



LESSONS LEARNED FROM ESOP OWNED COMPANIES FROM RECENT LITIGATION

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I. BACKGROUND

RECENT LITIGATION AND AUDIT ACTIVITY IS
FOCUSING ON “PROCESS”

Litigation Environment

Recent litigation and audit activity is focusing on the process undertaken by fiduciaries in connection with a transaction involving an ESOP

Litigation Environment – Summary Only

Brundle v. Wilmington Trust, N.A.

- “Constellis” case
- Court found a flawed process with respect to the establishment of the ESOP and following (close in time) sale of the ESOP-owned company
 - No record of robust negotiation
 - Value of stock declined
 - Existence of other valuations
 - Trustee inquiry of the valuation professional should have been more in-depth
 - Control issues

Litigation Environment – Summary Only

Perez (DOL) v. First Bankers Trust Services, Inc.

- “SJP” case
- Court held that the ESOP paid more than “adequate consideration” for the shares of stock acquired by the ESOP
 - Process pursuant to which the trustee reviewed the valuation report was lacking – valuation report was missing certain information
 - Customer concentration issues
 - Identification of competitors/discussion of competitive advantage
 - Lack of robust negotiation

Litigation Environment – Summary Only

Perez (DOL) v. Herbert Bruister

- Court affirmed a district court decision finding that the ESOP paid more than “adequate consideration” for the shares of stock acquired by the ESOP
 - Significant conflicts of interest
 - Lack of diligence on provider qualifications
 - Failure to identify (known) economic changes impacting the industry/geographic area in which the company operated
 - Failure to provide complete and accurate financial data to the valuation advisor

Litigation Environment – Summary Only

Bonnie Fish (et al) vs. GreatBanc Trust Company

- “Antioch” case
- Court held that the process undertaken by the ESOP and its fiduciary (trustee) was appropriate and sufficient (*i.e.*, no fiduciary breach) even in light of a post-transaction falling stock price
 - Management and the trustee team worked to ensure complete information was provided/obtained by the trustee
 - Projections involved significant work and review
 - Company clearly identified strengths, weaknesses, opportunities, and threats (“SWOT”)
 - The trustee had significant involvement with the company and multiple “touch points” prior to closing

Litigation Environment – Summary Only

Bonnie Fish (et al) vs. GreatBanc Trust Company

- Note – while the company and trustee were ultimately cleared of any wrongdoing, the case proceeded to a trial on the merits.
- The court conducted a 34 day bench trial.

Litigation Environment – Summary Only

Fiduciary Process Agreement

- FPA – agreed upon between the DOL and GreatBanc Trust Company
- Viewed as a “roadmap” for fiduciary process
 - Selection and oversight of valuation advisors
 - ✓ Emphasis on independence
 - ✓ Avoid “feasibility study” by same party
 - Review of financial statements
 - Understanding of provided projections
 - Valuation report considerations
 - ✓ Use of premiums and discounts
 - ✓ SWOT analysis
 - Documentation of process undertaken by the fiduciary

Litigation Environment – Summary Only

Other Litigation Issues

- *Tatum v. RJR Pension Inv. Comm.*, 855 F.3d 553 (4th Cir. 2017)
 - Can there be a claim under ERISA if there is a procedural violation but the fiduciary's actions were substantively prudent?

II. KNOW YOUR ROLE

Roles and Responsibilities

- **ESOP Trustee [Shareholder]**

- Appointed by the Board
- Elects the Board
- Approves certain major transactions
- Oversees the valuation process and sets the annual share value

- **Board of Directors**

- Oversees the corporate business via board meetings and board committees
- Appoints the officers
- Creates and appoints committee members
 - ESOP Committee [ESOP Committee may be an ERISA fiduciary]
 - Audit Committee
 - Compensation Committee
- Monitors appointed ERISA fiduciaries

- **Management**

- Operations of the business

- **Committees**

- Delegated duties

Corporate/ERISA Intersection

Board of Directors is charged with appointing plan fiduciaries (*e.g.*, the trustee, ESOP Committee, plan administrator)

- Cannot do so haphazardly
- Properly Appoint Fiduciaries
 - Carefully evaluate candidates and document the selection process
 - Verify that candidates' qualifications are consistent with their duties
 - Require that those to whom legal responsibility has formally been delegated assume an active role and exercise that responsibility
 - Provide training to internal fiduciary candidates

Trustee is not permitted to delegate Trustee duties (co-trustee relationship)

Board Responsibilities (vis-à-Vis the ESOP)

- Appoint and monitor ESOP Trustee
- Direct trustee per plan document
 - While directed action may be limited on an annual basis, the board must make sure it provides direction in those instances where a directed trustee is required to act (e.g., election of the members of the board of directors)
- Plan administration responsibility
 - Determine ESOP contributions
 - Oversee ESOP distribution process
 - Adopt, amend and/or terminate ESOP
 - Evaluate repurchase liability
 - May be delegated to a plan committee
- Declare dividends/distributions to be paid to shareholders

Trustee Responsibilities

Maintain custody of plan assets'

- Updated stock certificates for released shares

Manage liquid assets

- Investment requirements?
- Is the trustee directed?

Receive contributions and dividends/distributions

Make ESOP loan payments

Oversee participant distributions

- Based on plan administrator direction

Determine fair market value of shares held by ESOP

Vote ESOP shares

- May be directed

Monitor board of directors

- Must properly elect the board of directors

III. BEST PRACTICES

The Annual Valuation Update

Courts have been critical of the valuation process being undertaken in connection with ESOP transactions

- The Board of Directors and the Trustee must know the valuation requirements
 - “Fair Market Value”
 - The **Trustee** is the responsible party for setting value
 - Proper Process:
 - ✓ Proper selection of the Appraiser
 - ✓ Proper information provide to the Appraiser
 - ✓ Review the report
 - ✓ Ask questions
 - ✓ Review the valuation approach(es)
 - ✓ Review and question methodology used to determine value
 - ✓ Document the review process

Development/Use of Projections

Projections are a key component of the valuation process (both from a transactional point of view and for the annual valuation). Projections should be carefully reviewed, understood, and questioned or analyzed before the fiduciary accepts valuation information.

Understand the projection process

- Who is creating and providing the projections to the fiduciary?
- What experience does the company/management have in creating projections?

Understand the risks facing the company and review how this information was used when preparing the projections

Company provided projections should be scrutinized to determine that reliance on such projections was “reasonable”

- How do they compare to past performance?
- Are the future projections for “new” business reasonable?
- Factual and numerical internal consistency
- Do they account for risk appropriately

Development/Use of Projections

Understand use of company-specific risk or adjusted projections (by the buyer) to provide a sensitivity analysis as to the use of projections

Trustee must evidence its review and understanding of the financial analysis conducted by the trustee's financial advisor

- Participate in financial discussions
- Evidence review of the prepared financial analysis
- Identify concerns and (if appropriate) address transaction alternatives
- Question analysis undertaken and conclusions drawn with respect to provided financial information

Prepare appropriate evidence of a prudent process

The Valuation Process and Valuation Report

ESOP fiduciaries will carry their burden to prove that they arrived at their determination of fair market value by way of a prudent investigation in the circumstances then prevailing.

The trustee must evidence a review and understanding of the valuation process (understand methodologies) and an analysis of the valuation report.

Report should include key details

- Company specific information
- Industry requirements
- Market share considerations
- Specific identification of materials reviewed by the preparer
- Customer concentration concerns

Discussion of premiums/discounts– deserves high level of scrutiny:

- Control premium – evidence of control in fact?
- Discounts – question and understand selection of discount rate

Be “clean”

Understanding Governance Requirements

A fiduciary must understand its roles and responsibilities with respect to ongoing governance requirements of the ESOP owned company.

The fiduciary should be aware of the company's requirement to have independent board member(s) on the board of directors (if any).

- If required, the fiduciary should work to ensure appointment of the correct number of individuals and meet the appropriate deadlines.

Requirements relating to former seller(s) ability to sit on the board of directors or appoint/control other members of the board of directors should be carefully scrutinized and considered

Understand valuation updates and requirements based upon the composition of the board of directors

Implement (where appropriate) committee structure within the board of director requirements

Negotiation of a Transaction

A fiduciary should negotiate the terms pursuant to which an ESOP will purchase shares of stock.

Review and understand initial transaction structure

Identify transaction terms that are not fair or favorable to the ESOP

Conduct negotiation process with an eye to undertaking a transaction that is entered into solely in the interest of plan participants and their beneficiaries

Look for and negotiate for items that can be improved for the benefit of the ESOP

- **Second stage transaction issues**

Documentation of the Process

Courts and the DOL focus on actions taken by the fiduciary and the fiduciary's ability to evidence process is key.

Involvement and participation in the process should be evident

- Who was involved?
- What material were provided/who reviewed?
- Was the appropriate expertise had/available?

Identify substantive meetings and exchange of information

Maintain evidence of “team” interactions (trustee (trustee representative), counsel, and/or financial advisor)

[Document negotiation of transaction terms]

[Document process undertaken for the event (e.g., valuation update)]

Litigation tends to focus on transactions...remember that process is as important during the administrative process also. Ensuring plan fiduciaries are appropriately carrying out their roles and responsibilities is key.

Fiduciary Liability Insurance Overview

Who is Covered?

- Plan
- Plan sponsor
- Natural person fiduciary/trustee
 - Institutional trustees generally must be added via endorsement
- Members of the benefit plan committee

What is Covered?

- Violations of responsibilities, duties and obligations under ERISA
- Errors/omissions in the Administration of a plan
- Settlor capacity allegations
- Status claims

Fiduciary Liability Insurance Overview, *cont'd.*

What is excluded?

- Civil fines and penalties (other than those imposed under ERISA Sections 502(i) or 502(l))
- Benefits due
- Finally-adjudicated fraud or illegal profit

Key Considerations:

- Claims Made & Reported
- Defense and settlement provisions
- ESOP coverage (automatic vs. granted)
- Scope of coverage for investigations
- Limits

Other Insurance Considerations

- Coordination of Fiduciary Liability and E&O programs
- Fiduciary Liability vs. ERISA Bond
- Transaction-specific insurance placements
- Reps and warranties policies

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Questions ?

