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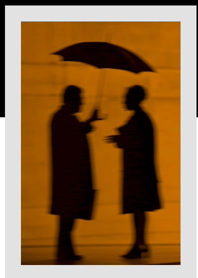

ESOPtions

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Jenkens & Gilchrist ESOP Solutions Group

In This Issue

Enron Update: Court Preliminarily Approves Benefit Settlement, But Enron Moves to Block Funding

On May 31, 2004, the District Court for the Southern District of Texas preliminarily approved an $85 million partial settlement of class action claims brought on behalf of participants in Enron's ESOP and 401(k) plans. *Tittle v Enron*, Case No. H-01-3913. The entire settlement amount was expected to be paid from Enron's liability insurance, but on July 26, 2004 Enron brought a motion in the Bankruptcy Court in New York to block the insurance payment.

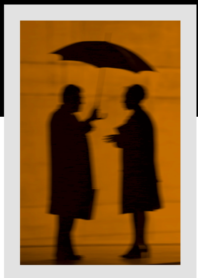
In the *Tittle* case, the participants in Enron's ESOP and 401(k) plans brought claims against the plan trustee, the administrative committee, various Enron officers, and Enron's outside directors. The plaintiffs alleged, among other claims, that the defendants breached their fiduciary duties under ERISA by failing to (a) disclose material information about the company's true financial condition, (b) correct misleading information provided by others, (c) consider the prudence of Enron stock as an appropriate investment for the plans, (d) investigate when learning of adverse circumstances affecting plan investments, and (e) monitor co-fiduciaries. The suit alleged that the plaintiffs, as a class, lost more than $1 billion as a result of the decline in value of Enron stock.

Under the class action settlement, certain defendants will settle all claims against them in the case for $85 million, to be paid from Enron's liability insurance. Excluded from the group of settling defendants are Northern Trust Company, Arthur Andersen, and officers Kenneth Lay and Jeffrey Skilling. The class action case will continue against these defendants.

In their motion for approval of the settlement, the *Tittle* plaintiffs submitted that their ERISA claims were very solid, but acknowledged that "this remains a rapidly developing area of the law that is only now starting to work its way through the courts of appeal" and that "there remains a risk that a given judge in a given case will view a particular legal issue differently." According to the plaintiffs, the $85 million settlement represented between 7 and 8 percent of the total potential damages suffered by the plans. A hearing to finally approve the settlement is scheduled for August 19, 2004.

At the same time as the *Tittle* settlement was approved, the Department of Labor ("DOL") also settled its claims against the same group of defendants, although the DOL settlement was conditioned upon the finalization and the funding of the class action settlement. Under the DOL settlement, the former directors are barred from assuming fiduciary duties with respect to any ERISA plan for five years, and the settling employees (those employees who were members of the Enron plan administrative committee) are permanently barred from acting as ERISA fiduciaries. The DOL, like the class action plaintiffs, did not settle with Kenneth Lay or Jeffrey Skilling.

On July 26, 2004, Enron brought a motion in the Bankruptcy Court of the Southern District of New York to block payment under Enron's insurance policies to fund the class action settlement. Enron argued that the insurance proceeds are an asset of the bankruptcy estate, and that distribution of that asset should be subject to the approval and the management of the Bankruptcy Court, not the Texas court. The unsecured creditors committee in the Enron bankruptcy supported Enron's position, noting that the Bankruptcy Court had only permitted the *Tittle* case to be brought in Texas for a limited purpose – to determine the plan participants' claims against the fiduciaries. However, they argued, the Texas court had never been given the authority to allow Enron assets to be used, such as insurance proceeds. If the insurance proceeds are not released by the Bankruptcy Court to pay for the class action settlement, the parties may



need to go back to the bargaining table, or to the courtroom.

Information on the *Tittle* class action case and proposed settlement can be obtained at http://enronerisa.com, and documents regarding the Enron bankruptcy in general can be obtained at http://elaw4enron.com.

Legislative Update

On June 17, 2004, the U.S. House of Representatives passed H.R. 4520, the American Jobs Creation Act of 2004. The Senate version of the bill, S. 1637, passed the Senate in May. Both bills would correct a deficiency in the law regarding use of distributions of earnings to S corporation ESOPs to pay off ESOP loans.

Under current law, the IRS has taken the position that only S corporation distributions on suspense account shares may be used to repay an ESOP loan. In contrast, C corporation ESOPs may repay their debt from dividends on both allocated and unallocated shares. Some experienced ESOP practitioners believe that the difference in treatment of C corporations and S corporations is due to a drafting oversight. [For a discussion arguing against the IRS position, see David Ackerman, "*Technical Issues Under the New S Corporation ESOP Laws*," Journal of Employee Ownership Law and Finance 11, no. 3 (Fall 1999).]

Both the House and Senate bills would correct this discrepancy and would permit all distributions on S corporation stock to be used to repay ESOP loans. The ESOP Association favors the Senate bill, which would apply retroactively to all distributions made after December 31, 1997, while the House bill would apply only to distributions paid after December 31, 2004.

It should be noted that the primary purpose of the bills is to address issues raised by the World Trade Organization relating to taxation of income earned by American companies overseas. However, a number of other provisions are covered, ranging from various tax breaks and revenue raisers to controversial provisions to buy out tobacco crop quotas. On July 15, 2004, the bills were sent to a joint conference committee, to work out a compromise. Observers note that the number of issues to resolve, as well as a shortened legislative session, may make it difficult to finalize this legislation this year.

In addition, The ESOP Promotion and Improvement Act of 2004 (the "Act") has been introduced in the House of Representatives (H.R. 4520) and in the Senate (S. 2298). If enacted, the Act would benefit current ESOP sponsors and their employees and foster the creation of new ESOPs. The key provisions of the Act are as follows: (a) permit S corporation distributions from current earnings paid on ESOP stock, both allocated and unallocated, to be used to pay ESOP debt; (b) repeal the 10 percent excise

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tax on S corporation distributions from current earnings paid on ESOP stock that are passed through to ESOP participants in cash; (c) permit owners of an S corporation to sell their shares of stock to an ESOP under the same tax-free rollover provisions of Section 1042 that currently apply to owners of a C corporation; (d) clarify that dividends paid by a C corporation on ESOP stock are not a preference item in calculating the corporate alternative minimum tax; (e) permit proceeds received from a 1042 transaction to be invested in mutual funds consisting of operating U.S. corporation securities; (f) redefine what is a 25 percent owner for purposes of the tax-free rollover provisions of Section 1042; and (g) permit early withdrawals from an ESOP for first time home purchases and college tuition under limited circumstances.

District Court Finds No Right of Contribution Among ERISA Fiduciaries

The District Court for the Western District of Tennessee has held, in the case of *May v. National Bank of Commerce*, that an ERISA fiduciary charged with violating his fiduciary duties cannot sue his co-fiduciaries for contribution.

In the *May* case, Laurence Scott, a fiduciary of the Memphis Equipment Company ESOP, was sued by a fellow member of the ESOP administrative committee for secretly purchasing 100% of the sponsoring company's stock for less than $10.00. Scott filed a counterclaim for contribution against the other fiduciaries, claiming that if he were held liable, the other fiduciaries should share responsibility because they failed to discover his alleged wrongdoing.

The district court noted that the federal courts were split on the issue of whether contribution was available among ERISA fiduciaries. The Ninth Circuit has held that no right of contribution exists, reasoning that ERISA incorporates many other principles of trust law, but it is silent on the issue of fiduciary contribution. It concluded that since ERISA is such a comprehensive statute, the absence of a provision relating to contribution among fiduciaries must have been intentional. By contrast, the Second and Seventh Circuits have upheld a right of contribution in ERISA cases, applying federal common law principles.

The district court in the *May* case sided with the Ninth Circuit, stating that denying a right of contribution is "more consistent with ERISA's statutory scheme, which is designed to protect beneficiaries and participants of employee benefit plans, and is likely to provide more expeditious litigation for these parties."

Rollovers of ESOP Distributions to IRAs – Recent Developments

The IRS has favorably addressed whether the following types of distributions may be rolled over from ESOPs into IRAs: (a) distributions of S corporation stock, and (b) distributions of rights in escrowed proceeds of ESOP stock sales.

With respect to the first issue, the IRS has confirmed in a series of revenue procedures that a participant may direct an ESOP to roll over S corporation stock distributions to the participant's IRA, without terminating the corporation's S election. Revenue Procedure 2003-23, as modified by Revenue Procedure 2004-14, provides that the S election is not affected by this kind of a rollover, if all of the following conditions are met:

- the participant directs that the distribution be made in a direct rollover;
- the terms of the ESOP require that the S corporation repurchase the stock immediately upon the ESOP's distribution to an IRA;
- either (a) the corporation actually repurchases the stock at the same time that it is distributed, or (b) the ESOP is permitted to assume the corporation's obligation to repurchase the stock, and the ESOP actually purchases the stock at the same time that it is distributed; and
- certain items of income, loss, deduction, and credit attributable to the distributed stock are not allocated to the IRA.

These procedures are needed because ESOP beneficiaries are entitled to direct that any stock distributions be paid in a direct rollover to an IRA. However, an IRA trustee is not a permissible S corporation shareholder. Thus, a participant in an ESOP sponsored by an S corporation could inadvertently cause the corporation to lose its status as an S corporation merely by directing that a rollover be made. With the issuance of these procedures, the IRS confirmed that this result will not occur.

The second issue relates to situations where an ESOP sells its stock and a portion of the purchase price is placed in escrow. The proceeds of the sale are then distributed to the plan participants in the form of (a) cash, and (b) certificates representing an interest in the escrowed funds. In Private Letter Ruling 2004-20036, the IRS stated that a distribution of these escrow certificates could properly be rolled over into an IRA.

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Relief for Late Filers of S Election Consents – Community Property States

The IRS has provided automatic relief for certain taxpayers who fail to timely file a consent to a corporation's S election. An S corporation election is valid only if all shareholders consent to the election. When stock is owned by a husband and wife as community property, both spouses must sign the consent. In Revenue Procedure 2004-35, the IRS implicitly recognized that it can be difficult for shareholders in community property states to timely obtain their spouses' signature to an S election consent.

To alleviate these concerns, the IRS has specified that an extension of time would automatically be granted for a late filing, if:

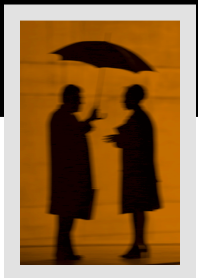
- The corporation files a statement with the IRS, indicating that the community spouses have reported all items of income, gain, loss, deduction, or credit consistent with the corporation's S corporation election; and
- Both community property spouses file a signed statement that they consent to the S election as of the intended effective date.

What We Are Doing, Where We Are Going

The members of the Jenkens & Gilchrist ESOP Practice continue to be involved in a number of activities in the ESOP community. David Ackerman made a presentation at the National Hardware Show in Las Vegas, Nevada on May 1, 2004 entitled "How to Perpetuate Your Business with an ESOP." David also recently spoke on the topic of "Cash Out, But Stay In: ESOPs as a Liquidity Strategy" at the 41st annual trade show of the Organization for the Promotion and Advancement of Small Telecommunications Companies ("OPASTCO") in Calgary, Alberta, Canada, on July 11, 2004.

John Kober attended the ESCA Advisory Committee meeting, with Treasury representatives and certain Congressional staffers, and the ESCA Conference on June 8 and 9, 2004. John made a presentation at the ESCA Conference on the topic of structures that could constitute tax shelters.

John Kober's article, "ESOP S-corporations - How Lenders Impact an S-corporation ESOP Company's Corporate Governance," was published in the July issue of ESCA Washington Watch, and a related article of John's dealing with both C and S corporations, entitled "ESOP Company Corporate Governance -



How Lenders Impact Corporate Governance," will be published in The Beyster Institute's August newsletter.

A private equity workshop was held in Denver, Colorado with Erin Turley and John Kober presenting the uses of an ESOP in a private equity environment, including exiting a protfolio company, co-investing, and planning the liquidity event.

John Kober and David Ackerman will be speaking at The ESOP Association's upcoming Repurchase Liability Seminar that will be held in Chicago, Illinois on September 28, 2004. John will speak on the "Legal ESOP Distribution and Diversification Requirements Creating Repurchase Liability," and David will participate in a roundtable discussion entitled, "Ask the Experts."

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Mark Your Calendar

September 28, 2004

The ESOP Association's 6th Annual ESOP Repurchase Obligation Seminar

The Hyatt Regency Chicago, Chicago, Illinois

(800) 233-1234

esopassociation.org/meetings

If you have questions about any of the J&G ESOPtions Newsletter articles, please contact the Jenkens & Gilchrist, P.C. attorney who routinely handles your legal affairs or any member of the ESOP Team listed below.

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