interested fiduciaries is also required. A plan fiduciary may rely on data, information, statistics, or analyses furnished by others. However, the fiduciary must exercise due care in the selection and retention of persons providing such information. The plan fiduciary will have acted prudently in such selection and retention if he has no reason to doubt the competence, integrity or responsibility of such persons.

The standard of prudence dictates that care must be exercised in documenting all meetings where action is taken concerning the management and control of assets. Written minutes of all conduct should be taken describing each action taken and how each

174. There is an external or objective standard which governs the conduct of trustees. Likewise, the "conduct of the trustee in making an investment is to be judged as of the time when he made it and not as of some later time." 3 SCOTT, THE LAW OF TRUSTS, § 227 (3d ed. 1967).

175. *Id.*


178. *Id.* at § 227.1. In Withers v. Teachers' Retirement Sys. of New York, 447 F. Supp. 1248 (S.D.N.Y. 1978), aff'd mem., 595 F.2d 1210 (2d Cir. 1979), the beneficiaries of a municipal trust fund established for public school teachers brought an action against the trustees of the fund. The beneficiaries sought damages and injunctive relief prohibiting further investment of pension fund assets in securities or obligations of New York City. The court found the trustees had acted prudently although the City of New York was on the verge of bankruptcy.


trustee voted.\textsuperscript{183} In \textit{Donovan v. Bierwirth},\textsuperscript{184} the court paid close attention to the lack of documentation of the fiduciaries' actions in utilizing the ESOP to avert a corporate takeover. The board of directors in \textit{Donovan} spent a mere ten minutes on ERISA requirements and any ramifications of the pending tender offer.\textsuperscript{185}

A review of a fiduciary's independent investigation is one of the well-established yardsticks courts have customarily used to test whether a fiduciary's conduct has satisfied the prudence standard, either at common law or under the statutory provisions set forth in ERISA.\textsuperscript{186} In analyzing trustee actions, courts will base their findings on the prudence of the trustee upon the independent and thorough investigation performed with respect to the merits of a particular investment or transaction.\textsuperscript{187} If the fiduciary of an ESOP fails to use proper care and patience in making an investigation, he is liable for losses which result from making an investment if an appropriate investigation would have disclosed that it was an improper or disadvantageous transaction for the trust.\textsuperscript{188}

The prudent man requirement is likened to the sound business judgment rule applicable to directors of a corporation.\textsuperscript{189} Therefore, in acting as a director and trustee, satisfaction of the prudent man standard will also fulfill the duty to act according to the sound business judgment standard.

\begin{itemize}
\item \textsuperscript{184} 680 F.2d 263 (2d Cir. 1982).
\item \textsuperscript{185} Id. at 267.
\item \textsuperscript{186} The court applied this test of independent investigation in \textit{Donovan}, 680 F.2d at 274.
\item \textsuperscript{187} \textit{Fiduciary Standards}, supra note 21, at 965.
\item \textsuperscript{188} In \textit{Donovan}, the court of appeals stated that the fiduciaries would not have been remiss in their fiduciary duties if a "careful and impartial" inquiry had led to the reasonable conclusion that purchasing Grumman stock best promoted the interests of the ESOP and its employee participants and beneficiaries. The trustees, who were also corporate directors and officers, failed to engage independent counsel and refused to fully examine the plan funding consequences in fighting the takeover attempt by LTV. \textit{Id.} at 272. Alan D. Lebowitz, Department of Labor Administrator for Fiduciary Standards stated: "Trustees must divorce themselves from the company's financial picture — even if corporate officers — and must act independently in the plan's best interests." \textit{Id.} Torn between corporate loyalty and fiduciary duty, the trustees of the Grumman ESOP subjected the plan to needless risk. The trustees invested in Grumman securities known to be diminishing in value, whether or not the corporate takeover succeeded. \textit{See} 1982 \textit{PENS. \& PROFIT SHARING (P-H)} \texttt{¶} 17.4.
\item \textsuperscript{189} \textit{See supra} note 103 and accompanying text.
\end{itemize}
IX. INDEMNIFICATION

An officer or director acting as a trustee of an ESOP will be personally liable for any losses incurred by his failure to meet the required fiduciary standard. Transactions utilizing the ESOP to avert a corporate takeover may violate the fiduciary standards of exclusive benefit and prudence. Monetary liability may be avoided by an indemnification clause provided in the trust instrument.

ERISA section 1110(a) states: "any provision in an agreement or instrument which purports to relieve a fiduciary from responsibility or liability for any responsibility, obligation or duty. . . shall be void as against public policy." However, section 1110(a) applies only to exculpatory clauses. Exculpatory clauses are expressly prohibited by ERISA.

Although indemnification arrangements do not contravene the provisions of section 1110(a), parties entering into an indemnification agreement should determine whether such agreement complies with the other provisions of ERISA and with applicable state and federal laws. The Department of Labor has interpreted this section to permit indemnification agreements which do not relieve a fiduciary from responsibility or liability under the fiduciary standards set forth in Title 1, Part 4, of ERISA. Therefore, indemnification provisions included in the trust instrument or an amendment thereto which leave the fiduciary fully responsible and subject to liability, but merely permits another party to satisfy any liability incurred by the fiduciary, will be valid.

For example, ERISA section 1110(b) states that a fiduciary or

191. An exculpatory clause is a clause in favor of the trustee which exculpates him where his power is exercised in good faith. BLACK'S LAW DICTIONARY (rev. 5th ed. 1979).
192. Fiduciary Standards, supra note 21, at 969.
193. Interpretive Bulletin Relating to Fiduciary Responsibility, 40 Fed. Reg. 47,491 (1975). Examples of indemnification provisions which are valid include: 1) indemnification of a plan fiduciary by (a) an employer, any of whose employees are covered by the plan, or an affiliate of such employer, or (b) an employee organization, any of whose members are covered by the plan; and 2) indemnification by a plan fiduciary of the fiduciary's employees who actually perform services.
194. In Donovan, the Grumman Corporation amended the plan document to provide indemnification to the trustees for any fines or disbursements they might incur from their actions in utilizing the ESOP to avoid the takeover of Grumman by LTV. 680 F.2d at 269. Amendment of the employee benefit plan is provided for in ERISA, 29 U.S.C. § 1102(b)(3).
195. ERISA, 29 U.S.C. § 1110(b) states:
Nothing in this subpart shall preclude—
(1) a plan from purchasing insurance for its fiduciaries or for itself to cover liability or losses occurring by reason of the act or omission of a fiduciary, if such insurance permits recourse by the insurer against the fiduciary in the case of a breach of a fiduciary obligation by such fiduciary;
the employer organization may purchase insurance to cover potential liability for any breach of fiduciary duty. The plan sponsor may purchase liability insurance which intentionally omits any recourse by the insurer against the fiduciaries of the ESOP. There is no existing public policy reason which would prohibit the employee benefit plan sponsor from indemnifying one or more fiduciaries instead of purchasing liability insurance. The overriding concern is the protection of the plan trust, its participants, and beneficiaries. Therefore, any design or device which permits the ESOP itself to indemnify the fiduciary for breach of his duties either under common law or ERISA standards is invalid.197

X. REMEDIES

If an ESOP is improperly used to avert a corporate takeover, several remedies are available to the employee participants and beneficiaries. Federal law controls the enforcement of ERISA and provides relief for the participants and beneficiaries of the ESOP.198 Trustees of an ESOP, like all fiduciaries, are subject to judicial sanction upon a showing that they have acted arbitrarily or capriciously towards the persons to whom their obligations and duties run.199 ERISA section 1109(a)200 is a comprehensive provi-

196. Developments, supra note 8, at 96. The Department of Labor has stated that indemnifications of plan fiduciaries from the employer-sponsor corporation assets are permissible. Kroll & Tauber, Fiduciary Responsibility and Prohibited Transactions Under ERISA, 14 REAL PROPERTY, PROBATE & TRUST J. 657, 667 (1979). See supra note 194 and accompanying text.

197. Interpretive Bulletin Relating to Fiduciary Responsibility, 40 Fed. Reg. 47,491 (1975). The Department of Labor interprets § 1110(a) as rendering void any arrangement for indemnification of a fiduciary or an employee benefit plan by the plan. Such an arrangement would have the same result as an exculpatory clause in that it would, in effect, relieve the fiduciary of responsibility and liability to the plan by abrogating the plan's right to recover from the fiduciary for breaches of fiduciary obligations. See generally Fishman, Fiduciary Responsibility Under ERISA, 10 COLO. LAw. 1635, 1638 (1981).


199. Kosty v. Lewis, 319 F.2d 744, 749 (D.C. Cir. 1963). See also Gordon v. ILWU-PMA Benefit Funds, 616 F.2d 433, 437 (9th Cir. 1980); Bayles v. Central States, Southeast & Southwest Areas Pension Fund, 602 F.2d 97, 100 (5th Cir. 1979).

200. ERISA, 29 U.S.C. § 1109(a) states: "[a]ny person who is a fiduciary with respect to a plan who breaches any of the responsibilities . . . shall be personally
sion which illustrates Congress' intent to arm the courts with broad remedial power to redress the interests of participants and beneficiaries when they have been adversely affected by a breach of fiduciary duty.

ERISA grants the federal court broad discretion in fashioning both legal and equitable relief to promote plan stability. In enacting ERISA, Congress was concerned with the potential transactions which lend themselves to a probability of loss of plan assets or insider abuse.201

Remedies for fiduciary breach of duty may include removal of the fiduciary, recission of unlawful transactions, and recovery of monetary loss to the plan.202 Not only is relief available for fiduciary breach of duty, but also, non-fiduciaries as well may be subject to liability by applying common law trust principles.203 ERISA specifically contemplates a remedy against a non-fiduciary to "correct" a prohibited transaction.204

In Donovan v. Bierwirth,205 injunctive relief was granted in order to enjoin the trustees of the plan from voting on the ESOP stock pending a corporate takeover. In Donovan, the district court issued a preliminary injunction against the trustees of the plan. Except upon further order of the court, the trustees of the ESOP were prohibited from buying, selling, or exercising any powers, rights, or duties on behalf of the ESOP. Additionally, the court appointed an investment manager as a receiver pendente lite206 for the pension plan. On review, the Court of Appeals for the Second Circuit reversed the appointment of the receiver,207 stressing that the appointment of a receiver is a harsh remedy

203. See supra notes 49-54 and accompanying text.
204. Freund v. Marshall & Isley Bank, 485 F. Supp. 629, 642 n.5 (W.D. Wis. 1979); see also I.R.C. § 4975(f) (5) and (h) (West 1982).
205. 680 F.2d 263 (2d Cir. 1982).
206. A receiver pendente lite is a person appointed to take charge of the fund or property to which the receivership extends while the case remains undecided. The title to property is not changed by the appointment. The receiver acquires no title, but only the right of possession as the officer of the court. The object of the appointment is to secure the property pending the litigation so that it may be appropriated in accordance with the rights of the parties, as they may be determined by the judgment in the action. Title Guarantee & Trust Co. v. 457 Schenectady Ave., 235 A.D. 509, 512, 257 N.Y.S. 413, 417 (1932).
207. 680 F.2d at 276. Although ERISA does not provide specifically for the appointment of a receiver, such power is conferred in § 1132(a)(5) which allows the Secretary of Labor to seek "other appropriate equitable relief." Id. In Marshall v. Snyder, 572 F.2d 894 (2d Cir. 1978), the Court of Appeals for the Second Circuit affirmed and explicitly approved the appointment of a receiver for several employee benefit plans. See Gallagher, supra note 44, at 764.
which can only be imposed upon a showing of necessity. The
court commented that the trustees' financial integrity was not at
issue. The trustees were permitted to continue in their fiduciary
capacity with respect to the balance of the plan's assets.\textsuperscript{208}

Factors to be considered in granting preliminary relief in an ac-
tion brought for alleged ERISA violations include: "1) the pur-
poses of the trust; 2) the relative pecuniary advantages to the
trust estate of the various remedies [available]; 3) the nature of
the interest of each beneficiary; 4) the practical availability of the
various remedies; and 5) the extent of the deviation from the
terms of the trust required by the adoption of each of the
remedies."\textsuperscript{209}

The court has the authority and duty to enforce the remedy
which is most advantageous to the participants and beneficiaries.
The proper remedy should be conducive to effectuation of the
purpose of the trust.\textsuperscript{210} In the case of an ESOP, the primary pur-
pose for a remedy should be the protection of the assets of the
plan for the benefit of plan participants and beneficiaries.

The trust instrument may state the decision of the management
if the employee benefit plan is conclusive. However, the courts
will review actions taken and decisions made to guard against ca-
price or fraud in an attempt to promote the policy behind ER-
ISA.\textsuperscript{211} Thus, judicial reivew of the acts of the ESOP trustees in
administering a non-contributory profit-sharing or pension plan,
"is limited to a determination as to whether the trustees acted ar-
bitrarily, capriciously, or in bad faith,"\textsuperscript{212} and provides a remedy
which best serves and furthers the interests of employee partici-
pants and beneficiaries.

\textsuperscript{208} Donovan, 680 F.2d at 276-77.
\textsuperscript{209} Eaves v. Penn, 587 F.2d at 462-63 (quoting \textit{Restatement (Second) of
Trusts} § 314, comment 2(b).
\textsuperscript{210} Id. at 462.
\textsuperscript{211} Gehrhardt v. General Motors Corp., 434 F. Supp. 981, 982-83 (S.D.N.Y. 1977),
aff'd, 581 F.2d 77 (2d Cir. 1978).
\textsuperscript{212} Miller v. Associated Pension Trust, Inc., 541 F.2d 726, 728-29 (8th Cir. 1976); acord
Fontecchio v. United Steelworkers of Am., 476 F. Supp. 1023 (D. Colo. 1979)
(administrators of pension plans are accorded considerable deference to interpret
terms of pension plans, and trustees of pension funds must be sustained as matter
of law unless plaintiff can prove that action taken by administrators was arbitrary
or capricious).
XI. Conclusion

The use of an ESOP by corporate directors and officers, while acting as trustees of an ESOP, to avert a corporate takeover, is difficult, if not impossible, considering the restrictions imposed by ERISA and the underlying common law. Acting as a fiduciary of the ESOP, the officer or director must always adhere to the exclusive benefit rule. Any deviation from the requirement that any transaction of the ESOP must be in the best interests of the plan's employee participants and beneficiaries will result in personal liability.

Additionally, the prudent man requirement places the responsibility on the corporate officer or director of the plan sponsor corporation to thoroughly investigate the merits of the tender offer proposed by the raider. If, in the best and impartial judgment of the board of directors, the takeover is detrimental to the shareholders and corporation, then the director has the affirmative duty to lawfully counter the tender offer. However, the use of an ESOP as a tactical maneuver will likely result in violations of the fiduciary standard. Incumbent management should utilize other methods to avert the takeover.

An ESOP is a valuable corporate device which confers benefits upon the employees and the corporation. The employees benefit by the stability of a plan which will provide future income. One corporate benefit is improved employee morale. However, the potential benefit to the corporation offered by the use of an ESOP as a corporate takeover defense tool should be deterred. In light of ERISA and recent court decisions, the scope of establishment and operation of an ESOP should be limited to its intended purpose — an employee benefit plan — not a weapon in the high-power arena of corporate takeovers.

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