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Employee Stock Ownership Plans — Whatcha Gonna Do When the DOL Comes After You

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The U.S. Department of Labor, Employee Benefits Security Administration (the ''DOL'') has enforcement authority to investigate retirement plans for compliance with Title 1 of the Employee Retirement Income Security Act (ERISA).[1] The DOL has for a very long time had a certain cynicism over employee stock ownership plans (ESOPs) and officially in 2005 created an ESOP National Enforcement Project to target ESOPs. According to the DOL, this national initiative is focused on whether the stock sold or purchased by the ESOP is valued at ''fair market value'' (FMV). In fact, the Deputy Assistance Secretary stated that stock valuation is the ''first, second, third, and fourth'' problems with ESOPs.[2]

Further caution is that the DOL is not hesitant in converting these investigations into lawsuits and issuing press releases on their successes. Earlier this year the DOL settled an ESOP case where a consent judgment was entered in the U.S. District Court of Minnesota to restore $9.3 million to an ESOP.[3] The DOL alleged that the trustee caused the ESOP to overpay for the stock and the company fiduciaries failed to monitor the trustee's determination of the stock value.[4]

This article will delve into the background on ESOPs, ERISA's fiduciary standards, the flow of a typical ESOP transaction, what is considered FMV, and how courts construed FMV.

BACKGROUND

As the labor shortage deepens, employers continue to offer attractive incentives to recruit candidates and retain current staff. These incentives can be offering hybrid work schedules, bonuses, increased salaries, changes in job title, and a variety of employee benefits. To improve retention and continue to grow a diverse and qualified workforce, employers may also find it appropriate to look past traditional benefits packages and consider adopting an ESOP.[5]

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[1] Pub. L. No. 93-406.

[2] Rebecca Moore, *Reducing the Risk of ESOP Investigations and Litigation*, PlanSponsor (Oct. 23, 2019).

[3] DOL News Release, *US DEPARTMENT OF LABOR RECOVERS MORE THAN $9.3M FOR MINNESOTA EMPLOYEE STOCK OWNERSHIP PLAN AFTER INVESTIGATION FINDS PLAN OVERPAID FOR SHARES* (Jan. 6, 2022).

[4] *See Walsh v. Reliance Trust Company et al.*, No. 17-cv-04540 (D. Minn. Jan. 5, 2022) (consent order). The trustee agreed to pay back to the ESOP $8,409,090 and pay penalties in the amount of $840,909. The company fiduciaries agreed to pay the ESOP $984,042 and pay penalties in the amount of $215,957.

[5] In *Donovan v. Cunningham*, 716 F.2d 1455, 1458-59 (5th Cir. 1983), the court presented a great snapshot of ESOPs:

> An ESOP is a form of employee benefit plan designed to invest primarily in securities issued by its sponsoring

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An ESOP is defined in §4975(e)(7)(A)[6] as ''a stock bonus plan which is qualified, or a stock bonus and a money purchase plan . . . which are designed to invest primarily in qualifying employer securities.'' Qualifying employer security means common stock issued by the employer that is readily tradable on an established market.[7] For nonpubliclytraded companies, employer securities having a combination of voting power and dividend rights equal to or in the excess of common stock of the employer having the greatest voting power, and the class of common stock of the employer having the greatest dividend rights.[8]

ESOPs award company employees by tying the financial success of the company to each participant's individual retirement. In turn, this leads to an ownership mentality and increased loyalty among the workforce. Additionally, ESOPs are in many ways more attractive for owners to sell their life works because owners often remain involved in the company as directors or officers after the transaction. Further, ESOPs also provide significant tax benefits for companies. For instance, a company that is 100% ESOP owned is exempt from federal income tax if the company is a corporation and elects to be taxed as an S corporation.

THE ANATOMY OF THE DEAL

Typically, companies interested in selling to an ESOP, first retain experienced and qualified legal counsel. ESOP deals are complex and involve significant negotiation between the company and the buyer, which is the ESOP trustee. ESOP counsel will prepare legal documents such as the term sheet, ESOP plan document, the ESOP trust agreement, seller notes, the internal loan agreement, employment agreements for key employees, and the purchase agreement between the selling shareholders, the company, and the ESOP trustee. Depending on how the ESOP purchase is structured, the company may need to obtain financing from a third-party lender, which involves a separate negotiation. Legal counsel will also advise the company of its fiduciary duties under ERISA, because the company or a company committee will be the named fiduciary of the ESOP. Selling shareholders may also decide to retain their own separate counsel if their interests are not aligned with the company's employees or its board.

A company will also engage an independent trustee, who may be an individual or a company, and may be retained specifically for the transaction or continue as a trustee of the ESOP after the transaction. The trustee is a fiduciary and therefore owes a duty of loyalty and prudence to the ESOP participants and beneficiaries. Although an independent trustee is paid by the company for its services, the fiduciary's loyalty runs with the plan and its participants and beneficiaries. Not only do professional trustees provide experience and knowledgeability to an ESOP transaction, but also reduce the inherent conflict of interest that would arise if the trustee was a company officer or director.

Trustees will perform due diligence on the company as if the company is being sold to a third-party buyer. A trustee will also review the plan document for compliance with §401(a), invest the plan's assets in accordance with the plan's terms, vote on behalf of the ESOP shareholders, and ensure that the company is annually valued for purposes of determining the company's share price.

The trustee will have its own legal counsel to assist the trustee with performing due diligence, reviewing, and negotiating transaction documents, and advising the trustee on its fiduciary duties. A trustee will in many cases engage an independent appraiser to perform due diligence on the company's financials and for valuing the company's share price. The independent appraiser will prepare an opinion that is not shared with the company. This report is relied on by

company. 29 U.S.C. §1107(d)(6) (1976). The ESOP concept is the brainchild of Louis O. Kelso, who has advanced it as a device for expanding the national capital base among employees — an effective merger of the roles of capitalist and worker. Congress has enacted a number of laws designed to encourage employers to set up such plans. *See* note 23, infra.

As is true of all employee benefit plans covered by ERISA, ESOPs are subject to an impressive and somewhat bewildering array of rules and regulations governing their substance and administration, as well as their eligibility for favorable tax treatment. *See generally L. Brown, ERISA Source Manual* (1982-1983). For present purposes, an understanding of these details is unnecessary; a thumbnail sketch of basic ESOP mechanics will suffice. An employer desiring to set up an ESOP will execute a written document to define the terms of the plan and the rights of beneficiaries under it. 29 U.S.C. §1102(a) (1976). The plan document must provide for one or more named fiduciaries ''to control and manage the operation and administration of the plan.'' Id., §1102(a)(1). A trust will be established to hold the assets of the ESOP. Id., §1103(a). The employer may then make tax-deductible contributions to the plan in the form of its own stock or cash. If cash is contributed, the ESOP then purchases stock in the sponsoring company, either from the company itself or from existing shareholders. Unlike other ERISA-covered plans, an ESOP may also borrow in order to invest in the employer's stock. In that event, the employer's cash contributions to the ESOP would be used to retire the debt.

[6] All section references herein are to the Internal Revenue Code of 1986, as amended (the ''Code''), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

[7] §409(l).

[8] §409(l)(2).

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the trustee to ensure that the ESOP participants are receiving adequate consideration.

To maintain the ESOP's compliance with ERISA and the Code, the company will hire a third-party administrator to prepare participant statements, plan notices, perform nondiscrimination testing, and file the plan's annual report with the DOL.

VALUATION METHODS

As mentioned above, ERISA imposes fiduciary duties on trustees. These fiduciary duties are the highest known duties under the law.[9] ERISA fiduciaries are required to: (1) act solely in the interest of the participants, and for the exclusive purpose of providing benefits to participants; (2) act with ''prudence;'' (3) diversify plan investments to minimize large losses; and (4) act in accordance with the plan's terms.[10] A trustee is a fiduciary under ERISA, because a trustee exercises discretionary authority or discretionary control of such plan respecting management or disposition of its assets.[11] Notably, a fiduciary can be held personally liable to make a plan whole for any losses sustained from breaching its fiduciary duties.[12]

Additionally, ERISA and the Code prohibit a plan from engaging in a prohibited transaction, such as the acquisition of employer securities with a party in interest or a disqualified person.[13] If a prohibited transaction occurs, the DOL can assess civil penalties and the IRS has the authority to impose excise taxes.[14] Notably, a prohibited transaction will not occur under ERISA if the transaction involves ''adequate consideration.''[15]

Determining adequate consideration of a private company's stock can present challenges for an ESOP fiduciary, because, unlike a publicly traded company, private companies are not valued daily on a publicly available stock exchange. To add an extra layer of complexity, the DOL has not issued final regulations defining adequate consideration. ERISA §3(18)(B) only defines ''fair market value of the assets as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with the regulations promulgated by the Secretary.''

In 1988, the DOL issued proposed regulations for determining adequate consideration.[16] Despite these regulations never being formally adopted, fiduciaries can use these as proposed regulations as guideposts. Further, courts will look to the conduct of the trustee, taking into account the circumstances at the time, and determine whether the fiduciary has met the ''prudent man'' standard of care under ERISA to determine FMV.[17] ERISA's duty of prudence requires trustees to act ''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.''[18] When determining if a trustee has satisfied this requirement, ''[t]he court's task is to 'inquire whether the individual trustees, at the time they engaged in the challenged transactions employed the appropriate methods to investigate the merits of the investment and to structure the investment.' ''[19] Hiring an independent valuation advisor is evidence of prudence, but expert advice is ''not a magic wand that fiduciaries may simply wave over a transaction to ensure that their responsibilities are fulfilled.''[20] Rather, an ESOP fiduciary must show that: (1) they investigated the expert's qualifications; (2) furnished the expert with complete and adequate information; and (3) ensure that reliance on the expert's opinion is justified.[21]

Under the proposed regulations, ''adequate consideration'' would mean the FMV of the assets determined in good faith by the fiduciary in accordance with the plan's terms.[22] FMV would be determined as of the date of the transaction and any assessment of fair market value would be in writing.[23] The proposed regulations also state FMV is the price at which an asset would change hands between a willing buyer and a willing seller when the former is not under any compulsion to sell, and both parties are able, as well as

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[9] *Brundle v. Wilmington Trust, N.A.,* 919 F.3d 763, 769 (4th Cir. 2019).

[10] ERISA §404(a). *See also* José M. Jara, Richard S. Lynn, and Sheldon Miles, *In ERISA Excessive Fee Cases*, *Will the Supreme Court Issue Guidance for Dividing the Plausible Sheep From the Meritless Goats*?, 49 Tax Mgmt. Comp. Plan. J. No. 11 (Nov. 5, 2021).

[11] ERISA §3(21).

[12] ERISA §409(a).

[13] ERISA §406.

[14] §4975. Under §4975, the initial tax is 15% of the amount involved. But if the transaction is not corrected within the taxable period, there is an additional tax equal to 100% of the amount involved. §4975(b).

[15] ERISA §3(18).

[16] Prop. 29 C.F.R. §2510.3-18(b), Proposed Regulation Relating to the Definition of Adequate Consideration, 53 Fed. Reg. 17,632 (May 17, 1988).

[17] *See Tatum v. RJR Pension Inv. Comm.*,761 F.3d 346, 356-357 (4th Cir. 2014).

[18] ERISA §404(a)(1)(B).

[19] *Katsaros v. Cody,* 744 F.2d 270, 279 (2d Cir. 1984) (quoting *Donovan v. Mazzola*, 716 F.2d 1226, 1232 (9th Cir. 1983).

[20] *Brundle,* 919 F.3d 763, 773.

[21] *Donovan v. Cunningham,* 716 F.2d 1455, 1474 (5th Cir. 1983).

[22] Prop. 29 C.F.R. §2510.3-18(b)(1)(i).

[23] Prop. 29 C.F.R. §2510.3-18(b)(2)(ii)-§2510.3-18(b)(2)(iii).

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willing, to trade and are well informed about the asset and the market for that asset.[24]

A critical component of defining FMV is the element of good faith, as a facts and circumstances test. According to the proposed regulations, a fiduciary would act in good faith if he or she determines FMV after conducting a prudent investigation of the company, and the fiduciary is independent of all parties in the transaction, or the fiduciary relies on a report by an appraiser who is independent of all parties.[25] Accordingly, to meet this good faith component, an independent fiduciary should be retained for any ESOP transaction to potentially avoid conflicts of interest.

For purposes of valuing any company, the proposed regulations outline the following information that must be in writing:[26]

> (A) A summary of the qualifications to evaluate assets of the type being valued by the person or persons making the valuation;
>
> (B) A statement of the asset's value, a statement of the methods used in determining that value, and the reasons for the valuation in light of those methods;
>
> (C) A full description of the assets being valued;
>
> (D) The factors taken into account in making the valuation, including any restrictions, understandings, agreements or obligations limiting the use or disposition of the property;
>
> (E) The purpose for which the valuation was made;
>
> (F) The relevance or significance accorded to the valuation methodologies taken into account;
>
> (G) The effective date of the valuation; and
>
> (H) In cases where a valuation report has been prepared, the signature of the person making the valuation and the date the report was signed.

In addition, for private companies, the written valuation requirement must also include the following content:[27]

> (A) The nature of the business and the history of the enterprise from its inception;
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> (B) The economic outlook in general, and the condition and outlook of the specific industry in particular;
>
> (C) The book value of the securities and the financial condition of the business;
>
> (D) The earning capacity of the company;
>
> (E) The dividend-paying capacity of the company;
>
> (F) Whether or not the enterprise has goodwill or other intangible value;
>
> (G) The market price of securities of corporations engaged in the same or a similar line of business, which are actively traded in a free and open market, either on an exchange or over-the-counter;
>
> (H) The marketability, or lack thereof, of the securities. Where the plan is the purchaser of securities that are subject to ''put'' rights and such rights are taken into account in reducing the discount for lack of marketability, such assessment shall include consideration of the extent to which such rights are enforceable, as well as the company's ability to meet its obligations with respect to the ''put'' rights (taking into account the company's financial strength and liquidity);
>
> (I) Whether or not the seller would be able to obtain a control premium from an unrelated third party with regard to the block of securities being valued, provided that in cases where a control premium is taken into account:
>
> *(1)* Actual control (both in form and in substance) is passed to the purchaser with the sale, or will be passed to the purchaser within a reasonable time pursuant to a binding agreement in effect at the time of the sale, and
>
> *(2)* It is reasonable to assume that the purchaser's control will not be dissipated within a short period of time subsequent to acquisition.

When valuing a selling company's shares, three common valuation methods are used: (1) the discounted cash flow method; (2) a market comparable method; and (3) the asset method. Under the discounted cash flow method, the company's future cash flow is estimated by discounting it to its present value. To value a company's future cash flow, its historical performance must be weighed along with adjustments to future risks, such as increases in taxes and interest rates. For the market approach, the company's stock price is compared to similar companies that are publicly traded. The last method is simply to compare the value of the company's assets to its liabilities. This method may not, however, be practicable if the selling company has limited assets, such as a professional service provider.

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[24] Prop. 29 C.F.R. §2510.3-18(b)(2)(i).

[25] Prop. 29 C.F.R. §2510.3-18(b)(3).

[26] Prop. 29 C.F.R. §2510.3-18(b)(4)(i). *See also* Rev. Proc. 66-49.

[27] Prop. 29 C.F.R. §2510.3-18(b)(4)(ii). *See also* CCA 200930038; Rev. Rul. 59-60.

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WALSH v. BOWERS – DOL CASE

A fairly recent DOL case hones in on the valuation principles and processes. In *Walsh v. Bowers*,[28] the DOL sued two shareholders (the owners of the company) who created the ESOP and then who sold all their shares to the ESOP for $40,000,000. The DOL alleged that the shareholders manipulated the price causing the ESOP to pay more than FMV thereby breaching their fiduciary duties and engaging in prohibited transactions in violation of ERISA.

The trustees of the ESOP retained an independent trustee (IT) for the sale transaction. In December 2012, the two shareholders offered to sell 100% of the company's common stock to the ESOP for $41 million. The IT negotiated a finance deal with two shareholders and agreed to a sale price of $40 million.

The IT hired a qualified independent appraiser (QIA) to prepare an analysis of the FMV of the stock and whether the loan was comparable to an arm's-length transaction. The QIA concluded that the FMV was $40,150,000, and thus the ESOP did not pay more than FMV. The QIA further concluded the loan was at arm's length.

The QIA used the following three methods to value the company:[29]

> (1) The guideline public company method – the QIA compared the company to other publicly held companies and determined that selling 100% of the interest in the company was $44,590,000.
>
> (2) The industry acquisitions method – the QIA compared the sale prices of other comparable companies and determined the company price to be $42,250,000.
>
> (3) The discounted cash flow method – where the QIA examined the company's projected cash flow and then applying a discount to get the company's present value. The QIA then added a ''control premium'' and determined that the 100% controlling interest in the company was $40,390,000.

Based on these various conclusions, the QIA thereafter added what the company has in excess cash and marketable securities. Finally, the QIA then applied a 15% discount for lack of marketability (the limited market of owning a controlling interest in a like company) and concluded the stock value was $40,150,000 on December 14, 2012.

Going deeper into the appraisal, the QIA listed the company's earnings before interest, taxes, depreciation, and amortization (EBITDA) at $7,050,000. However, the DOL's expert calculated and reduced EBITDA projection to $4.9 million for 2012. The court found the DOL's expert's calculation as unreliable because it relied on historical returns and failed to take into account the company's earnings were trending upwards and that there was a backlog of contracts. Furthermore, the QIA' s revenue growth projections for 2014-2017 were understated at 5% since the company's actual growth ended up being between 10%-12% percent.

One sticking point for the DOL appears to the amount of time a trustee spends on the transaction itself. In *Bowers*, the DOL's expert opined that the IT rushed through the transaction and performed minimal work. The court noted that the DOL's expert did not state what kind of review the IT should have done. Further the defense's expert opined that the IT spent sufficient time (about 30 hours) on the transaction and that the due diligence for this particular transaction was straight forward. Accordingly, the court found that the DOL did not meet its burden of proof. However, in *Walsh v. Vinoskey*,[30] the DOL again challenged an IT's work as being ''rushed and cursory,'' the court concluded that the IT's due diligence had several flaws.

A major issue with the court in *Bowers* was that the DOL's expert failed to address the Uniform Standards of Professional Appraisal Practice (USPAP) for appraising companies. The USPAP's scope of work and competency rules require research and analysis to be sufficient to produce credible results and to be conducted in a manner that is not careless or negligent.[31] The DOL's expert treated certain fees as company expenses (in the range of $10 million). However, if the DOL would have interviewed management regarding the fees they would have ascertained that the fees were passed to clients to pay and not expenses of the company.

Further flaws that the *Bowers* court found in the DOL's expert included matters viewed in hindsight of the sale. The DOL's expert relied on matters occurring after the sale in contravention to independent appraisal standards which limit the facts to be considered to facts existing at the valuation date and occurring up to the valuation date.

In conclusion, the court in *Bowers* found the DOL failed to prove its case beyond a preponderance of the evidence. Accordingly, the company was not sold for more than FMV and the defendants did not breach their fiduciary duties or engage in prohibited transactions in violation of ERISA.

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[28] 561 F. Supp. 3d 973 (D. Haw. 2021).

[29] *Bowers*, 561 F. Supp. 3d 973, 988.

[30] 19 F.4th 672 (2021).

[31] *Bowers*, 561 F. Supp. 3d 973, 991.

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CONCLUSION

ESOPs are an attractive benefit for employees, but as with any other benefit plan governed under ERISA, the fiduciaries of such plans should have a methodical due diligence process that is appropriately documented. Of utmost importance is ensuring that the valuation process meets the above-referenced standards. Furthermore, a robust process should be in place for hiring qualified service providers and carefully analyze the quality of services being offered with the fees proposed. Lastly, fiduciaries should review their fiduciary liability policy to ensure they have adequate coverage to fend off the DOL.

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