

## Practical Advice for Employee Stock Ownership Plan Fiduciaries

CRAIG C. MARTIN AND WENDY L. FRITZ

**T**he landscape of employee stock ownership plans (ESOPs) is changing rapidly, and as a result, ESOP fiduciaries are faced with difficult questions as to what their duties are and how to execute those duties responsibly. In the past few years, this corporate finance technique has been used by public and private companies alike for a variety of reasons, ranging from 401(k) plans to leveraged transactions to going-private deals. Today, according to the ESOP Association, approximately 11,000 ESOPs nationwide cover 10 million employees or 10 percent of the private-sector workforce.

The distinctive hybrid nature of ESOPs as an employee ownership/retirement plan that functions as a highly tax-efficient method of raising capital makes ESOPs a unique creature of the law. Furthermore, in this revitalized land of ESOPs, corporate executives, corporate boards, trustees, banks, valuation experts, and plan administrators face increased scrutiny as they discharge their fiduciary duties. Lawsuits by employees against employers and other alleged fiduciaries for breach of their fiduciary duties under ERISA have multiplied in recent years. As a result, it is essential for ESOP fiduciaries to understand the full scope of their fiduciary duties as plans are drafted, implemented, and administered.

### THE LEGAL AND REGULATORY CONTEXT OF ESOPS

Congress first regulated ESOPs with the Employee Retirement Income Security Act of 1974 ("ERISA") to promote employee ownership of companies, contemplating that ESOPs would function as both an employee retirement benefit plan and a method of corporate finance that would encourage employee ownership. In certain circumstances, the employer may elect Subchapter S status with the result that, if the ESOP is 100 percent owner of the corporation, there is no income tax at either the corporate or shareholder level. An ESOP may be either the sole retirement benefit plan for employees or one part of a larger defined contribution plan, such as a 401(k), but to qualify as an ESOP under federal law, the defined

contribution plan must invest primarily in qualifying employer securities.

ESOP fiduciaries are generally subject to the same high fiduciary standards as other ERISA fiduciaries with the exception of the duty to diversify. Incorporating the common law of trusts for fiduciaries, ERISA imposes the following general statutory duties on all those considered "fiduciaries": to act "solely in the interest" of participants and beneficiaries (also known as the duty of loyalty or the exclusive benefit rule); apply the "prudent man" standard of care; diversify investments to minimize risks; and act in accordance with the documents governing the plan insofar as they are consistent with ERISA. Pursuant to § 1104(a)(2) of ERISA, however, ESOP fiduciaries do not violate the duty to diversify by acquiring or holding employer stock. In addition, ERISA also prohibits certain categories of transactions believed to pose a high risk of fiduciary self-dealing. For example, ERISA prohibits the acquisition or sale by a plan fiduciary of employer securities, unless the acquisition or sale is for "adequate consideration." The specific duties of an ESOP fiduciary will vary depending on the terms of the plan, whether the plan is for a public or closely held company, and whether the ESOP is a stand-alone plan or a plan associated with a 401(k).

ERISA makes fiduciaries personally liable for breaching their fiduciary duties. As the uses for ESOPs continue to evolve, many parties who might not consider themselves ESOP fiduciaries may be surprised to learn that they fall within the statutory definition of a "fiduciary" under ERISA. Fiduciary status is not determined merely by the ESOP plan's formal designations, but instead by the substantive discretionary authority a party may exercise with respect to the management or administration of the plan. Fiduciary status is not an "all or nothing concept," as a party's duty only extends to those fiduciary activities defined in ERISA. Thus, many parties may have full or limited ESOP fiduciary duties, including the plan's sponsoring company, officers, directors, directed trustees, or benefits and finance committee.

## RECENT TRENDS IN ESOP FIDUCIARY DUTY LITIGATION

As the uses of ESOPs continue to evolve, so do the risks ESOP fiduciaries face and the types of claims brought against them, whether for ESOPs of a closely held company or a publicly traded company. For closely held ESOPs, fiduciaries face unique issues for employer stock valuation, disclosure, and voting rights and control. Those individuals having dual corporate and fiduciary duties in a closely held company face the difficult issue of determining where corporate governance ends and fiduciary responsibility to the ESOP begins. Valuation becomes a major issue for closely held companies because there is no external market to set the value of the company stock. But such fiduciary responsibilities have their basis in ERISA's fiduciary provisions and other regulatory requirements from the Internal Revenue Service and Department of Labor.

For ESOPs of public companies, fiduciaries should be aware of the recent trend of ERISA lawsuits filed when the stock of the employer significantly declines. The value of a public company's stock may be ascertained at any time on the stock market, which frames the issue of when it is no longer prudent to continue investing in declining employer stocks. Unlike other ERISA fiduciaries, ESOP fiduciaries have benefited in litigation from a rebuttable presumption (originally developed by the Third Circuit in *Moench v. Robertson*) that a fiduciary acts prudently by investing in employer stock. However, a plaintiff may overcome the *Moench* presumption by establishing that the fiduciary abused its discretion and that a prudent investor under the circumstances would not have followed the ESOP's mandate to invest in employer securities.

### Risks for ESOP Fiduciaries of Closely Held Companies

The majority of ESOPs today are still found in closely held companies,

where they are often used as a tax-efficient exit strategy or as a method to retain family ownership. Types of breach of fiduciary claims commonly brought against ESOP fiduciaries of private companies include: valuation, disclosure, and voting and control claims.

ESOP fiduciaries of closely held companies routinely encounter difficulty in valuing the price of the employer's stock, as they lack the constant valuation information provided to public companies by a public market. As a result, recent litigation against ESOP fiduciaries continues to challenge the prudence of the fiduciary's valuation of employer stock in various transactions. Valuation litigation arises in all stages of the valuation process, including the points of plan creation, stock repurchase or redemption, corporate merger, and plan termination.

Unlike other breach of fiduciary duty claims that plaintiffs must prove against the fiduciary, the fiduciary bears the burden of proving by a preponderance of the evidence that the ESOP paid no more than adequate consideration for its purchases of company stock. Courts closely consider the process that leads to a "good faith" determination of fair market value. To meet this "good faith" requirement, the fiduciary must employ independent financial and legal experts in the valuation process. Thus, the procedural due diligence of the fiduciary in the valuation process, as evidenced by the independent valuation reports and the fiduciary's own investigation, is critical.

A second type of breach of fiduciary duty claim involves the ESOP fiduciary's disclosure of information to plan participants. A fiduciary may not materially mislead participants or beneficiaries about the plan or its benefits. Though participants may have access to less information about a closely held company, the disclosure requirements for ESOP fiduciaries specified in ERISA are the same for public and private companies. Because ERISA imposes specific

disclosure obligations, courts will not typically create additional disclosure obligations in the absence of affirmative misrepresentations or materially adverse threats to plan assets.

Voting and control issues present a third type of claim potentially brought against ESOP fiduciaries of private companies. Voting rights for allocated shares are "passed through" to participants of closely held company ESOPs only for certain statutorily mandated major corporate transactions, unless the terms of the plan provide otherwise. Otherwise, the ESOP's trustees vote the ESOP's shares. Because corporate governance of closely held ESOPs is often insular, the control or management of ESOP voting may give rise to a breach of fiduciary duty claim if there is a contest for control of the company. While ERISA clearly authorizes corporate managers to serve as ESOP fiduciaries, ERISA also imposes a clear obligation on ESOP fiduciaries to discharge their obligations with respect to the ESOP plan solely in the interest of the plan participants and beneficiaries. The sticking point in voting and control litigation involves determining whether the "stock voting rights" are considered an ESOP "plan asset" under the circumstances and whether the voting transaction placed at issue involved a fiduciary breach. In sum, the dual roles often performed by corporate managers in closely held companies make determinations of when ESOP fiduciary duties begin and end quite complicated. Voting and control issues require both a close analysis of the terms of the ESOP plan and consistent reassessment of when and how ERISA might apply.

### Risks for ESOP Fiduciaries of Public Companies

ESOP fiduciaries of public companies typically face different types of breach of fiduciary duty claims, the most high-profile of which have been stock drop litigation cases. In these cases, employees have invested in employer stock through some form

of ESOP, and after the employer's stock price drops, the employees sue the fiduciaries under ERISA for the loss in value. The specific claim is that the ESOP fiduciary has failed to diversify or sell off the employer stock investment before the employer's stock declined in value.

While ESOPs are exempt from ERISA's general duty to diversify, ESOP fiduciaries are still subject to a duty of prudence regarding continued investment in the employer's stock. Indeed, with the Pension Protection Act of 2006 ("PPA"), Congress extended new diversification provisions to ESOP retirement plans integrated with 401(k) plans, provisions that do not apply to ESOPs of private companies or stand-alone ESOPs. Under the PPA, for example, plan sponsors must notify participants of their diversification rights and the "importance of diversifying the investment of retirement account assets."

As discussed above, ESOP fiduciaries are typically entitled to the *Moench* presumption that the fiduciary has acted consistent with ERISA and "reasonably" by investing in employer stock. However, there is much uncertainty as to what is necessary to rebut this presumption. In *Moench*, the Third Circuit noted that possible rebuttals may include a "precipitous decline" in employer stock value, as well as the fiduciary's knowledge of [the employer's] impending collapse."

Other courts have differed in their approaches to the *Moench* presumption. For instance, the Sixth Circuit adopted the *Moench* presumption but also required that the plaintiff "show a causal link between the failure to investigate [the appropriateness of liquidating or diversifying the ESOP] and the harm suffered by the plan." Most recently, Judge Posner has written two opinions for the Seventh Circuit on the ESOP fiduciary's duty of prudence. In *Armstrong v. LaSalle Bank National Association*, the court affirmed that a trustee "does not have a general duty to diversify, though such a duty

can arise in special circumstances." In *Summers v. State Street Bank & Trust Co.*, however, the court raised the possibility that it "may be beyond the practical capacity of the courts to determine" the point at which an ESOP fiduciary should "break the plan and start diversifying." The court suggested that the proper inquiry for diversification should be whether the ESOP participants were bearing inordinate risk, as measured by the debt-equity ratio of the employer (not declining stock value) and whether the ESOP was the participant's principal source of retirement income.

In sum, no definite set of circumstances has emerged for rebutting the *Moench* presumption. The terms of the plan and whether they absolutely require that the plan invest in employer securities may also affect how courts apply the presumption, since the fiduciary is also subject to claims of breach of fiduciary duty for failing to maintain investment in employer stock if the plan requires such investment.

#### CONSIDERATIONS FOR ESOP FIDUCIARIES

Knowing and appropriately executing the full range of duties required of an ESOP fiduciary is not an easy task. Because ESOP plans and their administrative structure tend to vary greatly, it is impossible for Congress or the courts to produce a list of what is necessary to satisfy a party's specific fiduciary duties in a given situation. As a result, ESOP fiduciaries may be uncertain of what the law requires of them. The recommendations below seek to provide a starting point for better understanding and executing ESOP plans in accordance with fiduciary duties.

- **Identify the ESOP fiduciaries and fiduciary duties.** For starters, any party that could potentially exercise discretionary authority with respect to an ESOP should first consider whether it might be considered an "ESOP fiduciary."

Then, the party should consider the extent of its potential fiduciary duties.

- **Fund the ESOP prudently.** The fiduciary's duty to prudently value the stock of the company begins with the formation of the ESOP. The fiduciary must, for example, consider how much debt would overburden the company and dilute stock value.
- **Utilize clear terms in the plan.** One common thread in breach of fiduciary duty litigation is ill-prepared, ambiguous language in the terms of the plan. It is important to ensure that the terms of the plan are consistent with ERISA and that those terms are understood by all parties involved.
- **Diversify the offered retirement benefits.** A stand-alone ESOP is an undiversified retirement benefit whose value is entirely dependant upon the success of the company. Diversification of participants' retirement benefits with 401(k) plans or pension plans may serve to limit the risk faced by participants.
- **Undertake a well-documented, independent valuation process for private company ESOPs.** Unlike a publicly traded company, the ESOP fiduciary of a closely held company does not have a market valuation of the employer's stock. Yet, the fiduciary sued on a valuation claim bears the burden of proving that he or she received adequate consideration for the purchase or sale of company stock. Thus, the fiduciary should document the valuation process with independent valuation reports and records of its investigation. An annual valuation is generally required by the Internal Revenue Code rules as well.
- **Maintain loyalty to the plan.** An ESOP fiduciary, particularly in a closely held company, will often have dual loyalties to the company and the plan. As a consequence of the "two hats" issue, it is often appropriate to hire an independent fiduciary.

- **Follow the plan's voting terms.** The fiduciary must follow the terms of the plan, ERISA mandates, and any applicable provisions of the Internal Revenue Code, which may give participants certain ownership or stock voting rights. Contests for control may implicate the stock voting rights of the plan and the fiduciary's duty to act solely in the interest of the plan's participants.
- **Minimize risk to the participants.** The value of the ESOP will necessarily rise and fall with the fortunes of the employer, but the

ESOP fiduciary may have the duty to cease acquiring employer stock or even to sell employer stock if the employer faces imminent collapse or the risk to the ESOP participants otherwise seems inordinate.

- **Closely monitor employee redemption of shares.** While financial success must be labeled a "good problem" for a company to have, it can nonetheless pose valuation issues for ESOP fiduciaries. If an especially attractive valuation prompts a large number of employees to cash out,

the resulting cash-flow issues may cause problems for the remaining participants. ❁

---

Craig C. Martin, who can be reached at [cmartin@jenner.com](mailto:cmartin@jenner.com), is a partner in Jenner & Block LLP's Chicago office and chairs the firm's ERISA Litigation Practice. Wendy L. Fritz is an associate in Jenner & Block LLP's Chicago office. Sundance Banks, a Jenner & Block summer associate, provided valuable assistance in the preparation of this article.