Settling the Standard for Prudence? Fall Brings New Guidance for ESOP Trustees

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Through a series of recent settlements, the US Department of Labor (DOL) has outlined the process steps fiduciaries should follow in connection with a transaction involving a purchase from, or sale to, an employee stock ownership plan (ESOP). Largely based on the “fiduciary process steps” first introduced by the DOL in the 2014 settlement of Perez v. GreatBanc Trust Co., this new guidance has neither the force of law nor the ability to change any current laws or regulations. The recent settlements may, however, provide helpful insight into the DOL’s position regarding what is required to meet fiduciary obligations under the Employee Retirement Income Security Act of 1974 (ERISA) when engaging in an ESOP transaction.

Background

Approximately 90 percent of ESOPs hold stock of closely held corporations. The ESOP will purchase stock from one or more company owners at a price determined by an ESOP fiduciary. Because most ESOP fiduciaries are not valuation experts, ERISA generally requires the fiduciary to determine the stock’s fair market value by relying
upon the work of an independent appraisal expert. If the fiduciary relies on an inadequate appraisal, however, the fiduciary can breach its duties and/or violate ERISA’s prohibited transaction rules.

ERISA requires that an ESOP’s fiduciaries—which generally include its trustees, the sponsoring employer, the individuals that sit on the sponsoring employer’s board of directors, and any employees involved in the administration and operation of the ESOP—establish and operate the ESOP for the exclusive purpose of providing benefits to ESOP participants and beneficiaries, while defraying reasonable expenses of administering the plan. This is a high standard that is often expressed as the idea that an ESOP fiduciary must act as a “prudent expert” would act. Given this “prudent expert” standard, ERISA permits, and may in fact require, the ESOP fiduciary to rely on an independent appraisal expert to assist the ESOP fiduciary in determining the value of closely held employer stock.

**Process Steps**

The DOL has *not* (in more than 20 years) promulgated formal rules addressing when a fiduciary may reasonably rely on a valuation provided by an independent appraisal expert. When the DOL settled *GreatBanc Trust Co.* in 2014, however, it noted that the ESOP industry would “do well to take notice” of the process steps it put in place. The recent settlements in *Acosta v. First Bankers Tr. Servs., Inc.*, and *Acosta v. BAT Masonry* build on these process steps and provide guidelines that the DOL believes an ESOP fiduciary is required to follow to establish that the fiduciary’s reliance on an independent appraisal of closely held employer stock was reasonable.

These guidelines are outlined below. In all instances involving an institutional trustee, all employees of the institutional trustee involved in the process must also be identified and their participation documented.

**Selecting an Appraisal Expert**

- When selecting an appraisal expert, a fiduciary should retain written documentation of at least three references checked and a discussion of those three references’ views.
  - The fiduciary must discuss, in writing, whether the selected appraisal expert has been the subject of criminal, civil or regulatory proceedings and/or investigations in connection with its previous valuation work, as well as the results of such criminal, civil or regulatory actions.
  - The above requirements are not applicable if the fiduciary has recently (within the last year if an institutional trustee and the last two years if an individual trustee) vetted the appraisal expert and the appraisal expert certifies, in writing, that the results of the fiduciary’s prior investigation are still accurate. *This marks a distinct change from GreatBanc Trust Co., which required that an institutional trustee’s previous analysis be completed within the prior 15 months.*

- A fiduciary may not rely on an appraisal expert that has previously performed
any work—including a preliminary valuation—on behalf of the plan sponsor’s ESOP committee.

- The fiduciary must document all the steps it took to determine that the appraisal expert received complete, accurate and current information, and to ensure the fiduciary understood the advice of the appraisal expert.

**Overseeing the Appraisal Expert**

- The valuation report should include background about the individuals that provided the projections, as well as how the projections compare to the company’s history, and the historic metrics of comparable public companies. If these details are absent, the fiduciary must prepare a supplement to the valuation report (if an individual trustee) or request that supplementary documents be prepared (if an institutional trustee).

- The valuation report should include the risks facing the plan sponsor that could cause the plan sponsor’s financial performance to fall materially below the projections relied upon by the appraisal expert, and any material differences between the present valuation and the most recent prior valuation of the plan sponsor performed within the past 24 months by any valuation firm for any purpose (if any).

- If the fiduciary is an individual trustee and its valuation report does not include any reliance on the discounted cash flow (DCF) valuation methodology, the valuation report must specifically explain, in writing, why the DCF methodology is missing.

- The fiduciary must also include details regarding the terms of any loans the ESOP receives in connection with the transaction, and must ensure that the loan terms are as favorable as the terms of any loans between the plan sponsor and any executive of the plan sponsor made within the two years preceding the transaction.

**Requirements for Financial Statements**

- In the absence of audited, unqualified financial statements, the fiduciary may only engage in a transaction if the stock purchase agreement includes a provision requiring the selling or purchasing shareholders who are officers, managers or members of the board of directors of the plan sponsor to compensate the ESOP for any losses or other harms caused by or related to financial statements that did not accurately reflect the plan sponsor’s financial condition.

**Fiduciary Review Process**

- All employees of the fiduciary who participated in decisions regarding (1) whether to proceed with the transaction or (2) the price of the transaction are expected to engage in reasonably prudent investigation and retain—for six years—all notes, minutes or other documentation on which they relied.
• If the fiduciary believes the projections in the valuation report are unreasonable, the fiduciary must ask the appraisal expert to account for the unreasonable projections in its valuation, request new and reasonable projections from management, or reject the transaction, and must document the basis for its decision.

• The fiduciary must ensure that the information the appraisal expert obtains from the plan sponsor and purchasing or selling shareholder(s) includes each of the following, to the extent it exists:
  ◦ Any prior attempts by the purchasing or selling shareholder(s) to purchase or sell their stock in the plan sponsor within the proceeding two years
  ◦ Any prior defaults within the past five years by the plan sponsor under any lending or financing agreement
  ◦ Any management letters provided to the plan sponsor by its accountants within the past five years
  ◦ Any information related to a valuation of the plan sponsor provided to the Internal Revenue Service within the past five years

**Requirements Relating to Control**

• If a fiduciary approves a transaction in which the ESOP cedes any degree of control to which it would otherwise be entitled based on its ownership interest, including but not limited to the unencumbered ability to vote its shares (for example, by electing members of the board of directors), the fiduciary must document any consideration received in exchange for such limitation on the ESOP’s control (or how the limitation on control is otherwise reflected in the purchase price) and why it is fair to the ESOP.

• If a fiduciary approves a transaction in which the ESOP pays a control premium, the fiduciary must document why it believes that the ESOP is obtaining voting control, and control in fact, and identify any limitations on such control as well as the specific amount of consideration the ESOP received for such limitations.

**Insurance Coverage – Individual Trustee Only**

Before agreeing to serve as a trustee or fiduciary in connection with any transaction for the purchase or sale of ESOP stock, an individual trustee should make a good faith effort to obtain insurance coverage under a non-wasting policy that is sufficient to provide coverage for liability under ERISA in connection with the proposed transaction.

In the event that the individual trustee is unable to obtain its own insurance after good faith efforts, the individual trustee must obtain a written agreement from the ESOP sponsor that that the individual trustee must be named as a covered individual under the ESOP sponsor’s insurance policy as a condition for the individual trustee to serve as trustee or fiduciary of the ESOP.
Conclusion

It is important to note that the recent DOL settlements discussed in this article do not specify all of a fiduciary's obligations under ERISA, nor do they supersede such obligations in any way. Rather, such guidance provides additional detail as to the DOL’s expectations for fiduciaries to meet their obligations as ERISA fiduciaries. Ultimately, the fiduciary is the party responsible for understanding the full risks posed by a transaction involving a private company ESOP and for asking serious questions about any government audits or legal action, customer concentration, industry risk, and financial and legal disclosures.

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