09-3804-cv

United States Court of Appeals
for the
Second Circuit

IN RE: CITIGROUP ERISA LITIGATION

STEPHEN GRAY, JAMES BOLLA and SAMIER TADROS,
Lead Plaintiffs-Appellants

(for continuation of caption, see inside cover)

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

AMICUS CURIAE BRIEF OF THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION IN SUPPORT OF APPELLEES' REQUESTING AFFIRMANCE

Of Counsel

Ira D. Hammerman
Kevin M. Carroll
SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION
1101 New York Avenue, NW
Washington, DC 20005
Telephone: (202) 962-7382

Ira G. Rosenstein
Orrick, Herrington & Sutcliffe LLP
666 Fifth Avenue
New York, NY 10103
Phone: (212)506-5000

Joseph Liburt
Orrick, Herrington & Sutcliffe LLP
1000 Marsh Road
Menlo Park, CA 94025
(650) 614-7400

SANDRA WALSH, ANTON K. RAPPOLD and ALAN STEVENS,
Plaintiffs-Appellants

– v. –

CITIGROUP INC., CITIBANK, N.A., THE PLANS ADMINISTRATION COMMITTEE, THE PLANS INVESTMENT COMMITTEE, CHARLES O. PRINCE, ROBERT E. RUBIN, JORGE BERMUDEZ, MICHAEL BURKE, STEVE CALABRO, LARRY JONES, FAITH MASSINGALE, THOMAS SANTANGELO, ALISA SEMINARA, RICHARD TAZIK, JAMES COSTABILE, ROBERT GROGAN, ROBIN LEOPOLD, GLENN REGAN, CHRISTINE SIMPSON, TIMOTHY TUCKER, LEO VIOLA, DONALD YOUNG, MARCIA YOUNG and JOHN DOES 1-20,

Defendants-Appellees.

RULE 26.1 CORPORATE DISCLOSURE STATEMENT

Amicus curiae Securities Industry and Financial Markets Association ("SIFMA") is a non-profit corporation. It has no parent corporation and no publicly held corporation owns 10% or more of its stock.

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STATEMENT OF IDENTITY AND INTEREST

The Securities Industry and Financial Markets Association (SIFMA)[1] brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA).

SIFMA has an interest in this case because the issues decided by the Southern District of New York below and about to be decided by the Second Circuit are vitally important to the operation, and even survival of employee stock ownership plans ("ESOPs"). A decision by this Court to overturn the lower court's grant of Defendants' Motion to Dismiss would run counter to the essence of ESOPs and threaten their very existence as a viable investment option. Imposing a fiduciary duty on Plan managers to diversify or divest an ESOP of employer-stock when stock prices declined, despite clear and unambiguous Plan terms requiring mandatory funding of employer stock, would leave Plan managers with an impossible choice – either deviate from the Plan documents and face inevitable

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[1] Pursuant to Local Rule 29.1(b), no other counsel authored the brief in whole or in part, no party's counsel contributed money that was intended to fund preparing or submitting this brief, and no other individual or entity contributed money that was intended to fund preparing or submitting of this brief.

liability or adhere to the terms of the Plan documents and still face liability. An employer facing such unavoidable risks would inevitably abandon ESOPs.

SIFMA is also interested in this case given the widespread use of ESOP's by its members – employers within the financial services industry. Given the role of financial service providers in advising and creating ESOPs for their various customers and clients, and the regular use of ESOPs within their own institutions, the financial services industry is uniquely concerned that Congress' longstanding encouragement of ESOP's is not chilled by a reversal of the District Court's well-reasoned holding.

Indeed, a decision by the Second Circuit reversing the decision of the District Court would be contrary to the well-documented Congressional legislative history and various studies and surveys supporting ESOPs as extremely useful tools for savings and economic growth. The Court below gave thoughtful consideration to the legal issues governing these claims, and simply got it right. The decision should not be disturbed on appeal.

I. INTRODUCTION

This case arises out of claims brought by a class of current and former employees of Defendants Citigroup who participated in two retirement plans offered by Citigroup – the Citigroup 401(k) Plan ("Citigroup Plan") and the Citibuilder 401(k) Plan for Puerto Rico ("Citibuilder Plan") – between January 1, 2007 and January 15, 2008. Compl. ¶ 289. Both the Citigroup and Citibuilder Plans were "employee benefit plans," as defined in 29 U.S.C. § 1002(2)(A), and "eligible individual account plans" ("EIAPs"), as defined in 29 U.S.C. § 1107(d)(3). Compl. ¶ 78. Plaintiffs participated in the Citigroup and Citibuilder Plans by contributing pre-tax payroll deductions that were matched by Defendants in certain instances. Compl. ¶ 81-82.

The terms of both Plans allowed participants to direct their contributions to certain investment funds. Specifically, the Citigroup Plan provided:

> *Investment Funds*. In order to allow each Participant to determine the manner in which his Accounts will be invested, the Trustee shall maintain, within the Trust, the Citigroup Common Stock Fund and other Investment Funds. ***Each Participant's Accounts shall be invested in such Investment Funds in the proportions directed by the Participant in accordance with the rules and procedures established by the [Administration] Committee, including but not limited to any timing and frequency limitations approved by the Investment Committee***. . . . Any one or more of such Investment Funds may be eliminated, or new Investment Funds may be made available, at any time by the Investment Committee without consent by any Participant or Employer; provided, the ***Citigroup Common Stock Fund shall be permanently maintained as an Investment Fund under the Plan***. . . .

Citigroup Plan, § 7.01, Compl. Ex. E (emphasis added). The Citibuilder Plan contained similar wording regarding both the lack of authority of Plan administrators to direct investment funds and the permanent maintenance of the Citigroup Common Stock Fund. See Citibuilder Plan, § 7.01, Compl. Ex. D.

Both Plans set forth specific provisions regarding investment in the "Citigroup Common Stock Fund" ("Common Stock Fund"):

> *"Citigroup Common Stock Fund"* means an Investment Fund comprised of shares of Citigroup Common Stock. Solely in order to permit the orderly purchase of Citigroup Common Stock in a volume that does not disrupt the stock market and in order to pay benefits hereunder, the Citigroup Common Stock Fund may hold cash and short-term instruments in addition to shares of Citigroup Common Stock, in accordance with guidelines prescribed by the Investment Committee.

Compl. Exs. E, D at § 2.01. The Plans also delineated the duties of the Investment Committee with regard to the Common Stock Fund:

> The duties of the Investment Committee shall extend to the promulgation of any guidelines with respect to the amount of cash or any short-term investments that may be held by the Citigroup Common Stock Fund. In addition, notwithstanding the fact that provisions in the Plan mandate the creation and continuation of the Citigroup Common Stock Fund and provide that certain contributions to the Citigroup Common Stock Fund must remain invested in the Common Stock Fund for certain periods of time, if it is determined that there exists a duty on the part of any person (appointed under this Plan or otherwise) to determine whether such provisions should be modified, such duty shall be that of the Investment Committee.

Id. at §7.09(e). Lastly, the Citigroup Plan designated the Common Stuck Fund as an ESOP:

> *ESOP Designation.* The Plan shall consist of a component that is designated as an ESOP within the meaning of Section 4975(e)(7) of the Code, and a component that is not designated as an ESOP. The component designated as an ESOP shall consist of any amount invested in the Citigroup Common Stock Fund under the Plan. The

> component that is not designated as an ESOP shall consist of the remaining portion of the Plan.
>
> *Designed to Invest in Employer Securities.* The component designated as an ESOP under the Plan is designated to invest primarily in Citigroup Common Stock, a qualifying employer security within the meaning of Section 409(1) of the Code.

Citigroup Plan, § 15.01-.02, Compl. Ex. E. The Citibuilder Plan, though it provided for the mandatory creation and funding of the Common Stock Fund in the same manner as the Citigroup Plan, did not specifically characterize the Common Stock Fund as an ESOP.

Plaintiffs assert that Defendants invested heavily in subprime mortgages in the mid-2000's, and that, following the collapse of the subprime mortgage market, Citigroup stock fell 52% during the class period. Compl. ¶¶ 7, 114-129, 172. Plaintiffs claim to have suffered significant losses as a result of having been invested in the Common Stock Fund and the drop in the price of Citigroup stock during the class period. *Id.* at ¶ 281. Additionally, Plaintiffs assert that Defendants breached their fiduciary duty to Plaintiffs as plan participants because Defendants knew or should have known of the precipitous price drop of Citigroup stock, and that under ERISA, Defendants were obligated to eliminate Citigroup stock because it was an imprudent investment option. *See id.* at ¶ 4; *See also In re Citigroup ERISA Litigation*, No. 07 Civ. 9790, 2009 WL 2762708 (S.D.N.Y. Aug. 31. 2009), at *1, *5. Plaintiffs also assert that Defendants breached their fiduciary duties by failing to provide complete and accurate information about Citigroup's financial condition to Plan participants (Count II), neglecting to monitor appointed fiduciaries (Count III), failing to disclose necessary information to their co-fiduciaries (Count IV), performing their duties while they had conflicts of interest (Count V), and by participating in the fiduciary breaches of others (Count VI). *In re Citigroup ERISA Litigation,* 2009 WL 2762708, at *1, *5.

Defendants filed a motion to dismiss the Complaint, which was granted in its entirety by the Southern District of New York on August 31, 2009. *See id.* at *1. In its decision to dismiss the Complaint, the lower court held that the Defendants had absolutely no discretion to eliminate Citigroup stock as an investment option because the explicit terms of both Plans required maintenance of the Common Stock Fund. The court explained:

> The Citigroup Plan unambiguously mandates that 'the Citigroup Common Stock Fund *shall be permanently maintained* as an Investment Fund under the Plan.' The Citibuilder Plan, similarly, provides that 'the Trustee shall maintain . . . the Citigroup Common Stock Fund.' Each Plan also stipulates that the Citigroup Common Stock Fund must hold Citigroup stock, as each Plan Agreement defines the 'Citigroup Common Stock Fund' as 'an Investment Fund comprised of shares of Citigroup Common Stock.' Therefore, defendants had no discretion whatsoever to eliminate Citigroup stock as an investment option, and defendants were not acting as fiduciaries, to the extent that they maintained Citigroup stock as an investment option.

In re Citigroup ERISA Litigation, 2009 WL 2762708, at *7-8 (internal citations omitted). Additionally, the court found no duty on the part of the Defendants to override the plain terms of the Plans and remove Citigroup stock as an investment option. *Id.* at *10. Though the Second Circuit has not yet addressed the proper standard for when or if a fiduciary is required to override Plan language, the Southern District of New York decided that "[t]he correct interpretation of ERISA simply requires fiduciaries to adhere to a plan's terms regarding employer stock, even if the price of employer stock falls." *Id.* at *13. This result, according to the court, prevents the "Catch-22" faced by similarly-situated plan fiduciaries:

> On the one hand, the fiduciaries could adhere to the plan's mandate regarding employer stock. In so doing, however, the fiduciaries could face liability for a breach of the duty of prudence for failing to divest. On the other hand, the fiduciaries could override the plan's terms and divest the plan of employer stock. That course of action, however, could lead to liability for violating the terms of the plan agreement; if the price of the divested stock rebounded, the fiduciary would almost certainly be sued for having overridden the plan terms.

Id. The court also reasoned that the result was dictated by traditional trust law principles and consistent with ERISA's language, structure, and purpose. *Id.*

II. <u>ARGUMENT</u>

The Southern District of New York's dismissal of the Complaint should be upheld on appeal, particularly the finding that Defendants, as Plan fiduciaries, owed no duty to override the terms of the Plans requiring mandatory investment in the Citigroup Common Stock Fund. The reasoning supporting the court's decision is sound. This brief addresses the court's proper reliance on the purposes of EIAPs and ESOPs.[2]

We urge the Second Circuit to affirm the judgment of the lower court and dismiss the Plaintiffs' Complaint in its entirety. Though the lower court provided a concise and convincing explanation of the legislative history of ESOPs, we intend to provide a more comprehensive and detailed description of the purposes, legislative history, and studies and statistics demonstrating the success of ESOPs in order to illustrate how a finding for the Plaintiffs would frustrate the purposes and operation of ESOPs.

A. Purposes of ESOPs: Employee Ownership

Though ESOPs are governed by ERISA, their distinct characteristics and purposes provide for certain exceptions from some of the requirements of traditional retirement plans under ERISA. ESOPs are exempted from ERISA's requirement that plan assets must be diversified, and also exempted from the prohibition against self-dealing. Ezra S. Field, *Money For Nothing and Leverage For Free: The Politics and History of the Leveraged ESOP Tax Subsidy*, 97

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[2] Any reference to ESOPs throughout this Brief encompasses both EIAPs and ESOPs, as much of the case law in this area discusses ESOPs in particular. As the lower court correctly pointed out, "nearly all of the points made about ESOPs apply equally to EIAPs." *In re Citigroup ERISA Litigation*, 2009 WL 2762708, at *11; *See also Edgar v. Avaya, Inc.*, 503 F.3d 340 (3d. Cir. 2007) (explaining that EAIPs and ESOP both share the purpose of promoting investment in employer securities, and thus, both EAIPs and ESOPs are exempt from ERISA's duty to diversify and prohibition against self-dealing).

COLUM. L. REV. 743, 748 (1997). Specifically, "the diversification requirement and the prudence requirement (only to the extent that it requires diversification) is not violated by acquisition or holding of qualifying employer securities." *Moench v. Robertson*, 62 F.3d 553, 568 (3d. Cir. 1995), *quoting* 29 U.S.C. § 1104(a)(2) (internal quotations omitted). As the Third Circuit explained:

> [U]nder normal circumstances, ESOP fiduciaries cannot be taken to task for failing to diversify investments, regardless of how prudent diversification would be under the terms of an ordinary non-ESOP pension plan. ESOPs also are exempted from ERISA's strict prohibition against dealing with a party in interest, and against self-dealing, that is, dealing with the assets of the plan in his own interest or for his own account.

Moench, 62 F.3d at 568, *citing Martin v. Feilen*, 965 F.2d 660, 665 (8th Cir. 1992), *citing* 29 U.S.C. § 1106(b)(1), *cert. denied*, 506 U.S. 1054 (1993) (internal quotations omitted).

ESOPs are exempted from the diversification requirement and the prohibition against self-dealing because the nature and purpose of ESOPs are substantially different from that of traditional retirement plans governed by ERISA. ESOPs were designed to invest primarily in the securities of the plan's sponsoring company. *See Donovan v. Cunningham*, 716 F.2d 1455, 1458 (5th Cir. 1983), *cert. denied*, 467 U.S. 1251 (1984); *see also* 29 U.S.C. § 1107(d)(6)(A). Accordingly, "ESOPs, unlike pension plans, are not intended to guarantee retirement benefits, and indeed, by its very nature 'an ESOP places employee retirement assets at a much greater risk than does the typical diversified ERISA plan." *Moench*, 62 F.3d at 568, *quoting Martin v. Feilen*, 965 F.2d at 664; *see also Edgar v. Avaya, Inc.*, 503 F.3d 340, 347 (3d. Cir. 2007); *Wright v. Oregon Metallurgical Corp.*, 360 F.3d 1090, 1094 (4th Cir. 2004) (explaining that EIAPs "place employee retirement assets at a much greater risk" than traditional ERISA plans). Moreover, ESOPs are intended to "give employees an ownership interest and thus a stake in the financial successes and failures of the companies for which they work." *In re Citigroup ERISA Litigation*, No. 07 Civ. 9790, 2009 WL 2762708 (S.D.N.Y Aug. 31. 2009), at *12, *quoting Steinman v. Hicks*, 352 F.3d 1101, 1003 (7th Cir. 2003).

As the case law in this area makes abundantly clear, ESOPs serve different purposes than traditional retirement plans. As will be more fully explained in the sections that follow, the purposes of ESOPs have been consistently expressed throughout their legislative history, with an eye towards expanding the goal of employee ownership.

B. Legislative History: Tax Incentives and Administration

Finding employee ownership of stock in their employers a laudable goal, Congress has passed numerous pieces of legislation in order to further and encourage employee ownership through ESOPs. In so doing, Congress has repeatedly shown its support of ESOPs by offering tax and other incentives to make establishment and maintenance of ESOPs both attractive and uncomplicated.

Certainly, the statutes passed over the past several decades have done much in the way to expand and strengthen the original purposes and benefits of ESOPs. After the passage of ERISA in 1974, it did not take long for Congress to begin passing legislation supporting the formation of ESOPs. In 1975, Congress passed the Tax Reduction Act of 1975, which gave ESOPs a corporate tax credit of 11%. See Tax Reduction Act of 1975, Pub. L. No. 94-12, 89 Stat. 26 (1975). The Tax Reform Act of 1976 ("Act of 1976") was the next significant piece of legislation Congress passed to encourage employers to set up ESOPs. In fact, the text of the statute expresses Congress' concern that the purpose of ESOPs will be frustrated by applying rules applicable to traditional retirement plans:

> The Congress is deeply concerned that the objectives sought by [the series of laws encouraging ESOPs] will be made unattainable by regulations and rulings which treat employee stock ownership plans as conventional retirement plans, which reduce the freedom of the employee trusts and employers to take the necessary steps to implement the plans, and which otherwise block the establishment and success of these plans.

Tax Reform Act of 1976, Pub. L. No. 94-455, § 803(h), 90 Stat. 1590 (1976), *quoted in Moench*, 62 F.3d at 569. The Tax Reform Act of 1976, aside from articulating Congress' intent with respect to ESOPs, also amended the Internal Revenue Code by doubling the dollar amount that could be allocated to a participant's account in a given year. Jack Curtis & Anna Jeans, *ESOPs – A*

Decade of Congressional Encouragement, 12 TAX MANAGEMENT COMP. PLANNING J. 377, 378 (Dec. 1984).

The Revenue Act of 1978 ("Act of 1978") "impos[ed] technical standards on how ESOPs may operate in certain areas.". Curtis & Jeans, *ESOPs – A Decade of Congressional Encouragement*, 12 TAX MANAGEMENT COMP. PLANNING J. at 378; Revenue Act of 1978, Pub. L. No. 95-600, § 141, 92 Stat. 2763 (1978). The Revenue Act of 1978 required privately-held companies with ESOPs to offer employees options to sell and permitted a cash distribution option. Curtis & Jeans, *ESOPs – A Decade of Congressional Encouragement*, 12 TAX MANAGEMENT COMP. PLANNING J. at 379. For publicly-traded companies, this Act required a pass-through of voting rights on allocated shares, but permitted closely-held companies with ESOPs to pass through rights only on delineated major corporate issues., Act of 1978, § 141, 92 Stat. 2763, *cited in* Robert W. Smiley, *ESOP Legislative History Summary, in* 1 ROBERT W. SMILEY, JR., ET AL., EMPLOYEE STOCK OWNERSHIP PLANS A20-1 (2007).

In 1981, Congress enacted the next piece of pro-ESOP legislation – the Economic Recovery Tax Act ("ERTA"). *See* Economic Recovery Tax Act, Pub. L. 97-34, 95 Stat. 172 (1981). The ERTA provided an important tax benefit for ESOPs by revising the tax-deductible limits applicable to employer contributions to ESOPs by excluding from tax liability contributions made by employers used to pay interest on a loan made from an ESOP. Prior to the enactment of the ERTA, employers making contributions to ESOPs could only deduct up to 25% of interest paid to loans made from an ESOP. *Id.*, *cited in* Smiley, *ESOP Legislative History Summary* at A20-1. ERTA made such employer contributions fully deductible by the employer. Curtis & Jeans, *ESOPs – A Decade of Congressional Encouragement*, 12 TAX MANAGEMENT COMP. PLANNING J. at 380.

Following the ERTA, Congress passed the Tax Reform Act of 1984 ("1984 Act") which provided significant tax incentives for companies sponsoring ESOPs. Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (1984). The 1984 Act provided the following benefits for ESOPs:

> (a) A tax exclusion for commercial lenders of 50% of the interest income received on loans made to finance ESOP acquisition of employer stock; (b) A deferral of taxation on gains from a sale of stock to an ESOP by the owner of a closely held corporation to the extent that the ESOP owns at least 30% of the common equity after the transaction and the proceeds of the sale are reinvested in securities of other U.S. operating companies; (c) A tax deduction for dividends 'passed through' in cash to ESOP participants; and (d) A provision allowing an ESOP to assume the obligation for payments of estate tax liability in exchange for stock worth at least as much as the tax liability in those situations where closely held company stock qualified an estate for installment payments of federal estate tax.

Smiley, *ESOP Legislative History Summary* at A20-2, *citing* Tax Reform Act of 1984, Pub. L. No. 98-369. Specifically, with regard to estate tax liability, the 1984 Act permitted an ESOP to assume the liability for federal estate taxes in the decedent's estate attributable to the value of stock transferred from the estate to the ESOP. Michael W. Melton, *Demythologizing ESOPs*, 45 TAX L. REV. 363, 410 (Spring 1990). This incentive was "designed to help estates with closely held stock cope with liquidity problems by providing a bargain purchase for the ESOP . . . ." *Id.* Finally, ERTA carved out a special rule for closely-held banks under previous put option requirements. Specifically, ERTA deemed a bank – which was barred by law from purchasing its own stock – to have satisfied the requirements of the Internal Revenue Code if the bank's ESOP permitted participants to receive cash distributions. Curtis & Jeans, *ESOPs – A Decade of Congressional Encouragement*, 12 TAX MANAGEMENT COMP. PLANNING J. at 381.

Just two years later, Congress enacted the Tax Reform Act of 1986 ("1986 Act"), which provided even more support for ESOPs in the form of tax credits and by defining certain aspects of plan administration. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 383 (1986). The 1986 Act expanded the interest exclusion set forth in the 1984 Act to include loans made by mutual funds and corporations, where company contributions of employer stock matched loans made to corporations and were allocated to employee accounts within one year. *Id.*; *see also* Smiley, *ESOP Legislative History Summary* at A20-2. Moreover, the 1986 Act created a deduction for dividends used to repay an ESOP loan, allowed for an exclusion of up to 50% from the sale of employer securities from an estate to an

ESOP, and exempted ESOPs from an early withdrawal tax of 10% from employee plans. *Id.* The 1986 Act also exempted ESOPs from a 10% excise tax imposed on excess assets recovered from a terminated defined benefit pension plan if the assets were transferred to an ESOP within 90 days. *Id.* Additionally, the 1986 Act amended the Internal Revenue Code to provide that in determining the value of a taxable estate upon death, 50% of the proceeds of a sale of employer stock to an ESOP was deductible from the value of the decedent's estate. Melton, *Demythologizing ESOPs*, 45 TAX L. REV. at 410.

However, the 1986 Act did more than just provide added benefits and incentives to companies providing ESOPs – it also created new guidelines for ESOPs regarding distributions and other aspects of plan administration. Smiley, *ESOP Legislative History Summary* at A20-2. For example, the 1986 Act imposed new rules that required ESOPs to make payments to departing employees within six years after termination of their employment, that employees be cashed out completely within a period of five years, and that a new diversification option be offered to employees approaching the retirement age to diversify 25% of their ESOP stock account balances. Id. The result of this early outpouring of Congressional support for ESOPs had the effect of increasing their popularity from 500,000 participants in 1974 to ten million in 7,000 companies in 1986. Stephen

Friedmann & Peter W. Gehnrich, Pending Tax Legislation Will Change ESOP Rules, 22 Pension World 42, 42 (Mar. 1986).

The Omnibus Budget Reconciliation Act of 1989 ("OBRA") brought about several changes to the favorable treatment enjoyed by ESOPs up to that point. Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, 103 Stat. 2106 (1989). The OBRA, in an effort to generate revenue, repealed and/or limited a number of tax incentives formerly granted to ESOPs, including limiting the interest exclusion available to loans made to ESOPs to situations where the ESOP owns more than 50% of the company's common equity. Id.; see also Smiley, ESOP Legislative History Summary at A20-2. The OBRA also repealed the estate tax deduction for certain employer securities sales to ESOPs adopted by the Tax Reform Act of 1984. Id. Though the OBRA limited some of the benefits provided to ESOPs, it was not long before Congress once again began encouraging ESOPs through the passage of supporting legislation.

In 1996, Congress passed the Small Business Job Protection Act of 1996 ("SBJPA"), which widened the availability of ESOPs by permitting S corporation shareholders to participate in ESOPs. Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1755 (1996); *see also* Fred J. Diss, *Unwinding ESOPs*, 32 COMP. PLANNING J. 362 (2004). Although the SBJPA repealed the ESOP lender's interest exclusion, the Act effectively opened the door for S corporations to sponsor ESOPs. Smiley, *ESOP Legislative History Summary* at A20-3. The SBJPA required all items of income, loss, credit, or deduction allocated to an exempt organization, and any gain or loss recognized on the disposition of the S stock, be taken into account in an S corporation's unrelated business taxable income (UBTI). Robert R. Trumble & David L. Knight, *ESOP Tax Incentives: New Proposals Enhance a Powerful Financial Tool*, 7 J. TAX'N & EMP. BENEFITS 160 (1999). This made the ownership of S corporation stock unattractive to tax-exempt organizations. *Id.*

The Taxpayer Relief Act of 1997 ("1997 Act") following shortly thereafter, clarifying the provisions of the SBJPA as they related to the taxation of S corporations. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (1997); *see also* Smiley, *ESOP Legislative History Summary* at A20-3. The 1997 Act extended an important tax exemption to S corporation ESOPs previously available only to C corporations. *Id.* Furthermore, the 1997 Act allowed S corporation ESOPs to distribute cash to plan participants and repealed any business income tax on the ESOP's share of its S corporation sponsor's taxable income, effectively eliminating any federal tax imposed on an S corporation's income prorated to an ESOP. *Id.* Importantly, the 1997 Act also repealed the UBTI requirement for ESOPs that own S corporation stock for tax years after 1997.

Trumble & Knight, *ESOP Tax Incentives: New Proposals Enhance a Powerful Financial Tool*, 7 J. TAX'N & EMP. BENEFITS 160 (1999).

The year 2001 brought about further refinements of ESOP laws with the passage of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("2001 Act"), which was enacted to prevent abuse and to further encourage the creation and operation of ESOPs. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 (2001); *see also* John A. Kober, Esq., *The New S Corporation Law*, 30 COMP. PLANNING J. 36 (2002). The 2001 Act amended the 1996 and 1997 Acts by initiating a 50% excise tax on prohibited allocations by ESOPs sponsored by S corporations. 2001 Act, Pub. L. No. 107-16 at §656(p). Additionally, a 50% excise tax was imposed on "disqualified persons," defined as individuals who own 10% of the shares, or part of a 20% shareholder group (individuals and family members collectively), owning "synthetic equity."[3] At first glance, these new taxes may appear to have restricted the expansion of S corporation ESOPs, but in reality, the taxes were intended to prevent abuse and were, in fact, "promoted by supporters of ESOPs who authored the 1996 and 1997 S corporation ESOP laws in order to further the intent of Congress to promote widespread employee ownership through ESOPs and to

[3] The 2001 Act defines "synthetic equity" as follows: "[A]ny stock option, warrant, restricted stock, deferred issuance stock right, or similar interest or right that gives the holder the right to acquire or receive stock of the S corporation in the future. . . ." 2001 Act, Pub. L. No. 107-16 at § 656(p)(6)(C).

ensure that arrangements that did not do so would not lead to cutbacks in [other exemptions]." Smiley, *ESOP Legislative History Summary* at A20-3. The 2001 Act also created a dividend deduction for C corporations, expanding the provisions of the 1984 Act that allowed deductions for dividends paid on ESOP stock voluntarily reinvested in the ESOP for more company stock. 2001 Act, Pub. L. No. 107-16 at § 662; *see also* Smiley, *ESOP Legislative History Summary* at A20-3. Lastly, the 2001 Act included provisions that increased the contribution limits to all defined contribution plans, including ESOPs. 2001 Act, Pub. L. No. 107-16 at § 611 (amending I.R.C. § 415).

The most recent occurrence of legislative support for ESOPs was the enactment of the Americans Jobs Creation Act of 2004 ("Jobs Act"). Pub. L. No. 108-357, 118 Stat. 1418 (2004). The Jobs Act did much to encourage the formation of ESOPs in S corporations by permitting S corporations to use distributions on stock held by its ESOP to repay loans used by the ESOP to acquire stock for employees. *See* Jobs Act, Pub. L. No. 108-357 at § 240; *see also* Press Release, The ESOP Association, The American Jobs Creation Act of 2004 – A Victory for ESOPs (November 2004), *available at* http://www.esopassociation.org/pdfs/tips11_04.pdf (last visited Feb. 3, 2010). The Jobs Act "greatly benefits plan participants because it enables ESOPs to repay their loan amounts on a much faster basis." Smiley, *ESOP Legislative History Summary* at A20-4.

More recently, there have been several bills introduced in both the House and Senate in support of ESOPs. On August 6, 2009, Senator Lincoln introduced Senate Bill 1612 – the ESOP Promotion and Improvement Act of 2009 ("2009 Act"), co-sponsored by Senator Landrieu. *See* ESOP Promotion and Improvement Act of 2009, S.1612, 111th Cong. (2009). The 2009 Act would repeal a 10% penalty tax currently in force on dividends that are distributed to ESOP participants in cash. *Id.*; *see also* Press Release, The ESOP Association, The ESOP Association 2009 Year-End Legislative Update (Dec. 2009), *available at* http://www.esopassociation.org/pdfs/Tip_Sheet_Dec_2009.pdf (last visited Feb. 3, 2010). The 2009 Act would also make clear that dividends paid by C corporations on ESOP stock are not calculated in the corporate alternative minimum tax and would make certain improvements to the ESOP tax deferred rollover provisions. *Id.* Finally, the 2009 Act would purportedly eliminate a bias toward majority-owned ESOP companies by providing that any non-ESOP small business that was eligible for a Small Business Administration program prior to becoming a majority-owned ESOP company would still be eligible after becoming majority owned. *Id.* Senate Bill 1612 has been read twice and referred to the Committee on Finance for further review. S. 1612, 111th Cong. (2009), *available at* http://www.thomas.gov/cgi-bin/bdquery/D?d111:1:./temp/~bdD3oz:@@@X|/bss/111search.html|.

Other recent legislation includes House Bill 3586, The S Corporation ESOP Promotion and Expansion Act of 2009, which would permit S corporation stockholders to sell their stock to an ESOP and receive the same favorable tax treatment that stockholders of private C corporations receive in the same situation, along with several other beneficial provisions designed to encourage the formation of ESOPs in S corporations. S Corporation ESOP Promotion and Expansion Act of 2009, H.R. 3586, 111th Cong. (2009); *see also* The ESOP Association, The ESOP Association 2009 Year-End Legislative Update. House Bill 3586 was referred to the House Subcommittee on Health, Employment, Labor, and Pensions on November 16, 2009. H.R. 3586, 111th Cong. (2009), *available at* http://www.thomas.gov/cgi-bin/bdquery/D?d111:1:./temp/~bdR0EX:@@@X|/bss/111search.html. An amendment introduced by Representative Rohrabacher – House Bill 692 – would amend the Internal Revenue Code to exclude compensation in the form of qualified distributions of employer stock. To Amend the Internal Revenue Code of 1986, H.R. 692, 111th Cong. (2009); *see also* The ESOP Association, The ESOP Association 2009 Year-End Legislative Update. Similarly, Representative

Hinchey introduced a Concurrent Resolution in the House expressing support for ESOPs, the text of which reads as follows:

> Whereas in the Employee Retirement Income Security Act of 1974, Congress codified a technique of corporate finance which utilizes employee stock ownership, officially named an employee stock ownership plan (ESOP);
>
> Whereas in the 35 years since the statutory recognition of ESOPs, there have been ample data collected by objective research indicating that the vast majority of corporations sponsoring employee stock ownership through ESOPs are high performing companies that, among other indicia of high performing companies, have better sales, are more sustainable, pay better, and provide more retirement savings compared to similar companies that are not employee-owned; and
>
> Whereas Congress, in more than 15 laws since 1974, has made it explicit that ESOPs are to serve the dual purpose of providing retirement savings and stock ownership for employees, as well as being a financing technique for corporations . . .
>
> Congress expresses its continued support for employee stock ownership plans.

H. Con. Res. 204, 111th Cong. (2009), *cited in* The ESOP Association, The ESOP Association 2009 Year-End Legislative Update. House Bill 692 was referred to the House Committee on Ways and Means on January 1, 2009. H.R. 692, 111th Cong. (2009), *available at* http://www.thomas.gov/cgi-bin/bdquery/D?d111:1:./temp/~bdfuu7:@@@X|/bss/111search.html.

Finally, the most recent pro-ESOP pieces of legislation were introduced on December 18, 2009 – both by Senator Sanders. Press Release, The ESOP Association, Senator Sanders and Colleagues Propose New, and Effective, Ideas to Save American Jobs (Jan. 2010), *available at* http://www.esopassociation.org/pdfs/Tip_Sheet_Jan_2010.pdf (last visited Feb. 3, 2010). First, Senate Bill 2909, the WORK Act, would sponsor and expand state programs to encourage employee ownership and participation in business decision making, particularly for small businesses. WORK Act, S. 2909, 111th Cong. (2009); *see also* The ESOP Association, Senator Sanders and Colleagues Propose New, and Effective, Ideas to Save American Jobs. The Second, Senate Bill 2914, the United States Employee Ownership Bank Act, would establish the United States Employee Ownership Bank, thereby providing for the first time, "a Federal loan guarantee program to save jobs in certain situations when the result of the financing would be a company owned 50% or more by the employees." The ESOP Association, Senator Sanders and Colleagues Propose New, and Effective, Ideas to Save American Jobs; *See also* United States Employee Ownership Bank Act, S. 2914, 111th Cong. (2009). Senate Bill 2909 was read twice and referred to the Committee on Health, Education, Labor, and Pensions. S.B. 2909, 111th Cong. (2009), *available at* http://www.thomas.gov/cgi-bin/bdquery/D?d111:1:./temp/~bdXdAq:@@@X|/bss/111search.html. Senate Bill 2914 was read twice and referred to the Committee on Banking, Housing, and Urban Affairs. S.B. 2914, 111th Cong. (2009), *available at* http://www.thomas.gov/cgi-bin/bdquery/D?d111:1:./temp/~bdACoR:@@@X|/bss/111search.html.

GERALD KALISH, ESOPS: THE HANDBOOK OF EMPLOYEE STOCK OWNERSHIP PLANS 275 (1989). The NCEO study examined the performance of employee ownership companies five years before and five years after they set up ESOPs, finding that "ESOP companies had sales growth rates 3.4% per year higher and employment growth rates 3.8% per year higher in the post-ESOP period than would have been expected based on pre-ESOP performance." *Id.* Significantly, the study showed a strong correlation between participative management and a company's decision to offer an ESOP, finding that the most participatively managed companies examined in the study "grew 8% to 11% per year faster than they would have been expected to grow." *Id.* As the results of the study indicated, companies with ESOPs performed better and grew at a higher rate than their competitors after establishing ESOPs. GERALD KALISH, ESOPS: THE HANDBOOK OF EMPLOYEE STOCK OWNERSHIP PLANS 275 (1989). Thus, ESOPs are good for businesses and their employees, generating increased productivity and resulting in more jobs.

Similarly, two studies led by Gorm Winther – one in New York in 1992 and the other in Washington State in 1993 – concluded that corporate performance increased due to the existence of ESOPs within a company, combined with participative management. GORM WINTHER, EMPLOYEE OWNERSHIP: A COMPARATIVE ANALYSIS OF GROWTH PERFORMANCE (1995) ("New York Study"); Gorm Winther and Richard Marens, *Participatory Democracy May Go a Long*

Way: Comparative Growth Performance of Employee Ownership Firms in New York and Washington States, 18 ECON. AND INDUSTRIAL. DEMOCRACY 3, at pgs. 393-422 (Aug. 1997) ("The Washington Study"), *cited in* 1 ROBERT W. SMILEY, JR., ET AL., EMPLOYEE STOCK OWNERSHIP PLANS 2-3 (2007). For example, in the Washington study, companies combining ESOPs and participative management grew in employment 10.9% per year, while sales grew 6% per year more. Gorm Winther and Richard Marens, *The Washington Study.*

In 2000, in what is perhaps the largest ESOP study completed to date, Douglas Kruse and Joseph Blasi of Rutgers University ("Rutgers Study") tracked 1,100 ESOP companies with 1,100 comparable non-ESOP companies and recorded their performance for over a decade. Joseph Blasi and Douglas Kruse, *Largest Study Yet Shows ESOPs Improve Performance and Employee Benefits*, available at www.nceo.org/library/esop_perf.html (last visited Jan. 28, 2010), *cited in* 1 ROBERT W. SMILEY, JR., ET AL., EMPLOYEE STOCK OWNERSHIP PLANS 2-1 (2007). The Rutgers Study found that "ESOPs increase sales, employment, and sales per employee by about 2.3% to 2.4% per year over what would have been expected absent an ESOP." *Id.* The study also found that ESOP companies are more likely to stay in business than comparable companies that do not offer ESOPs. *Id.*

On August 17, 2009, the Employee Ownership Foundation released the results of its 18th annual "ESOP Economic Performance Survey" (the "Survey").

Since the formal recognition of ESOPs in 1974 by their inclusion in ERISA, Congress has continuously examined and altered the operation and requirements of ESOPs, with the aim of making ESOPs easier and more attractive to establish for all types of companies, both large and small. To this day, members of Congress continue to recognize the importance of ESOPs in the fabric of American business through the introduction of legislation expanding the scope of ESOPs and encouraging their formation.

C. Further Support: Statistics and Studies

ESOPs have not only enjoyed continuous legislative support, but also academic support, through various studies and surveys. The results of these studies and surveys have consistently revealed the positive and beneficial effects of ESOPs for a company's growth and overall vitality. However, it is not just corporations that benefit from ESOPs. As the following studies reveal, employees of ESOP corporations are more motivated and productive, undoubtedly due to their participation in the ownership of their employers.

In 1986, the National Center for Employee Ownership ("NCEO") published the first study to show a causal link between ESOPs and increased corporate performance. Michael Quarrey and Corey Rosen, *How Well is Employee Ownership Working*, HARV. BUS. REV. (Sept.-Oct. 1987), *cited in* 1 ROBERT W. SMILEY, JR., ET AL., EMPLOYEE STOCK OWNERSHIP PLANS 2-3 (2007); *See also*

Press Release, Employee Ownership Foundation, ESOP Companies Outperform Stock Market in 2008 (Aug. 17, 2009), *available at* www.esopassociation.org/media/media_stock_market_outperform.asp (last visited Feb. 1, 2010). The Survey revealed, as it has every year since the survey's creation, that an overwhelming majority of companies surveyed report that the creation of ESOPs was a "good business decision that has helped the company." *Id.* In addition, the Survey revealed that "88.5% of ESOP companies outperformed the stock market in 2008," even despite the severe economic downturn. *Id.* The President of the Employee Ownership Foundation, J. Michael Keeling, made the following remarks regarding the Study:

> In a turbulent year, these results speak wonders for the power of employee ownership. On the other hand, this survey and most news reports show that American companies are hurting, profits are down, and layoffs are taking place across the country. Objective academic research evidences that employee owned companies are higher performing, have high employee retention rates, and have employees that are more motivated and productive. Our national leaders need to promote policies to encourage more companies to become employee owner through an ESOP to create a more fair and equitable society.

Id.

As is evident from the results cited above, companies that employ ESOPs enjoy more success, especially when combined with participative management, than those without employee ownership. Importantly, employees benefit from ESOPs in very real ways. ESOPs produce more satisfied and productive employees, which results in a more successful corporation, which in turn, spurs job creation and overall growth.

D. *The Purposes and Legislative History of ESOPs, Along With Statistics and Studies, Strongly Support a Decision by This Court Affirming the District Court's Order*

As it clear from the above-cited legislative history and studies, ESOPs clearly play an important role in the fabric of the American workforce, with important benefits resulting to both companies with ESOPs and their employees. Congress has continuously incentivized the use of ESOPs in order to "to encourage business owners to extend to their employees ownership of an economic interest in the financial well-being of their employer." Kober, *The New S Corporation ESOP Law*, 30 COMP. PLANNING J. 36 (2002). If Plaintiffs' claims were allowed to be pursed against Defendants, companies would surely refrain from establishing and administering such plans as a result of the unsettled liability issues that would be presented. This is the precise "Catch 22" on which the lower court relied in coming to its conclusion to dismiss the Plaintiffs' claims. *In re Citigroup ERISA Litigation*, 2009 WL 2762708, at *13. As the court correctly observed, requiring fiduciaries to decide either to violate the terms of a plan and divest it of employer stock when the value of the stock value declines, or to adhere to plan terms despite the decline—facing liability no matter the decision—would place ESOP companies and their fiduciaries in an impossible situation. When faced with this ruinous prospect, the only rational course of action would be to avoid the decision entirely and forego offering an ESOP as an investment option.

We urge this Court to recognize the devastating effects that a reversal of the lower court's decision would have on the progression and steady growth of ESOPs to date. Not only would such a decision undo decades of Congressional support for the retirement plans, but it would also prevent companies and employees from enjoying the many benefits of ESOPs, including enhanced performance and growth.

In order to avoid these undesirable results, this Court should uphold the district court's well-reasoned interpretation that ERISA requires plan fiduciaries to adhere to plan terms by continuing to invest in employer stock even if the price of the stock declines. This is in keeping with the original purpose of ESOPs, which, as the district court pointed out, was to "give employees an ownership interest and thus a stake in the ***financial successes and failures*** of the companies for which they work." *In re Citigroup ERISA Litigation*, No. 07 Civ. 9790, 2009 WL 2762708 (S.D.N.Y Aug. 31. 2009), at *12 (emphasis added), *quoting Steinman v. Hicks*, 352 F.3d 1101, 1003 (7th Cir. 2003).

III. CONCLUSION

For all of the foregoing reasons, we urge this Court to affirm the decision of the Southern District of New York and dismiss the Plaintiffs' Complaint in its entirety.

Respectfully submitted,

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Orrick, Herrington & Sutcliffe LLP

IRA G. ROSENSTEIN
JOSEPH LIBURT

Of Counsel

MICHAEL DELIKAT
SARAH BREISINGER
Orrick, Herrington & Sutcliffe LLP

IRA D. HAMMERMAN
KEVIN M. CARROLL
Securities Industry and Financial Markets Association