What Is An ESOP Fiduciary To Do?

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On the whole, employee stock ownership plans ("ESOPs") unquestionably deliver significant benefits to the companies that sponsor them, and their employees. ESOP sponsors tend to see increased productivity and employee morale, and the employees of successful ESOP-owned companies secure additional retirement benefits. Nevertheless, private company ESOPs attract more than their fair share of litigation, and most of this litigation arises out of transactions in which ESOPs buy and sell stock from the sponsor company. The Department of Labor ("DOL") has historically been particularly critical of those transactions, focusing on their vulnerability for abuse by conflicted fiduciaries.

These cases turn on two primary legal issues: (1) whether the ESOP's fiduciaries breached their duties of prudence and loyalty in authorizing the transaction, and (2) whether the purchase or sale violated ERISA's prohibited transaction provisions. These issues largely go hand in hand. (Most courts require fiduciaries to prove that an exemption applies to ERISA's prohibited transaction provisions.)

ERISA § 408(e) provides that a plan's acquisition or sale of employer stock does not constitute a prohibited transaction, provided certain conditions are met. One of those conditions is that the purchase or sale is for "adequate consideration."

What constitutes "adequate consideration?" As to assets for which there is no generally recognized market (such as private company stock), ERISA defines the term to mean "… the fair market value of the asset as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with regulations promulgated by the [Secretary of Labor]." (ERISA § 3(18)(B).) In 1988, the DOL issued proposed regulations (29 CFR 2510.3-18(b)) aimed at further defining "adequate consideration." Generally, the regulations required that in order for there to be a finding of adequate consideration: (1) the value assigned to the stock must reflect its fair market value - meaning the price at which the stock would change hands between a willing buyer and a willing seller when neither is under any compulsion to act and both parties are well informed about the stock, and (2) the value assigned to the stock must be the product of a determination made by the fiduciary in "good faith."

Not surprisingly, the proposed regulations - which have never been finalized - did little to clarify the meaning of "adequate consideration," and even less to give fiduciaries certainty about what they needed to do to carry out their duties prudently and in "good faith."

Although the DOL has issued no official guidance on the subject since the 1988 proposed regulations, it has recently provided unofficial guidance to ESOP fiduciaries in connection with settlements reached in three litigation matters: *Perez v. GreatBanc Trust Company,* No. 5:12-CV-01648, C.D. CA in 2014, Perez v. First Bankers Tr. Servs., Inc., No. 12 CV 8649 (VB), 2016 WL 2343889 (S.D.N.Y. May 3, 2016), and *Acosta v. BAT Masonry Company,* Docket, No. 6:15-CV_00028, VA W.D. in 2017. The documents agreed to as part of these settlements focus largely on selecting an independent, qualified valuation advisor, avoiding conflicts of interest, and documenting a prudent process.

While these settlement documents are only technically binding on the parties to the agreements themselves (the defendant fiduciaries), when read together, they provide a checklist of items that, in the DOL's view, ESOP fiduciaries should consider when entering into agreements on behalf of an ESOP to buy or sell company stock.

A detailed recitation of the points addressed in the settlement documents in those cases is beyond the scope of this article. But these are some of the more important points raised in the settlement documents:

Steps Relating To The Selection and Reliance Upon the Valuation Advisor:

(1) The fiduciary should prudently investigate the valuation advisor's qualifications, and document who performed the investigation and the steps that were taken to determine that the valuation advisor received complete, current, and accurate information.

(2) The fiduciary should prudently determine that it is reasonable to rely upon the valuation advisor's advice before entering into the transaction, and document its conclusions;

(3) The fiduciary should determine that the valuation advisor has not previously performed work, including any "preliminary valuation," for the ESOP sponsor or any other party involved in the transaction;

(4) The fiduciary should prepare a written analysis describing the reason for selecting the valuation advisor, which sets forth: (a) a list of all advisors the fiduciary considered, (b) the qualifications that were considered, (c) at least three references the fiduciary checked regarding the selected advisor, and (d) whether the advisor was the subject of any criminal, civil, or regulatory proceedings or investigations, and the outcome of those proceedings. The fiduciary need not engage in this analysis anew if it engaged in that same analysis within 15

months of its selection. Note: the settlement document in the *BAT Masonry* matter would exempt the trustee in that case from engaging in the analysis anew if the prior analysis was conducted no more than 24 months before, but the more conservative approach would be to engage in a fresh analysis if the prior analysis was done more than 15 months before.

Analyzing The Transaction and the Valuation

(1) Identify in writing the persons responsible for providing projections to the valuation advisor, and conduct and document a reasonable inquiry as to whether any of those persons have a conflict of interest (including - without limitation - an interest in the purchase or sale of the ESOP sponsor's stock) or serve as agents or employees of persons with a conflict of interest;

(2) Document how the fiduciary and the valuation advisory considered any conflicts of interest in determining the value of the stock;

(3) Document opinions regarding the reasonableness of the projections that were considered, and at minimum, consider how the projections compare to the sponsor's five-year history averages and/or medians, and those of a group of comparable public companies, if they exist;

(4) If guideline public companies are used for any part of the valuation, document the bases for concluding that the companies are actually comparable to the company being valued;

(5) If a discounted cash flow analysis is not used as part of the valuation, explain why in writing;

(6) Explain in writing any material differences between the present valuation and the most recent prior valuation within the past 24 months.

The settlement documents addressed additional, equally significant considerations for fiduciaries. These include: (a) factors to be considered regarding the financial statements relied upon by the valuation advisor (including whether it is reasonable to rely upon unaudited or qualified financial statements); and (b) as part of the stock purchase agreement, requiring the purchaser or seller to make the ESOP whole for any losses caused by financial statements that did not accurately reflect the ESOP sponsor's financial condition, if the purchaser or seller is an officer, manager or member of the board of directors.

Prudent fiduciaries should obtain and carefully review each of the settlement documents in these cases. While adhering to this checklist may not prevent litigation involving an ESOP transaction, it will provide valuable evidence that a fiduciary who approves an ESOP transaction did so prudently, and in the interests of the ESOP's participants.