EMPLOYEE BENEFITS LAW
INFORMATION MEMO
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Important Recent ESOP Developments

There were several significant legal developments relating to employee stock ownership plans (ESOPs) last year. This information memo will summarize a few of the most important developments.

Fiduciary Indemnification and Insurance – Scalia v. Professional Fiduciary Services, LLC

Fiduciaries of benefit plans covered by the Employee Retirement Income Security Act of 1974 (ERISA), including ESOPs, are subject to personal liability if they breach their fiduciary duties to the plan participants. Consequently, trustees and other ESOP fiduciaries often try to protect themselves by securing fiduciary liability insurance or indemnification commitments from the plan sponsor or others. However, the protection that fiduciary insurance and indemnification agreements can provide is limited by Section 410 of ERISA.

ERISA section 410 and the related Department of Labor (DOL) regulation[1] provide as follows:

- **General Rule:** An agreement that purports to relieve a fiduciary from fiduciary responsibility is void as against public policy.
- **Fiduciary Liability Insurance:** But, Section 410 does not preclude a fiduciary from purchasing insurance to cover fiduciary liability nor does it, generally, prohibit the plan sponsor from purchasing such insurance for a fiduciary's benefit.
- **Indemnification Agreements.** With respect to agreements to indemnify a plan fiduciary:
  - The plan itself can never indemnify a fiduciary for a fiduciary breach – that would amount to an agreement to relieve the fiduciary from responsibility and would be void under the general rule.
  - However, an indemnification agreement that leaves the fiduciary fully responsible but permits another party to satisfy any fiduciary liability, in the same manner as insurance, is usually permissible. The DOL regulation states specifically that the plan sponsor or an affiliate of the sponsor can indemnify a fiduciary in this manner.

Beyond these basic principles, however, the scope of permissible fiduciary liability insurance and indemnification agreements in the ESOP context is uncertain. For example, although (as noted above) the DOL's regulation under Section 410 permits a plan sponsor to indemnify a trustee or other plan fiduciary, two different federal courts held in 2009 that an ESOP trustee cannot be indemnified by the ESOP sponsor if the indemnity funds will come from the sponsor's assets.[2] The courts pointed out that, because the ESOP owned all or a significant part of the sponsor's shares in these cases, permitting the sponsor to indemnify the fiduciary would indirectly harm ESOP participants. However, in a later decision,[3] a different court refused to invalidate an agreement by an ESOP sponsor to indemnify the trustee and

1 29 CFR sec. 2509.75-4 (1975).

2 *Johnson v. Couturier,* 572 F.3d 1067 (9th Cir. 2009); *Fernandez v. K-M Industries Holding Co.,* 646 F.Supp.2d 1150 (N.D. Cal. 2009).

3 *Harris v. GreatBanc Trust Co.,* 2013 WL 1136558 (C.D. Cal. 2013).

advance the trustee's defense costs, where the agreement prohibited indemnification in the event of a final court judgment finding that the trustee had breached its fiduciary duties.

In short, it is not clear whether or to what extent an ESOP sponsor can agree to indemnify the trustee with respect to fiduciary liability. In this uncertain legal environment, the DOL now appears to have staked out an aggressive position on this issue. In a 2021 settlement agreement with an ESOP trustee involving alleged fiduciary breaches,[4] the DOL required that the fiduciary agree not to accept indemnification with respect to fiduciary liability from any company owned, in whole or in part, by an ERISA plan – such as a partly ESOP-owned company. The DOL's position appears to be that even a company *partly* owned by an ESOP cannot indemnify the ESOP trustee or another fiduciary of the plan, presumably for the reasons relied on in the two 2009 court decisions – the indemnification funds would come from an indirect asset of the plan.

It remains to be seen whether the DOL will take the same position in future lawsuits alleging breaches of fiduciary duty by ESOP trustees, but this appears likely. If that happens, ESOP trustees and fiduciaries will have to assess how this affects their ability to be protected from fiduciary liability.

Valuation of Private Company Shares (Walsh v. Bowers)

In *Walsh v. Bowers*[5], a federal district court ruled that the DOL had failed to prove that the sale of a closely held corporation's stock to an ESOP constituted violations of the ERISA fiduciary duty and prohibited transaction rules. The DOL had sued the ESOP's fiduciaries, alleging that they had violated these ERISA rules by causing the ESOP to pay more than fair market value for shares purchased from the plan sponsor's founders. However, the court sided with the fiduciaries, and in her published opinion, Judge Mollway discussed and analyzed several important issues relating to the valuation of closely held shares in ESOP transactions. In particular, the court discussed whether management's financial projections were appropriately vetted by the independent ESOP fiduciaries, analyzed the effect on the appraised share value of an earlier third-party purchase offer, and considered whether the speed with which the sale transaction was completed indicated an inadequate fiduciary process.

Background – Share Valuations in Private ESOP Transactions

Walsh v. Bowers involved a private company leveraged ESOP transaction, in which the company's owners sell shares to a new or existing ESOP in exchange for a promissory note. The note is secured by the purchased shares, which are held by the plan in a "suspense account" and released to participants' accounts only as the note is paid off. Usually, the ESOP pays back the note with contributions by the plan sponsor.

These transactions are subject to several strict rules and requirements under ERISA and the Internal Revenue Code (Code). Most importantly, the "prohibited transaction" and fiduciary duty rules under ERISA and the Code mandate that the ESOP pay no more than fair market value for the purchased shares, as determined in good faith by the ESOP trustee or other named fiduciary.[6]

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4 *Scalia v. Professional Fiduciary Services, LLC,* No. 7:19-CV-07874-KMK-PED (S.D. N.Y. 2021).

5 2021 WL 4240365 (D. Haw. Sept. 17, 2021).

6 Specifically, the ESOP must not pay more than "adequate consideration" for the purchased shares. "Adequate consideration" for closely held shares is defined in ERISA as "the fair market value of the [shares] 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."

A separate Code rule requires that the value of shares purchased by an ESOP must initially be determined by an independent appraiser. However, courts have consistently held that the ESOP trustee or other independent fiduciary cannot simply adopt the appraiser's valuation without further examination. One court explained this principle as follows:

> Expert advice, like an advisor's independent valuation, can of course serve as evidence of prudence in the discharge of an ESOP trustee's duties under [ERISA] … But such advice "is not a magic wand that fiduciaries may simply wave over a transaction to ensure that their responsibilities are fulfilled." Rather, a plan trustee must at least show that it (1) investigate[d] the expert's qualifications, (2) provide[d] the expert with complete and accurate information, and (3) [made] certain that reliance on the expert's advice was reasonably justified under the circumstances.[7]

In summary, the primary duty of the ESOP trustee or fiduciary with respect to the purchase of closely held shares is to ensure that the plan pays no more than fair market value for the shares by prudently selecting an independent appraiser to value the shares and ensuring that the appraiser's valuation is based on accurate information and is otherwise reasonable.

The Most Common Valuation Issues

Whether ESOP fiduciaries have fulfilled this basic duty has been the subject of numerous lawsuits and DOL investigations. The allegation most frequently made in these actions is that the shares purchased by an ESOP were overvalued, to the benefit of the selling shareholders and the detriment of ESOP participants. Timothy Hauser, the DOL's Deputy Assistant Secretary for Program Operations, was quoted in 2014 to the effect that "virtually all" the Department's ESOP cases involve allegations that purchased shares were overvalued and that "valuation is the first, second, third, and fourth problem" in private company ESOP cases.[8]

The most common violations in these cases are:

- unrealistic or otherwise improper financial projections;
- improper valuation methodology;
- use of inappropriate "guideline companies" (guideline companies are public companies that the independent appraiser uses to value closely held shares because they are viewed as comparable to the private company);
- use of imprudent or otherwise improper fiduciary processes;
- failure to prudently monitor the independent appraiser;
- conflicts of interest;
- inappropriate use of a "control premium" (a control premium, as its name suggests, is a surcharge added to a tentatively determined share value to account for the fact that the acquisition will give the ESOP control of the company); and
- failure to take into account third-party purchase offers for the shares.

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7 *Brundle on behalf of Constellis Employee Stock Ownership Plan v. Wilmington Trust, N.A.*, 919 F.3d 763 (4th Cir. 2019).

8 Simon and Needleman, "U.S. Increases Scrutiny of Employee Stock Ownership Plans", *Wall Street Journal,* June 22, 2014, accessed at https://www.wsj.com/articles/u-s-increases-scrutiny-of-employee-stock-ownership-plans-1403484135.

The Court's Ruling

In *Walsh v. Bowers,* the court held that the sale of 100% of an engineering firm's shares to a newly formed ESOP did not violate ERISA, rejecting the DOL's allegations that the $40 million purchase price was almost 50% higher than the shares' fair market value. In holding for the ESOP fiduciaries, the court made the following points:

1. **Management Projections.** As required by the Code, the ESOP trustee retained an independent appraiser to value the shares. The appraiser used three different methods to value the shares and then computed a blended average of the three resulting values.[9] The DOL challenged all three values, but the agency especially objected to the way in which the "discounted cash flow" methodology was used. The appraiser used financial projections provided by the company's management, including (the agency alleged) projected cash flow of approximately $9.3 million for 2012, the year of the ESOP purchase. The $9.3 million estimate was more than four times higher than the company's average cash flow for the four preceding years, and actual 2012 cash flow turned out to be only about $7 million. Despite these troubling facts, the court ruled that the DOL had not proven that the allegedly flawed projections were unreasonable or that they had produced an inflated share value, noting that the government's own valuation expert made several significant errors in its analysis and that the revenue projection for 2012 was justified by certain profitable contracts that the company had "in the pipeline" and which the government's valuation expert wrongly ignored.
2. **Earlier Purchase Offer.** The court also held that an expression of interest by a potential third-party purchaser of the shares, less than a year before the ESOP transaction closed and at a much lower price ($15 million plus cash on hand), was largely irrelevant to the share's value because it was not a firm offer and was contradicted by other evidence of the share's higher value.
3. **The Rush to Close the Deal.** The DOL also argued that the parties had closed the ESOP transaction in less than four months and that the negotiations between the shareholders and the ESOP with respect to the purchase price lasted only three days. However, the court noted that the company had retained experienced counsel and that the independent trustee had properly completed a "due diligence" investigation of the company and saved the ESOP millions of dollars by negotiating a lower interest rate on the ESOP's promissory note to the shareholders.

Walsh v. Bowers is a significant ESOP valuation case because, although the DOL was able to point out several deficiencies in the share valuation process, the fiduciaries successfully argued that they had retained appropriate experts, properly investigated financial projections provided by company management, and generally followed a prudent fiduciary process.

Reduction of Fiduciary Liability Based on Partial Forgiveness of an ESOP Loan (Walsh v. Vinoskey)

In this case, the DOL successfully charged that the sale of shares by a private company's founder to an ESOP for $20.7 million, of which $10.4 million was paid in cash and $10.3 million in the form of a promissory note, represented ERISA breaches on the part of the founder and the ESOP trustee because

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9 The appraiser used (1) the "guideline public company" method, in which the appraiser compares the company to publicly traded companies with comparable characteristics; (2) the "industry acquisitions method", in which the appraiser looks at the sale prices of comparable companies that have been sold; and (3) the "discounted cash flow method", in which the appraiser examines the company's projected cash flow in future years and its residual value at the end of the forecasting horizon.

the purchase price was far in excess of the shares' fair market value. The federal district court ordered the defendants to pay $6.5 million to the ESOP – the excess of the purchase price (including the note) over the fair value of the shares – even though the founder (Vinoskey) had forgiven about $4.6 million of the note after the company experienced financial difficulties following the sale.[10]

The appellate court agreed with the lower court that Vinoskey had breached his fiduciary duty but held that the $6.5 million award should have been offset by the amount of debt forgiveness.[11] This holding reduced the damage award significantly, to approximately $1.8 million.

In its decision, the appellate court distinguished earlier cases in which courts had refused to reduce fiduciary liability awards and held that reduction of the award was necessary in order to preclude a windfall to the ESOP.

This decision is significant because it suggests that a seller of closely held shares to an ESOP in a leveraged transaction may be able to reduce their fiduciary liability by negotiating a reduction or cancelation of the ESOP's promissory note.

Sale of ESOP Shares for Inadequate Consideration (Walsh v. Peterson)

In November 2021, the DOL filed a complaint in federal court alleging that an ESOP trustee and three members of the sponsor's board of directors breached their fiduciary duties by approving the sale of the ESOP's shares for less than their fair market value.[12] The complaint alleges that the ESOP trustee and the directors caused the ESOP to sell its shares back to the sponsor for approximately $12.5 million when their true value, according to the DOL, was between $44.8 and $58.2 million. The sale by the ESOP for inadequate consideration is alleged to have worked to the detriment of ESOP participants and to the benefit of the new shareholders. The company's assets were subsequently sold for $200 million.

Although, as discussed above, the vast majority of private company ESOP valuation cases involve allegations that the trustee caused an ESOP to purchase shares for more than their fair value, the *Peterson* complaint illustrates that the "adequate consideration" requirement under ERISA applies equally to the *sale* of shares by an ESOP.

If you have any questions about ESOPs, please contact Robert W. Patterson, any attorney in our Employee Benefits and Executive Compensation practice or the attorney at the firm with whom you are regularly in contact.

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10 *Pizzella v. Vinoskey,* 409 F.Supp.3d 473 (W. D. Va. 2019).

11 *Walsh v. Vinoskey*, 19 F.4th 672 (4th Cir. 2021).

12 *Walsh v. Peterson,* Civ. No. 4:21-CV-00867 (E. D. Tax. 2021).

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