CHAPTER 9

Basic Fiduciary Guidance for the ESOP Trustee in Corporate Finance Transactions

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SYNOPSIS

§ 9.01 INTRODUCTION

Trustees of Employee Stock Ownership Plans (ESOPs)[1] face fiduciary issues that are more difficult to analyze than the issues faced by fiduciaries of other employee benefit plans. This is because ESOPs are uniquely designed to provide benefits in addition to retirement benefits to parties other than plan participants and their beneficiaries.

There is a misfit between some of the fiduciary principles articulated in ERISA[2] and virtually all employee benefit plans in actual operation. For example, for many years commentators have noted that the exclusive benefit rule, the equivalent of the common law duty of loyalty,[3] does not apply easily to any employee benefit plans,[4] particularly employee pension benefit plans,[5] because the

[1] Some people distinguish between the "Employee Stock Ownership Plan" (ESOP) and the "Employee Stock Ownership Trust" (ESOT). We have used the term ESOP to refer to both.

[2] Employee Retirement Income Security Act of 1974, 29 U.S.C. §§ 1001–1461 (2006); ERISA §§ 2-4402 (2006).

[3] ERISA sates "a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and for the exclusive purpose of providing benefits to participants and their beneficiaries. . . ." ERISA § 404(a)(1), 29 U.S.C. § 1104(a)(1).

[4] Defined as "an employee welfare benefit plan or an employee pension benefit plan or a plan which is both an employee welfare benefit plan and an employee pension benefit plan." ERISA § 3(3), 29 U.S.C. § 1002(3).

[5] Defined as "any plan, fund, or program which was heretofore or is hereafter established or maintained by an employer or by an employee organization, or by both, to the extent that by its express terms or as a result of surrounding circumstances such plan, fund or program (i) provides retirement income to employees, or (ii) results in a deferral of income by employees for periods extending to the termination of covered employment or beyond, regardless of the method of calculating the contributions made to the plan, the method of calculating the benefits under the plan or the method of distributing benefits from the plan." ERISA § 3(2)(A), 29 U.S.C. § 1002(3).

fiduciaries of the plans do not in fact owe loyalty only to participants and their beneficiaries.[6] Courts, commentators, the Internal Revenue Service (IRS) and the Department of Labor (DOL) have helped solve some of these problems of fit.[7]

Like the difficulty of analyzing fiduciary issues generally, the misfit between the articulation of ERISA fiduciary principles and their application in actual transactions is exacerbated for trustees of ESOPs because the ESOP is not only a retirement plan but it is also a corporate finance vehicle and a corporate shareholder.[8] Furthermore, the participants and beneficiaries of the ESOP have multiple and potentially conflicting interests as beneficial shareholders, employees and retirees. In addition to retirement benefits, ESOPs have been used among other things to diversify wealth, for tax planning, to encourage productivity increases, to bolster regional economic and community development, as a tool for the entrenchment of management and as a poison pill to prevent the sale of firms.

As a result of the many uses of ESOPs, even the simplest of ESOP transactions require sophisticated business judgments. Like other careful and knowledgeable investors, in addition to performing due diligence as to the past and the present, the ESOP fiduciary must make many decisions in anticipation of unknowable future micro economic and macro economic conditions. Also, like other careful and knowledgeable investors, the ESOP fiduciary will confront and must answer *ex ante* questions "whose answer can only be guessed at."[9]

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[6] *See, e.g.*, Daniel Fischel & John H. Langbein, *ERISA's Fundamental Contradiction: The Exclusive Benefit Rule*, 55 U. CHI. L. REV. 1105 (1988).

[7] In fashioning a workable version of the exclusive benefit rule courts have crafted a *de facto* duty of impartiality among participants and beneficiaries and an "incidental" benefit rule that accommodates the interests of other parties. *See* discussion *infra* section 9.04[1] for further discussion of the incidental benefit rule and duty of impartiality.

[8] Sometimes the ESOP acts like a direct corporate shareholder when the trustee votes the shares and applies dividends to ESOP debt. Sometimes the ESOP acts like an indirect shareholder when voting rights and dividends are passed directly through to participants.

[9] The definition of a "conundrum," William Safire, *On Language*, N. Y. TIMES, October 23, 2005, § 6 (Magazine), at 31.

Unlike other careful and knowledgeable investors and unlike other ERISA fiduciaries, however, the ESOP trustee has a substantially increased risk that the answers at which the fiduciary must perforce guess will be second-guessed after the unknowable conditions have become known. *Ex post*, some disgruntled participant or some ambitious bureaucrat may well seek a surcharge against the still careful and knowledgeable, but now hapless fiduciary.

Unlike other business fiduciaries, ERISA fiduciaries do not enjoy a presumption that their decisions are correct. Courts are generally loath to consider tax and ERISA issues, and they have developed a fiduciary judgment rule that helps protect the careful, prudent, expert fiduciary, but they have been reluctant to follow the business judgment rule in ERISA fiduciary matters because of the requirement that the ERISA fiduciary act as a prudent expert.[10] As a result, ESOP fiduciaries may well be called upon well after the fact to justify their fiduciary decisions made in very complex business transactions.

The brew of strict standards for ESOP fiduciaries, the difficulty of applying retirement plan fiduciary principles to complex multi-party corporate finance transactions and the potential *de novo* review of the fiduciary's decisions is the stuff of midnight awakening.

This article provides the potential ESOP trustee with a simple checklist of recommended actions to follow when making fiduciary decisions in the context of a corporate finance transaction. First, the article will provide a brief background for those unfamiliar with ESOPs and their various goals and uses, as well as an introduction to the function of the ESOP trustee. We will then discuss a selection of legal principles governing the conduct of the ESOP trustee and provide recommendations on how the ESOP trustee can help to insulate itself from liability. It is our hope that we increase the confidence of current and potential fiduciaries to use the ESOP tool boldly and creatively all the while fulfilling "the highest fiduciary duty known to the law."[11]

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[10] ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B); *see also* discussion *infra* section 9.03.

[11] Donovan v. Bierwirth, 680 F.2d at 263, 271 (2d Cir. 1982).

[1] Leveraged Employee Stock Ownership Plans

An ESOP is a tax qualified retirement plan under the Internal Revenue Code of 1986 (Code)[12] and an employee pension benefit plan under ERISA. As a tax qualified retirement plan, ESOPs must comply with the same Code qualification rules as other qualified plans, and ESOP fiduciaries are bound by the fiduciary duties of ERISA.[13]

The ESOP Association[14] reports that there are approximately 11,000 ESOPs in place in the United States covering 10 million employees.[15] An estimated 2,000 companies are 100% owned by their ESOPs.[16]

What distinguishes ESOPs from all other tax qualified retirement plans is that they are designed to invest primarily in stock of the sponsoring company[17] and they are allowed to purchase the stock from the sponsoring company or from a current shareholder with funds borrowed directly from the sponsoring company or with the sponsoring company's guarantee.[18] In a leveraged ESOP,[19] the

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[12] 26 U.S.C. § 4975(e)(7) (2006). An ESOP is a defined contribution plan, meaning that the employer's contribution is defined and the employee's retirement benefit is variable. 26 U.S.C. § 414(i).

[13] ERISA § 404, 29 U.S.C. § 1104.

[14] The ESOP Association, founded in 1978, is a national non-profit membership organization, with 18 local Chapters, serving approximately 2,400 employee stock ownership plan (ESOP) companies, professionals with a commitment to ESOPs, and companies considering the implementation of an ESOP. The Association is the only association devoted solely to ESOPs although the National Center for Employee Ownership and other organizations are also heavily involved with ESOPs. *See* www.esopassociation.org; www.nceo.org.

[15] The ESOP Association, ESOP Statistics, www.esopassociation.org/media/media_statistics.asp (last visited March 24, 2006).

[16] Id.

[17] 26 U.S.C. § 4975(e)(7)(A). While other qualified plans (e.g. profit sharing plan, money purchase plan) are permitted to invest in employer stock without violating the prohibited transaction rules of ERISA, those plans are subject to additional limitations on their ability to acquire and hold such stock. *See* ERISA § 407(a)(2), (b)(1), (d)(3)(A), 29 U.S.C. § 1107(a)(2), (b)(1), (d)(3)(A).

[18] 26 U.S.C. § 4975(d)(3), provides for an exemption from the Code's prohibited transaction rules for a loan to a leveraged ESOP if such loan is primarily for the benefit of participants and beneficiaries of the plan, and such loan is at a reasonable rate of interest and any collateral given to a disqualified person

ESOP borrows funds to acquire employer stock, specifically referred to in the Code as "employer securities,"[20] either directly from a lender, or alternatively, the sponsoring company borrows the funds from a lender and then the sponsoring company lends the funds to the ESOP. In both scenarios the ESOP borrows funds to purchase the employer securities and, generally, the ESOP pledges the employer securities purchased as collateral for its loan.[21] The sponsoring company agrees to make contributions to the ESOP that are in turn used by the ESOP to repay the ESOP loan (either directly to the lender or to repay the sponsoring company's loan and then the lender's loan). Initially, the employer securities are held in a "suspense account,"[22] and as the loan is repaid a portion of the employer securities is released[23] from the suspense account and allocated to the accounts of the ESOP participants.[24]

(including the employer sponsoring the ESOP) consists of only qualifying employer securities.

[19] *See* 26 U.S.C. § 4975(d)(3) (referencing a "leveraged employee stock ownership plan" in the context of the loan exemption).

[20] 26 U.S.C. § 409(*l*)(1). "Employer securities" are defined as "common stock issued by the employer . . . which is readily tradable on an established securities market" or where such stock is not readily tradable such common stock has "a combination of voting power and dividend rights equal to or in excess of (A) that class of common stock of the employer . . . having the greatest voting power, and (B) that class of common stock of the employer . . . having the greatest dividend rights." 26 U.S.C. § 409(*l*)(1) and (2).

[21] 26 C.F.R. § 54.4975-7(b)(5) (2006).

[22] 26 C.F.R. § 54.4975-11(c). Employer stock held in the suspense account is known as "unallocated" stock because it has not yet been allocated to the accounts of participants of the ESOP.

[23] The amount of employer stock released is determined in accordance with Treasury Regulation 54.4975-7(b)(8) which describes two possible release formulas depending on the term of the ESOP loan. The general rule requires that "[f]or each plan year during the duration of the loan, the number of securities released must equal the number of encumbered securities held immediately before release for the current plan year multiplied by a fraction. The numerator of the fraction is the amount of principal and interest paid for the year. The denominator of the fraction is the sum of the numerator plus the principal and interest to be paid for all future years." 26 C.F.R. § 54.4975-7(b)(8)(ii). Therefore, upon the payment in full of the loan, all of the employer stock acquired with the loan proceeds will be allocated to the accounts of ESOP participants.

[24] Employer stock released from the suspense account and allocated to accounts of ESOP participants is known as "allocated" employer stock.

[2] ESOP Trustee

Just like other retirement plans, ESOPs are required to hold plan assets in trust.[25] The assets of the ESOP held in trust are generally managed and controlled in the "exclusive authority and discretion" of the ESOP's trustee(s).[26] Under ERISA, trustees are included in the definition of a fiduciary[27] and therefore the fiduciary obligations of ERISA are applicable to ESOP trustees.[28]

The ESOP trustee is generally appointed by the board of directors of the sponsoring corporation and can take a variety of forms, including an individual, a group of individuals, or an institution.[29] The ESOP trustee may be the sponsoring company's CEO, another officer, director or group of officers or directors of the sponsoring company, a committee of employees, an individual, or a bank, or other professional trustee.[30] ESOP trustees are typically categorized as "inside" trustees or "outside" trustees. "Inside" trustees refer to individuals from within the sponsoring company who serve as an ESOP trustee, and "outside" trustees are those individuals or entities who are not employed by or related to the sponsoring company.[31]

ESOP trustees are also differentiated based on their degree of autonomy. A "directed" ESOP trustee is told what to do by someone else and does not make his/her own decisions regarding the trust assets. This type of ESOP trustee has somewhat limited liability based on their limited authority.[32] By contrast, the independent ESOP trustee must make decisions regarding the ESOP based on their own investigation and judgment. We deal primarily with the issues faced by an independent trustee.

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[25] ERISA § 403(a), 29 U.S.C. § 1103(a).

[26] Id.

[27] ERISA § 3(21), 29 U.S.C. § 1002(21).

[28] ERISA § 404, 29 U.S.C. § 1104.

[29] ERISA § 403(a), 29 U.S.C. § 1103(a); ERISA § 402(c)(1), 29 U.S.C. § 1102(c)(1).

[30] Nat'l Ctr. For Employee Ownership, *Should You Trust Your Plan's Trustee?*, EMP. OWNERSHIP REP., Mar.-Apr. 2006, at 15.

[31] Sometimes companies use inside trustees to avoid the cost associated with an outside trustee, and other companies use inside trustees because they believe that the inside trustee will be more likely to make decisions that are consonant with the needs and desires of other stakeholders.

[32] ERISA § 403(a)(1), 29 U.S.C. § 1103(a)(1); *see* Nat'l Center for Employee Ownership, *supra* note 30 at 15.

§ 9.02 THE MULTIPLE GOALS & USES OF ESOPs

[1] Retirement Vehicle

As a tax-qualified defined contribution plan, ESOPs serve as a retirement vehicle for employees of the sponsoring company. Specifically, an ESOP is a stock bonus plan, a money purchase plan, or a combination of those plans designed to invest primarily in employer securities.[33] In an ESOP, each participating employee's account is credited with employer shares and other assets over the period of his employment as any loan is repaid or as shares or assets are contributed to the ESOP.[34] Upon retirement, death, disability, or termination of service, the employee's account is distributed to the employee or the employee's beneficiaries in shares of stock or in cash, depending on the design of the ESOP and the employee's election.[35] As with other defined contribution plans, the amount of the employee's ultimate benefit is determined by the value of the stock and other assets allocated to his account when his or her benefits become due. Because the ESOP is heavily (maybe exclusively) invested in securities of the sponsoring corporation,[36] the employee's ultimate retirement benefit is dependent on the value of the stock of the employer. This distinguishes the ESOP from other defined contribution plans and makes the duty of ESOP fiduciaries more difficult than the duty of fiduciaries of other retirement plans.[37]

Protecting and enhancing the value of the retirement funds of participants and their beneficiaries is the most important obligation of the ESOP trustee.

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[33] 26 U.S.C. § 4975(e)(7)(A); ERISA § 407(d)(6), 29 U.S.C. § 1107(d)(6).

[34] 26 C.F.R. § 54.4975-11(d).

[35] 26 U.S.C. § 409(o).

[36] 26 C.F.R. § 54.4975-11(b).

[37] Academic commentators who oppose ESOPs on policy grounds often comment that retirement savings that are dependent on the performance of the employer result in an unacceptable level of risk to the employee. *See* Fischel & Langbein, *supra* note 6. For this reason, ESOP companies often sponsor 401(k) plans or other qualified plans. One interesting academic question is whether the ESOP trustee should be able to take into account the diversification and risk spreading provided by other plans of the sponsor whether or not these plans are jointly administered with the ESOP.

[2] Corporate Finance Tool

In addition to their function as a retirement vehicle for employees of the sponsoring company, Congress intended ESOPs to be a "technique of corporate finance."[38] ESOPs can be used for a variety of business purposes, such as providing working capital, buying out a large shareholder, facilitating a management buyout of a company, or financing acquisitions or other business investments.[39] Congress has intentionally facilitated these uses through the ESOP's ability to shelter from income tax the principal paid on corporate debt.[40]

The ability of an ESOP to shelter from income tax both corporate cash accumulations and principal payments on business loans can reduce the cost of an acquisition no matter whether the ESOP is the principal beneficiary of the purchase or a mere partner to the transaction. Most of the time, the ESOP alone or together with management employees and/or venture funds, is used to purchase shares of retiring former owners of the sponsoring corporation. The ESOP can also be used, however, to reduce the cost of acquiring a target business by an ESOP owned purchaser or to help the sponsor purchase business assets such as real estate on a tax favored basis. Each of the various possible corporate finance transactions requires the ESOP fiduciary to make transaction specific judgments about the effect of the purchase of employer securities on participants and their beneficiaries.

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[38] 129 Cong. Rec. S16,629, S16,636 (daily ed. Nov. 7, 1993) (statement of Sen. Long).

[39] *See* Michael E. Murphy, *The ESOP at Thirty: A Democratic Perspective*, 41 WILLAMETTE L REV. 655, 664 (2005).

[40] S. COMM. ON FINANCE, 96TH CONG.,EMPLOYEE STOCK OWNERSHIP PLANS: AN EMPLOYER HANDBOOK (Comm. Print 1980). In 1996, Congress reinforced the use of ESOPs as business finance tools by allowing ESOPs to own the shares of S Corporations. *See* Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1755. This amendment to the statute allows S corporations that are owned by ESOPs to accumulate corporate cash for expansion or other business purposes without the payment of federal income tax. The extent of the ability to accumulate pretax cash depends on a number of factors, the principal of which is the percentage ownership of the S Corporation by the ESOP. State taxation of ESOP owned S Corporations varies.

[3] Employee Incentive/Productivity Tool

Like other employee benefits, sponsors use ESOPs to attract and retain employees. Unlike other employer-sponsored benefits, ESOPs can provide an incentive for employees to enhance their productivity in order to increase the value of their stock in the sponsoring company. The response by employees to the incentive produced by an ESOP depends on to what extent the sponsoring company builds an "ownership culture" around the ESOP. Many ESOP companies develop elaborate programs to involve employees in various business decisions and to communicate to employees their role as owners of the company. There is evidence that an effective employee ownership culture contributes not only to financial success but also to other desirable business goals such as workplace safety and the development of a satisfying workplace environment.[41]

ESOPs have been shown to increase productivity in various studies looking at the affects of employee ownership.[42] One study paired 1,100 ESOP companies with 1,100 comparable non-ESOP companies and compared the companies over a decade. The study found that ESOPs increase sales, employment, and sales/employee by about 2.3% to 2.4% over what would otherwise be estimated absent an ESOP.[43]

The ESOP structure may also create an environment for efficient shareholder-management relations.[44] The current corporate environment is susceptible to a disconnect between management and shareholders, commonly referred to as the separation of ownership and control.[45] As a result, shareholders are not in the best position

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[41] *See* Douglas Kruse, *Research Evidence on the Prevalence and Effects of Employee Ownership*, J. EMP. OWNERSHIP L. & FIN., Fall 2002, at 65, 69; Leon Grunberg, Sarah Moore & Edward Greenberg, *The Relationship of Employee Ownership and Participation to Workplace Safety*, 17 ECON. & INDUS. DEMOCRACY 221 (1996).

[42] *See* DOUGLAS KRUSE & JOSEPH BLASI, EMPLOYEE OWNERSHIP & CORPORATE PERFORMANCE (2004).

[43] The ESOP Association, Corporate Performance, www.esopassociation.org/media/media_corporate.asp (last visited Apr. 17, 2006).

[44] The structuring needed to create this benefit is the pass-through of voting rights to participants to elect management.

[45] Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power,* 53

to monitor management. Particularly in public companies and multi-family closely-held companies where shareholdings have passed through a number of generations shareholders are widely dispersed, have little information about the firm, and as a result are in a poor position to police management.[46] In a properly managed ESOP owned firm, workers may have substantial information, a personal stake, and the ability to organize to effectuate a change in management if necessary.[47] If the plan grants participants the right to elect management the proper incentives could be maintained.

[4] Succession, Estate Tax and Income Tax Planning for Owners

ESOPs are often used by owners of a closely held sponsoring company as part of a succession plan.[48] ESOPs allow the sponsoring company to create a market for non-public securities without selling the company to an outside buyer. An Ohio survey found that purchasing employer securities from a retiring owner was a major reason for implementing an ESOP in 58% of companies surveyed and one of the reasons for adopting an ESOP in 70% of companies.[49]

Financial return is not ordinarily the sole concern of sellers of closely held family businesses. In addition to obtaining a satisfactory financial return on the sale of a family business, owners often wish to achieve a gradual rather than immediate reduction in their control over the business they have created and nurtured. Characteristically, family business owners also have a special maternal or paternal affinity with their employees, and they do not wish to see their workforce disbanded by a buyer motivated solely by financial returns. Typically, the family business is the principal repository

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UCLA L. REV. 561, 565 (2006); Henry Hansmann, *When Does Worker Ownership Work? ESOPs, Law Firms, Codetermination, and Economic Democracy*, 99 YALE L.J. 1749, 68 (1990).

[46] Id.

[47] Id.

[48] Ninety-percent of all U.S. businesses are family-owned and controlled according to the U.S. Small Business Administration. The Ohio Employee Ownership Center, Five Commonly Used Tools to Transfer the Business, http://dept.kent.edu/oeoc/spp/FiveTools.htm (last visited Apr. 12, 2006).

[49] Murphy, *supra* note 39 at 665; *see* JOHN LOGUE & JACQUELYN YATES, THE REAL WORLD OF EMPLOYEE OWNERSHIP 193 (2001).

of the wealth of its shareholders and their relatives, and the owners often wish to diversify part but not all of their risk. An ESOP is often attractive to these family business owners because it enables them to diversify their risk, retain some control and protect their employees without the tax cost of a partial redemption or the uncertainty of introducing a new unrelated shareholder.[50]

In 1984 Congress enacted § 1042 of the Code to give selling shareholders the opportunity to defer gain on the sale of their stock to an ESOP. Under Code § 1042, the shareholder of a privately held company who sells all or a portion[51] of his stock to an ESOP may defer or avoid incurring capital gains tax on the sale by reinvesting the proceeds of the sale in securities ("qualified replacement property" or "QRP")[52] issued by a US corporation that is an operating company.[53] Tax on the gain from the ESOP sale is deferred until the QRP is sold.[54] The selling shareholder can use various sophisticated monetizing techniques to build a diversified and manageable portfolio of investment properties, some of which would not qualify as QRP while postponing the recognition of gain indefinitely. Under current law, if the taxpayer holds the QRP until his/her death, the gain on the original sale of stock to the ESOP will escape income tax entirely.[55]

The reduction of tax resulting from a properly designed ESOP transaction can help eliminate the difference between the amount that might by gained by a purely financial seller selling to an affinity buyer and the amount received by a family business seller with multiple financial and non financial goals.

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[50] In addition, it is often very difficult to find a buyer for part of a closely held business particularly when the part being sold is a minority interest. This is why business valuators apply control premiums and discounts for lack of marketability to closely held business valuations.

[51] Immediately after the transaction, the ESOP must own at least thirty-percent of the stock of the employer by vote and by value.

[52] 26 U.S.C. § 1042(c)(4). Mutual funds, certificates of deposit, securities issued by foreign corporations, interests in a real estate trust (REIT), and securities issued by governmental agency, such a treasury bonds or municipal bonds, are not considered QRP under § 1042.

[53] There are other conditions that must be fulfilled to be able to take advantage of Code § 1042.

[54] 26 U.S.C. § 1042(e).

[55] 26 U.S.C. § 1014 (The selling shareholder's heirs receive a fair market value basis in the property).

The multiple goals of the seller of a family business are not necessarily consonant with the goals of the ESOP fiduciary. This may cause serious fiduciary problems if the selling shareholder insists on functioning as ESOP trustee for the purchase transaction.

[5] Poison Pill

The share voting rules that govern ESOPs have been used as a part of a defensive mechanism to prevent hostile takeovers.[56]

ESOPs are subject to provisions of the Code that require pass through of voting rights to participants and beneficiaries on employer securities allocated to their accounts under certain circumstances.[57] The scope of those pass through voting rights depends on whether the sponsor is a closely held company or a public company.[58]

By statute, in closely held companies, pass through voting rights apply only to certain major corporate issues such as "merger or consolidation, recapitalization, reclassification, liquidation, dissolution [or] sale of substantially all of [the company's] assets."[59] A closely held company is permitted to expand the circumstances under which voting rights must be passed through. In a public company[60] the ESOP participants and beneficiaries must be entitled to direct the ESOP trustee as to how they desire to vote the employer securities allocated to their accounts on all matters requiring a vote of shareholders.[61] Giving participants the right to vote on a potential sale of employer securities may well prevent a hostile takeover or other sale of the ESOP company, if employees disapprove of a proposal that may end their jobs. Absent the ESOP, the takeover is actually a threat to management, not to shareholders. It is

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56 *See* Gina Marie Agresta-Richardson, *Employee Stock Ownership Plans: Uncertainties Plaguing the Duties of the ESOP Fiduciary with Respect to Voting and Defensive ESOPs,* 14 AKRON TAX J. 91 (1999).

57 26 U.S.C. § 409(e)(2).

58 Pass through voting rights generally apply only to securities allocated to employees' accounts. Unallocated employer securities are voted at the direction of the ESOP trustee. 26 U.S.C. § 409(e).

59 26 U.S.C. § 409(e)(3).

60 Technically, a company with a "registration-type class of securities." 26 USC 409(e)(2).

61 26 U.S.C. § 409(e)(2).

essentially a contest about who can manage the corporate assets better, and it is the managers' jobs that are at stake. In the ESOP context however, both the shareholders and the managers are concerned about their employment prospects, creating an alignment of shareholder and management interests, where normally one would find a divergence.

When an individual ESOP trustee is also related to the company in another capacity such as an officer, director or employee, there may be a tension between the trustee's fiduciary obligation and the trustee's personal best interest.

[6] Economic Development

ESOPs have been used to promote economic development for many years. Governments and other economic development organizations have used the tax leverage of ESOPs and the employee ownership of ESOP companies to help retain local jobs just as the family-owned business have used ESOPs to achieve multiple goals, including but not limited to financial goals.

For example, when the Belgian parent of Hedwin Corporation decided to sell the fifty-six year old plastic manufacturing company, many employees and others were concerned that potential buyers would reduce employment and benefits for current Hedwin employees through layoffs or by moving the company out of Maryland or out of the U.S.[62] Employees of the company sought to purchase it through an ESOP, but the total purchase price of the company exceeded the amount that the senior lender was willing to advance.[63] The transaction was ultimately completed with senior debt, subordinated debt and other financing.[64] The critical piece that enabled Hedwin Corporation to become a 100% ESOP S Corporation was a $2.5 million debt guarantee from The Maryland Industrial Development Financing Authority (MIDFA).[65] The literature and

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[62] Press Release, South Franklin Street Partners (Feb. 4, 2004), www.sfspartners.com/news.htm (last visited Apr. 12, 2006).

[63] Id.

[64] Id.

[65] Dean Storm, *Hedwin to Keep More Than 300 Local Jobs*, MD. BUS. REV., Issue Eleven 2004, at 5, *available at* www.choosemaryland.org/Resources/pdffiles/publications/MBR11.pdf.

commentary surrounding the Hedwin purchase mentions the saving of more than 300 jobs and the elimination of the threat employees faced that their benefits would be reduced. The report from the Maryland Department of Business and Economic Development attributed to Ronald J. Gilbert of ESOP Services, Inc.[66] a statement that research has shown that ESOP companies create more jobs, provide employees with more retirement benefits and are more likely to survive.[67]

Economic development is not a fiduciary responsibility of the ESOP trustee, and it will be necessary for the trustee to analyze the economic development transaction as it is likely to affect the interests of plan participants and their beneficiaries.

Each of these corporate uses of ESOPs may conflict with the duty of the ESOP trustee to enhance and protect the retirement benefits of plan participants and their beneficiaries and create the conundrums that confront the ESOP trustee in the many different transactions in which the ESOP is a useful tool. For the prudent expert ESOP trustee, the guess must be informed and well considered, but there is no certain answer. Other parties may need only to be satisfied with the benefits of their own bargains, but the ESOP trustee has the unique obligation to discharge the fiduciary obligations of ERISA.

§ 9.03 THE PRUDENT EXPERT: "THE HIGHEST FIDUCIARY OBLIGATION KNOWN TO LAW"

It is not happenstance that the application of ERISA fiduciary standards must be pondered in each instance. It is by design that there are no safe harbors in this law. The judicial gloss and administrative patina that have articulated the fiduciary obligations of ERISA over the past thirty-two years have set a standard for the analysis of any transaction that requires a thorough, independent, informed and orderly decision that each specific transaction is in the best interest of participants and their beneficiaries. This is the same for ESOPs as it is for more pedestrian decisions about retirement plan funding. The added complexity and the multiple parties to the ESOP transaction are what make the ESOP trustee's task more difficult.

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[66] Mr. Gilbert was a principal planner in the transaction.

[67] Storm, *supra* note 65 at 6.

Fiduciary duties under ERISA have been characterized as the "highest known to law."[68] An ESOP Trustee must observe the ERISA standard of care that requires the fiduciary to discharge his duties, "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."[69] This standard is derived from "the prudent person test as developed in the common law of trusts," but it has been modified so that the standard is required to be applied in light of "the special nature and purpose of employee benefit plans."[70] Courts and commentators have come to call the ERISA standard one of a "prudent expert."[71] In lay terms, it is not enough that the trustee acted with a pure heart and an empty head.[72] Therefore, an ERISA fiduciary's relative unfamiliarity with a certain transaction is no excuse for failure to meet its obligation to participants and beneficiaries, even if the fiduciary acted in good faith.[73]

The traditional operation of the business judgment rule (BJR) resembles the common law test of subjective good faith, in that it presumes that directors' decisions are honest, well-intended, and informed. This presumption acts as an abstention doctrine which precludes the court from reviewing the substance of the director's decisions absent fraud, illegality or self-dealing.[74] Attempting to

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[68] Donovan v. Bierwirth, 680 F.2d 263, 272 (2nd Cir. 1982); Reich v. Valley Nat'l Bank of Ariz., 837 F. Supp. 1259, 1273 (S.D.N.Y. 1993).

[69] ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B). *See also* Fiduciary Responsibility Under the Employee Retirement Income Security Act of 1974, Investment Duties, 29 C.F.R. § 2550.404a-1 (2006).

[70] Donovan v. Mazzola, 716 F.2d 1226, 1231 (9th Cir. 1983). Although the ERISA fiduciary obligations are derived from the common law of trusts, the court in *Varity* stated, "ERISA's standards and procedural protections partly reflect a Congressional determination that the common law of trusts did not offer completely satisfactory protection." Varity Corp. v. Howe, 516 U.S. 489, 497 (1996).

[71] *E.g.*, Robert J. Aalberts & Percy S. Poon, *The New Prudent Investor Rule and the Modern Portfolio Theory*, 34 AM. BUS. L.J. 39, 45 (1996). *But see* Donovan v. Cunningham, 716 F.2d 1455, 1467 (5th Cir. 1983) (stating that the "prudent expert" standard does not provide for the flexibility intended by Congress when enacting section 404).

[72] Id.

[73] Katsaros v. Cody, 744 F.2d 270, 279 (2d Cir. 1984).

[74] Stephen Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND L. REV. 83 (2004).

reap the benefits of such a deferential standard of review, ESOP fiduciaries have argued that the BJR is the correct standard to be applied when their conduct is subject to second-guessing.[75] Courts, however, have consistently held that the business judgment rule is inappropriate when analyzing whether an ERISA fiduciary's conduct was proper in the context of section 404.[76]

Although it is true that that traditional abstentionist model of the BJR may be too deferential for ERISA fiduciary litigation, the modern BJR which operates more as a standard of substantive liability, which only frees directors from second guessing if they acted consistently with their fiduciary duties of good faith, loyalty, and due care[77] resembles the approach taken by courts in deciding ERISA fiduciary breach cases. When deciding whether or not an ESOP trustee breached its fiduciary obligation, courts tend to focus on three issues: (1) whether the trustee was independent or free from a conflict of interest; (2) whether the trustee acted with the exclusive purpose of providing benefits (duty of loyalty), and (3) whether such a decision was reached using the appropriate investigatory methods (prudent expert).[78] Where the court has answered in the affirmative to these three questions it has deferred to the trustee's judgment.[79]

In some sense, unlike the subjective determination of good faith under the common law, the test for prudence under ERISA's standards is measured objectively. The inquiry into whether the transaction was prudent requires the court to answer the following question: "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?"[80] Prudence is measured at the time the transaction

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[75] Howard v. Shay, 100 F.3d 1484, 1489 (9th Cir. 1995); Donovan v. Mazzola, 716 F.2d 1226, 1231 (9th Cir. 1983).

[76] Id.

[77] Bainbridge, *supra* note 74.

[78] *See e.g.,* Keach v. U.S. Trust Co., 313 F. Supp. 2d 818 (C.D. Ill. 2004); Andrade v. Parsons Corp., No. CV 85-3344-RJK, 1990 U.S Dist. LEXIS 14932 (C.D. Ca. 1990); Thompson v. Avondale Industries Inc., No. 99-3439, 2003 U.S. Dist. LEXIS 2318 (E.D. La. 2003).

[79] *E.g.*, Andrade v. Parsons Corp., 1990 U.S Dist. LEXIS 14932 (C.D. Ca. 1990).

[80] Wright v. Oregon Metallurgical Corp, 360 F.3d 1090, 1097 (9th Cir. 2004); Flanigan v. General Elec. Co., 242 F.3d 78, 86 (2d Cir. 2001); Katsaros v. Cody, 744 F.2d 270, 279 (2d Cir. 1984); Donovan v. Mazzola, 716 F.2d 1226, 1232 (9th Cir. 1983).

was entered into, and the subsequent success or failure of the decision has no theoretical bearing on a finding of prudence so long as the fiduciary's investigation was sufficient.[81] However, an investigation into a transaction for which the trustee is inexperienced, even if highly thorough and undertaken in good faith will not satisfy the prudence requirement. This is where the distinction between the prudent expert and the prudent person is most apparent. For if the ERISA Trustee does not have the requisite knowledge to analyze the transaction it is his responsibility to seek outside advice from an expert.[82]

[1] Reliance on the Advice of an Expert

Because the ESOP trustee is held to the standard of a "prudent expert,"[83] it is not sufficient for the ESOP trustee to make a decision based solely on good faith unless that decision was the result of a reasonable investigation.[84]

If an ERISA trustee lacks the expertise required in making the determination at hand, the trustee is obligated to obtain the assistance of an expert.[85] The failure to obtain the assistance of an expert is a violation of the duty of prudence. In *Donovan v. Bierwith*, an ESOP purchased employer securities based purely on the decision of the ESOP's Trustees.[86] The court reviewed the Trustees' decision by reviewing the inquiries and investigations the Trustees made prior to deciding to purchase the employer securities.[87] In the absence of any evidence of an investigation, the court held the ESOP trustees breached their duty of prudence because they failed to acquire the advice of legal counsel or to make any investigation

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[81] Marshall v. Glass/Metal Assoc. & Glaziers & Glassworkers Pension Plan, 507 F. Supp. 378, 384 (D. Haw. 1980) ("The application of ERISA's prudence standard does not depend upon the ultimate outcome of an investment, but upon the prudence of the fiduciaries under the circumstances prevailing when they make their decision and in light of the alternatives available to them."); Keach v. U.S. Trust Co., 419 F.3d 626, 638 (7th Cir. 2005) ("ERISA requires prudence, not prescience.").

[82] *Katsaros*, 744 F.2d at 279.

[83] Aalberts & Poon, *supra* note 71.

[84] *See* sources cited *infra* note 80.

[85] *Katsaros*, 744 F.2d at 279.

[86] Donovan v. Bierwirth, 680 F.2d 263 (2d Cir. 1982).

[87] Id. at 273.

into the underlying facts.[88] The ESOP trustees made no attempt to obtain the assistance of an expert and the result was therefore predictable. However, the court specifically noted that it did not intend to suggest that engaging independent legal counsel and following their advice would have operated as a complete "white-wash."[89]

The courts have established that even where an expert is retained to provide assistance to the ESOP trustee, the ESOP trustee must still exercise its own independent judgment regarding the issue at hand.[90] In the absence of such independent judgment courts have routinely found a breach of fiduciary duty.[91] The circumstance in which the ESOP trustee finds himself challenged most often is where he is involved in a purchase of employer securities by an ESOP from a party in interest. In this context it is imperative that the ESOP pay only "adequate consideration" for the employer securities purchased.[92] This requires a good faith determination by the ESOP trustee that the purchase price is no more than fair market value.[93] It is clear that the failure of the ESOP trustee to analyze and consider the fair market value, whether with or without expert assistance is considered a breach of fiduciary duty.[94] However, as

[88] Id. at 272.

[89] Id.

[90] Id.; Chao v. Hall Holding Co., 285 F.3d 415, 430 (6th Cir. 2002); Howard v. Shay, 100 F.3d 1484, 1489 (9th Cir. 1996).

[91] *Hall Holding*, 285 F.3d at 437; *Howard*, 100 F.3d at 1490.

[92] ERISA § 408(e)(1), 29 U.S.C. § 1108(e)(1).

[93] ERISA § 3(18)(B), 29 U.S.C. § 1002(18)(B). ERISA defines "adequate consideration" as "the fair market value of the asset 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 [of Labor]." Id. There is a circuit split as to the appropriate test for adequate consideration. The 8th circuit has determined that even if an ESOP trustee fails to make a good faith effort to determine the FMV of the stock, "he is insulated from liability if a hypothetical prudent fiduciary would have made the same decision anyway." Roth v. Sawyer-Cleator Lumber Co., 16 F.3d 915, 919 (8th Cir. 1994); Herman v. Mercantile Bank, 143 F.3d 419, 422 (8th Cir. 1998). The Sixth circuit declined to follow this approach and held that a good faith determination is a requirement for a finding of adequate consideration. Chao v. Hall Holding Co., 285 F.3d 415, 437 (6th Cir. 2002). Note also that the services of an independent evaluator are generally required.

[94] In *Eyler v. Commissioner*, the court found that the ESOP fiduciary may have

the court indicated in *Donovan v. Bierwith*, it is also a breach of fiduciary duty for the ESOP trustee to rely solely on expert advice without more.[95]

Even when independent valuations are not required, many ESOP trustees obtain them to assist in making a determination of the fair market value of employer securities, and many would argue that such information should shield the ESOP trustee from potential liability. The courts have rejected this argument and held that ESOP trustees cannot rely on an independent appraisal or opinion without reviewing its basis and determining whether the appraisal may be missing information or be otherwise deficient.[96] The ESOP trustee relying on the report of an expert must "evaluate the report, ask the kinds of questions that a sophisticated investor would ask, assess the quality of the response, and ultimately make a judgment whether or not it is prepared to rely on that valuation."[97] The court in *Donovan v. Cunningham* stated, "[a]n independent appraisal is not a magic wand that fiduciaries may simply wave over a transaction to ensure that their responsibilities are fulfilled. . . . [A]s the source of the information upon which the experts' opinions are based, the fiduciaries are responsible for ensuring that the information is complete and up-to-date."[98]

This level of review is not confined to valuations, and is required for all experts, even if the expertise is not fact based. In *Donovan v. Mazzola*, the trustees of a pension plan attempted to argue that a decision made regarding an expenditure was prudent because the trustee relied on the advice of counsel.[99] The court refuted this

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breached his duty of prudence by failing to seek independent information on the fair market value of shares to be purchased by the Company ESOP. 88 F.3d 445 (7th Cir. 1996). Instead of seeking the assistance of an expert, the board relied upon an old valuation letter that was based on outdated assumptions. Id. at 456.

[95] Donovan v. Bierwirth, 680 F.2d 263, 272 (2d Cir. 1982).

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

[97] Henry v. Champlain Enterprises, 334 F. Supp. 2d 252, 272 (N.D.N.Y. 2004).

[98] *Cunningham*, 716 F.2d at 1474. *See also* Correspondence on Proposed Leveraged Buy-Out of Blue Bell, Inc., 12 Pens. & Ben. Rep. (BNA) 52 (1985) (Department of Labor states that an opinion of fairness obtained from Houlihan Lokey Howard & Zukin provided a "less than adequate basis for the decisions facing the fiduciaries of the Plan," because Houlihan's analysis failed to apply the appropriate weight to the facts involved. The DOL believed an opinion of an investment broker was more appropriate.) Id. at 53.

[99] Donovan v. Mazzola, 716 F.2d 1226, 1234 (9th Cir. 1983).

argument stating that "reliance on counsel's advice without more cannot be a complete defense to an imprudence charge."[100]

The prudence requirement does not require that every decision an ESOP trustee makes must result in the best of all consequences. Instead, the focus of the court in reviewing ESOP trustee decisions is on the process applied by the ESOP trustee in reaching the final decision. In *Donovan v. Cunningham*, the court explained that the test of whether a Trustee's decision was prudent "is one of conduct and not a test of the result of performance of the investment."[101]

One decision the ESOP trustee makes on a fairly consistent basis is a determination of whether the stock price of employer securities held by an ESOP is reasonable and accurate given the facts and circumstances then existing. Notwithstanding the assistance of an expert, the ESOP trustee should review the valuation report, ask questions about the report, review the approaches of the valuator look over the type and variety of methodologies applied by the valuator and be aware of other information that may affect the valuation such as the solvency of the company and the repurchase liability and funding needs of the ESOP. With this kind of review and evaluation of the expert's recommendation, the independent ESOP trustee will be shielded from a claim of imprudence as long as that process is adequately documented.

[2] Making the Record

Given the importance of the process involved in reaching prudent fiduciary decisions, it is just as important to ensure that the process is adequately documented. Absent the appropriate paper trail evidencing conversations, documents reviewed, questions asked, and decisions made, when an ESOP trustee's procedure is questioned the court has little choice but to hold that the ESOP trustee failed to act prudently based on the evidence, or lack thereof.

In *Henry v. Champlain Enterprises*, the court found the ESOP trustee failed to provide sufficient documentation of the actions they argued were taken in reaching a good faith determination of fair value.[102] U.S. Trust, a highly respected independent trustee was

[100] Id.

[101] *Cunningham*, 716 F.2d at 1467. *See also* Laurence B. Wohl, *Fiduciary Duties under ERISA: A Tale of Multiple Loyalties*, 20 DAYTON L. REV. 43 (Fall 1994).

[102] Henry v. Champlain Enterprises, 334 F. Supp. 2d 252 (N.D.N.Y. 2004).

retained to act as the ESOP trustee for a transaction involving an ESOP's purchase of employer securities.[103]

The ESOP trustee was later sued by participants of the ESOP alleging the plan paid more than adequate consideration for the purchase of convertible preferred stock from the owners of CommutAir.[104] The court's review of the case focused on whether the ESOP trustee "employed the appropriate methods" to investigate the merits of the particular transaction.[105] Although the ESOP trustee, U.S. Trust, hired an independent valuation firm and legal counsel the court held that U.S. Trust "failed to engage in a good faith investigation" because it was unable to present any documentary evidence that a good faith investigation was undertaken.[106] The only evidence of an investigation presented to the court was small notes and oral recollections. There was no written record of the "comments, assessments, and questions posed" during the process.[107] *Henry v. Champlain Enterprises* illustrates the importance of a paper trail in ESOP transactions. It is simply insufficient for an independent prudent expert fiduciary to go through the process of a good faith inquiry if that process is not well documented.

[3] Prudent Expert and Independence

In addition to implementing the appropriate procedure, to be entitled to deference for substantive decisions, the ESOP trustee must also be independent and free from any conflicts of interest. Courts are more suspicious of fiduciaries with dual loyalties, and as a result have subjected them to a less deferential standard of review by considering their conduct under a "heightened standard of care."[108] Specifically, "[w]hen it is possible to question the fiduciaries' loyalty, they are obliged at a minimum to engage in an intensive and scrupulous independent investigation of their

[103] Id. at 261.

[104] Id. at 255.

[105] Id. at 271 (citing *Katsaros*, 744 F.2d at 279).

[106] Id at 271.

[107] Id. at 273.

[108] Newton v. Van Otterloo, 756 F. Supp. 1121, 1129 (N.D. Ind. 1991).

options to insure that they act in the best interest of the plan beneficiaries."[109]

Courts and the DOL have consistently taken the position that an independent fiduciary, or the use of independent advice is a wise decision and in some circumstances required where a significant conflict of interest is present.[110] In such a situation, if the conflicted fiduciaries choose not to resign they will bear a heavy burden to establish they were in compliance with ERISA's fiduciary rules, and as a result would be held to a higher level of conduct.[111]

In this context, for example, a selling shareholder who insists on functioning as trustee in connection with an ESOP's purchase of his own shares is embarking on a very dangerous path. It is not so clear, but it may also be dangerous for other inside trustees whose fiduciary duty to participants and beneficiaries may be compromised by their status as an employee, director or creditor or by another relationship with the sponsor or the selling shareholder.

§ 9.04 BALANCING SELECTED SUBSTANTIVE PRINCIPLES

The principles governing fiduciary conduct for ERISA plans are derived primarily from Title I of ERISA.[112] Each principle taken individually may seem reasonably clear in its application, however when the rules must be applied collectively it is often the case that the individual rules do not work well together. The trustee's responsibility with respect to a transaction or decision is not normally evident simply by examining the applicable principles. In the ESOP fiduciary legal framework those principles that are

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[109] Howard v. Shay, 100 F.3d 1484, 1488 (9th Cir. 1996); Leigh v. Engle, 727 F.2d 113, 125–26 (7th Cir. 1984). *See also* Firestone Tire & Rubber Co. v. Bruch, 489 U.S. 101, 115 (1989) ("Of course if a benefit plan gives discretion to an administrator or fiduciary who is operating under a conflict of interest, that conflict must be weighed as a factor in determining whether there is an abuse of discretion.").

[110] *E.g.,* Leigh v. Engle, 727 F.2d 113, 122 (7th Cir. 1984); Donovan v. Bierwirth, 680 F.2d 263, 273 (2d Cir. 1982); Danaher Corp. v. Chicago Pneumatic Tool Co., 635 F. Supp. 246, 250 (S.D.N.Y. 1986); DOL Letter Regarding Proposed Buy-Out of Raymond International, Inc., 11 Pens. & Ben. Rep. (BNA) 1464, 1495 (Sep. 12, 1983).

[111] *See Bierwirth*, 680 F.2d 263.

[112] ERISA §§ 2-734, 29 U.S.C. §§ 1001–1191.

supposed to act as a guide for ERISA fiduciaries, often simply establish a continuum along which action may be judged.

[1] The Exclusive Benefit Rule v. The Incidental Benefit Rule

The ESOP trustee must "discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and for the exclusive purpose of providing benefits to participants and their beneficiaries."[113] This statutory language has been condensed into what is commonly known as the "exclusive benefit" rule and is ERISA's enunciation of the duty of loyalty found in the common law of trusts.[114] This rule requires a fiduciary to make decisions with "an eye single to the interests of the participants and beneficiaries."[115] A common law trust is different from an ERISA trust, so the traditional duty of loyalty does not quite fit the ERISA context. In the conventional sense a trust is a gratuitous transfer in which only the donees benefit.[116] An ERISA trust however, not only provides benefits to the plan's participants, but also incidentally to the employer, to selling shareholders and possibly to others, particularly in ESOP transactions.[117] The fact that an ESOP is intended to be used as a tool in many financial and non financial circumstances that must necessarily benefit multiple parties[118] makes it very difficult to apply the exclusive benefit rule to ESOP transactions within the plain meaning of the words. The ESOP fiduciary must indeed be guided by a single minded insistence that the decision to participate in a given transaction be made solely

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[113] ERISA § 404(a)(1), 29 U.S.C. § 1104(a)(1).

[114] JOHN LANGBEIN & BRUCE A. WOLK, PENSION AND EMPLOYEE BENEFIT LAW 649 (2d ed. 1995).

[115] *Bierwirth*, 680 F.2d at 271.

[116] John H Langbein, *The Conundrum of Fiduciary Investing Under ERISA*, in PROXY VOTING OF PENSION PLAN EQUITY SECURITIES 129 (Dan M. McGill ed., 1989).

[117] Notwithstanding the belief of some sponsors, the ESOP does not result from a gratuitous transfer. It is considered a part of an overall benefit plan that substitutes in some measure for the direct payment of wages. Trustees have a duty to avoid new, speculative, hazardous or unwise investments that would jeopardize the employees indirect wage contribution.

[118] See discussion *supra* section 9.02 regarding the multiple goals and uses of ESOPs.

on the basis of the likely return to participants and their beneficiaries, but in reality the fiduciary need not insist that the ESOP participants be the exclusive beneficiary of the transaction.

Like the fiduciaries of pure retirement plans, the ESOP trustee must act in the interest of all participants. This is often described as the duty of impartiality,[119] and effectively requires the ESOP trustee to consider the participants' interests in the aggregate without favoring any one particular group.[120] This requirement, like the duty of loyalty, can be difficult in its application. It assumes that a fiduciary can somehow ascertain what is best for all of the participants collectively. This does not reflect the complicated reality of the situation. As time passes the participant pool comes to consist of people with diverse interests, the most obvious example being current employees and retirees.

Courts have recognized that even with respect to fundamental loyalty and impartiality requirements, officers and employees who are also trustees may take actions that provide incidental benefits to the sponsoring company or themselves, so long as prudent investigatory measures were taken to determine the beneficial effect the action will have on the participants and beneficiaries.[121] To facilitate operations of ERISA plans in the actual world of commerce, Congress and the courts have transformed the common law "exclusive benefit" into an "impartial primary benefit rule" under which the fiduciary may allow others including management, investment bankers, town, states, governors and employees to receive their fair benefit from a proposed transaction if he is convinced by impartial, informed and diligent inquiry that participants will receive the benefit of their own bargain.

This is how the fiduciary must make inquiry into transactions like Hedwin discussed previously.[122] The decision is made with foresight, not with hindsight, so even if the sponsor ultimately fails, as the Weirton Steel ESOP did after twenty years due to

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[119] LANGBEIN & WOLK, *supra* note 114 at 650.

[120] This obligation is similar to the common law trust obligation to balance the interests of income beneficiaries with those interested in the remainder.

[121] Donovan v. Bierwirth, 680 F.2d 263, 271 (2d Cir. 1982).

[122] *See infra* note 65 and text accompanying note 65.

international market forces, the ESOP fiduciary will have performed according to the obligations required by ERISA.[123]

[a] *Financial Benefit v. Social Benefit*

Much has been written in academic circles about social investing by pension plans.[124] In the context of ERISA, social investing is a controversial topic because the term presupposes that the investment entered into for social purposes is inferior to other alternatives, otherwise free market forces would gravitate the fiduciary towards the investment notwithstanding its purported social benefit.

For pension benefit plans, generally, apprehension about using plan assets to pursue a social cause[125] at the expense of the participants' retirement income security is understandable. For ESOPs the situation is much more complicated. Not only does the sponsoring company employ participants, but they are also part owners of the sponsoring company. Due to an ESOP's unique nature, from the participants' perspective, the fiduciary should be able to consider the participants' job security as well as their retirement income security. After all, job security and retirement income security are closely intertwined. Job loss usually means loss of future retirement benefits accruals. The courts, the IRS[126] and the DOL have refused to acknowledge this reality in their examination of the fiduciary responsibilities.[127]

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[123] See the somewhat polemical treatment of the Weirton Steel failure, John D. Russell, *Lessons from the Recent Failure of Weirton Steel's ESOP*, LABOR NOTES, May 2004, www.labornotes.org/archives/2004/05/articles/f.html (last visited April 24, 2006).

[124] *E.g.*, John H. Langbein & Richard A. Posner, *Social Investing and the Law of Trusts*, 79 MICH. L. REV. 72 (1980); Ronald B. Ravikoff & Myron P. Curzan, *Social Responsibility in Investment Policy and the Prudent Man Rule* 68 CAL L. REV. 518 (1980); Maria O'Brien Hylton, *"Socially Responsible" Investing: Doing Good Versus Doing Well in an Inefficient Market*, 42 AM. U. L. REV. 1 (1992).

[125] There was a trend in the 80's to divest pension funds from corporations that did business in South Africa to protest apartheid. *See* Joel C. Dobris, *Arguments in Favor of Fiduciary Divestment of "South African" Securities*, 65 NEB. L. REV. 209 (1986).

[126] Although the IRS is generally concerned with plans from a tax perspective, both the IRS and the DOL contribute to the dialogue regarding ERISA fiduciary conduct. *See* I.R.S. Gen. Couns. Mem. 39,870 (January 23, 1992).

[127] *See* Fischel & Langbein, *supra* note 6 at 1141; Danaher v. Chicago Pneumatic Tool Co., 635 F. Supp. 246, 250 (S.D.N.Y. 1986).

The DOL, IRS, and the courts have taken the position that ESOP fiduciaries must consider the interests of plan participants solely in their capacities as participants in a plan providing retirement benefits.[128] The DOL has opined that only when two possible courses of action are economically equivalent may a fiduciary take into consideration social factors.[129] This is what has been referred to as costless social investing.[130]

The fiduciary action required by this position is raised very interestingly in the context of a tender offer to an ESOP. The DOL and the IRS issued a joint statement that opines that a fiduciary is not automatically required by ERISA to tender shares when a cash tender offer is made at a premium over market price.[131] Instead the fiduciary must balance the value of the tender offer against the intrinsic value of the target and the likelihood that the value will be realized.[132] Presumably the entity that made the tender offer arrived at its tender price through an evaluation of the intrinsic value of the target and the likelihood that such a value will be realized. Therefore, it is likely that in many situations, assuming both parties have valued the target properly, the decision of whether or not to tender will be economically equivalent and that the fiduciary may consider the job security of the participants, and allow the intrinsic value of the company to come to full fruition by holding on to the stock. Given the difficulty of determining whether two alternatives are economically equal, the deference given to procedurally prudent and independent fiduciaries should provide some level of comfort in decision-making.

The Seventh Circuit has decided that consideration of participants' job security offends the impartiality prong of the exclusive

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[128] *E.g.* DOL/IRS Joint Statement, 16 Pens. & Ben. Rep. (BNA) 215 (1989); Danaher, 635 F. Supp. at 250 ("[T]he trustees must discharge their duties by evaluating the best interests of beneficiaries in the abstract as beneficiaries.").

[129] Ian D. Lanoff, The *Social Investment of Private Pension Plan Assets: May It Be Done Lawfully Under ERISA?* 31 LABOR L. J. 387 (1980); DOL Interpretive Bulletin 94-1, 59 Fed. Reg. 32,606, 32,608 (June 23, 1994) (codified at 29 C.F.R. § 2509.94-1).

[130] LANGBEIN & WOLK, *supra* note 114 at 777.

[131] DOL/IRS Joint Statement, 16 Pens. & Ben. Rep. (BNA) 215 (Jan. 31, 1989). The DOL has reiterated this position, *see e.g.* DOL letter to Ian D. Lanoff Regarding Pass-Through Voting Provisions in Collectively Bargained ESOPs, 22 Pens. & Ben. Rep. (BNA) 2249 (Sep. 28, 1995).

[132] Id.

benefit rule because it favors currently employed participants over retired participants, and new employees over older employees who may be more likely to keep their jobs after a successful takeover.[133] Presumably, in the unlikely special case where the ESOP covered only fully vested current employees all of whom began work on the same day the trustee would be free to take into account participants' job security.

In economic terms, the benefits of social investing are as real as monetary investment benefits.[134] One can imagine a situation where a tender offer is pending for a corporation that is the largest employer in an economically depressed small town. The acquiring corporation has expressed a desire to shut down the company upon a successful takeover. Even a diverse participant pool may be united in their interest to resist the tender and preserve the town. Should the trustee be able to consider the consumption of this social benefit in addition to any financial benefit that will be realized in the event of a successful tender?

The IRS has taken the position that the consideration of employment-related factors in response to a tender offer violates the exclusive benefit rule, and the prudent man standard of care.[135] The IRS acknowledged the unique nature of ESOPs but held that although they may be exempt from the diversification requirement and certain prohibited transactions, they are not exempt from the anti-diversion rule of § 401(a)(2).[136] The IRS also determined that the consideration of employment-related factors would run afoul of the prudent expert rule because it "could sway the trustee to reject tender offers that otherwise would be acceptable had the decision rested solely on financial criteria."[137]

In each circumstance the ESOP trustee must answer only the factual question whether current participants and retires will get the

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[133] *See, e.g.*, Summers v. State St. Bank & Trust Co., 104 F.3d 105, 108 (7th Cir. 1997).

[134] Langbein & Posner, *supra* note 124 at 107.

[135] I.R.S. Gen. Couns. Mem. 39,870 (January 23, 1992).

[136] Treasury Regulation § 1.401-2(a)(3) prevents the trustee from considering "objects or aims not solely designed for the proper satisfaction of all liabilities to employees or their beneficiaries covered by the trust." 26 C.F.R. § 1.401-2(a)(3) (2006).

[137] I.R.S. Gen. Couns. Mem. 39,870 at 7.

financial benefit of their retirement investment in the ESOP. This is a question that has no generalized answer. It is the question that the ESOP fiduciary must answer *ex ante,* however, in each individual case.

This conclusion seems peculiar given the background and legislative history of ESOPs. At least two presidents of the United States have touted the value of employee ownership.[138] Many other commentators have noted the social benefit ESOPs have brought by encouraging employee ownership.

"With few exceptions, the [American economic] system works like this: capital hires labor and capital claims ownership of the final product. Can one imagine an economy in which labor hires capital? Where workers have a legal right to the profits and legal responsibility for the liabilities because they are the owners, where workers jointly manage the firms and themselves in a democratic fashion?"[139] This working environment has become a reality for millions of Americans. Employee ownership has experienced enormous growth since 1974 when Congress created tax advantages for companies establishing ESOPs, to the point where every twelfth American worker employed in the private sector is a participant in an ESOP.[140]

When enacting the ESOP legislation, Congress stated that it was designed to achieve three goals; (1) *to broaden the ownership of corporate stock*, (2) to encourage capital formation, and (3) to

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138 Former President Ronald Reagan, Address in Gdansk, Poland (Sept. 15, 1990) (". . .Meanwhile, what about the workers in those state monopolies that are being put up for sale? I am reminded of a technique for employee ownership that has worked well for many U.S. companies. It goes by various names but the best known is 'Employee Stock Ownership Program' or 'E.S.O.P'. . . The workers, as owners, make sure by insisting that unprofitable or obsolete products be replaced by new ones; that operating costs be kept down; and that new efficiencies of operation are adopted. In the U.S. we have seen it happen time and again."); President George W. Bush (June 17, 2004) (". . .if you own something, you have a vital stake in the future of our country. The more ownership there is in America, the more vitality there is in America, and the more people have a vital stake in the future of this country.")

139 John Logue & Jacquelyn Yates, THE REAL WORLD OF EMPLOYEE OWNERSHIP xiii (2001) (this book provides an in depth look at the employee ownership situation in Ohio, and discusses, among other things, studies which have shown increased productivity when employee ownership is combined with participation).

140 Id. at 1.

improve corporate performance.[141] At least one commentator has argued that these purposes should affect the manner in which the fiduciary duties are discharged, "[s]ince prudence is defined with reference to 'the conduct of an enterprise of a like character and with like aims,' and since the purpose of an ESOP is not only pecuniary gain but also ongoing ownership by participants and beneficiaries, the trustee should not be obligated to sell employer securities in most circumstances."[142]

The intent of Congress clearly contemplates some degree of social investing, at least with respect to keeping the stock in the hands of the ESOP participants. Under the cases and other formal guidance, however, it is clear that the ESOP trustee may participate in ventures that serve other purposes only if the trustee determines that the venture will enhance the retirement benefits of participants and their beneficiaries.

[2] Adequate Consideration v. Fairness in an ESOP Leveraged Buyout

Using an ESOP to effect a corporate buyout often requires the cooperation of a group of investors including the ESOP trustee, each attempting to gain an advantage, whether it be preferential purchase price, rate of return, or increased ownership attributes.[143] At a minimum, the parties to an leveraged buyout include, the ESOP, the sponsoring company, and the lender, however it is also common for the company's management and outside investors to participate in the transaction.[144] Absent the requirements of ERISA, the parties would freely negotiate and come to terms based on the risk the party is willing to undertake, and the rate of return with which each party is satisfied.

The legal commentary surrounding ERISA's requirement that the ESOP pay no more than adequate consideration for the stock it

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[141] Id. at 16; U.S. General Accounting Office, *Initial Results of a Survey on Employee Stock Ownership Plans and Information on Related Economic Trends* 5 (Sept. 30, 1985) (emphasis in text added).

[142] Arthur H. Kroll, *Dilemmas Facing ESOP Fiduciaries*, *in* ERISA FIDUCIARY LAW 201, 204 (Susan P. Serota ed., 1995).

[143] Richard C. May & Robert L. McDonald, *Valuation Issues in Multi-Investor ESOP LBOs*, in LEVERAGED ESOPS AND EMPLOYEE BUYOUTS 98 (Scott S. Rodrick ed., 2000).

[144] Id.

purchases[145] operates to constrain at least the words used to describe free market negotiations involving the ESOP. Theoretically, of course, the adequate consideration legal requirement cannot actually constrain price negotiations since any party including the ESOP would presumably walk from the transaction if it did not think it was to receive adequate consideration. It is more likely in the world of imperfect information that the adequate consideration doctrine simply gives the ESOP trustee some additional bargaining power.

The basic rules for determining adequate consideration are straightforward and reflective of fundamental economic principles. Where the stock to be purchased is publicly traded, adequate consideration is determined by the price prevailing on the national securities exchange.[146] In the case of a closely-held corporation, adequate consideration is "the fair market value of the asset 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 [of Labor]."[147] The proposed regulations, which are consistently followed, provide a two-part test for determining adequate consideration for the stock of a closely held company:

1. The consideration must reflect fair market value. "Fair market value" is the price at which the asset would change hands between a willing buyer and willing seller if neither party is under any compulsion to enter into the transaction and both are well informed about the asset and the market for the asset. The value of the asset must be determined as of the date of the transaction involving the asset, and must be reflected in written documentation that summarizes the qualifications of the appraiser and the factors taken into account in valuing the assets.

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[145] ERISA § 406(a)(1)(A), 29 U.S.C. § 1106(a)(1)(A) provides that the sale, exchange, or leasing of any property between the plan and a party in interest constitutes a prohibited transaction. This section would prevent an ESOP from buying stock from the sponsoring corporation or any other party in interest; however ERISA § 408(e), 29 U.S.C. § 1108(e) authorizes the purchase of qualifying stock of the employer if it is for adequate consideration.

[146] ERISA § 3(18), 29 U.S.C. § 1002(18).

[147] Id.

2. The valuation must be made in good faith. The good faith standard requires prudent investigation of prevailing circumstances, the application of sound business principles of evaluation, and independence on the part of either the fiduciary making the valuation or the appraiser on whom the fiduciary relies.[148]

The position taken by the DOL regarding adequate consideration in individual transactions has not reflected the theoretical integrity of the proposed regulations. When applying the adequate consideration principles to complex multi-investor leveraged buyouts the Department of Labor has consistently taken the position that the ESOP must pay no more, dollar for dollar, than any other party to the transaction.[149] This simply means that if the ESOP invests sixty percent of the total dollars invested, it should receive sixty percent of the equity received by the parties in the buyout. There is a tension between the standard the DOL tries to apply in individual cases and the economic reality reflected in the regulations.[150]

Oddly, three of the first and most well known adequate consideration challenges posed by the DOL were leveraged buyouts where Louis Kelso, the individual credited with inventing ESOPs, was one of the investors.[151] The Labor Department's response to the proposed Blue Bell leveraged buy-out represents the iconic expression of the DOL's view. The DOL challenged the Blue Bell transaction on the basis of the relative fairness of the transaction to the ESOP, particularly focusing on the trustee's duty of prudence

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[148] Proposed Regulation Relating to the Definition of Adequate Consideration, 53 Fed. Reg. 17,632 (May 17, 1988) (to be codified at 29 C.F.R. pt. 2510).

[149] Reich v. Valley Nat'l Bank of Ariz., 837 F. Supp. 1259 (S.D.N.Y. 1993).

[150] Note that the reduction in the net worth of the sponsor due to the debt-funded purchase of employer securities by the ESOP is required by generally accepted accounting principles. These principles are not relevant to the theoretical proposition that the employees have actually incurred a "debt" that they must amortize with their benefit payments to the ESOP in lieu of salary. This may be the origin of the difference between the DOL position and economic reality.

[151] Correspondence on Proposed Leveraged Buy-Out of Blue Bell, Inc., 12 Pens. & Ben. Rep. (BNA) 52 (1985); Correspondence on Proposed Leveraged Buy-Out of Scott & Fetzer Co., 12 Pens. & Ben. Rep. (BNA) 1182 (1985); DOL Letter Regarding Proposed Buy-Out of Raymond International, Inc., 11 Pens. & Ben. Rep. (BNA) 1494 (1983).

and obligations regarding adequate consideration.[152] The DOL contended that a prudent investor would not agree to terms that are unfavorable with respect to the other parties. Also, that the determination of adequate consideration involves viewing the transaction as if the parties were at arm's length[153] and an arm's length party would not agree to terms less favorable than others to the transaction. In Blue Bell, the institutional investors received 36% of the common stock for $62.6 million, whereas the plan received only 32.8% for its larger investment of $67 million.[154] The DOL did qualify its position, stating that if this discrepancy was justified based on relative risk then it may past muster.[155] The management group's equity allocation was considerably more disproportionate; $9 million for 24.6% of the common stock. The DOL recognized the need to provide management with incentives; however, they stated this "appears out of proportion to any reasonable incentive scheme."[156]

More recently, in *Reich v. Valley National Bank*, the DOL again tried to argue for the application of the dollar for dollar approach.[157] The court, however, elected not to decide the validity of the DOL's approach, and instead determined that a breach of fiduciary duty was present because the trustee passively relied upon the advice of others without engaging in its own prudent inquiry.[158]

Some commentary has suggested that it is unfair for the other investors to pay the same amount as the ESOP, where the investors are contributing capital in exchange for stock, and the ESOP is "contributing" debt.[159] A simple polar example illustrates the issue:

> Assume XYZ Company is purchased by an ESOP and an outside investor group for $100 million. The ESOP contributes $80

[152] 12 Pens. & Ben. Rep. (BNA) at 53.

[153] Id.

[154] Id. at 54

[155] Id.

[156] Id.

[157] Reich v. Valley Nat'l Bank of Ariz., 837 F. Supp. 1259, 1290 (S.D.N.Y. 1993).

[158] Id. at 1274–1282.

[159] May & McDonald, *supra* note 143 at 101; Ezra S. Field, Note: *Money for Nothing and Leverage for Free: The Politics and History of the Leveraged ESOP Tax Subsidy*, 97 COLUM. L. REV. 740 (1997).

> million in the form of a nonrecourse note; the outside investors contribute $20 million in cash. Assume present value of the ESOP tax savings (deductibility of principal) and interest savings (reduced borrowing rate) is $20 million. The post-deal value of the equity is $40 million ($100 million + $20 million − $80 million). If the ESOP receives 80 percent of the value, it means the outside investors receive an investment worth $8 million for their contribution of $20 million cash — an immediate capital loss of $12 million.[160]

No rational investor would enter into such a transaction, and this example illustrates how the DOL's position is inequitable to the outside investors. As a practical matter, of course the ESOP trustee does not need to worry about outside investors. If they don't feel the transaction is fair they will not participate in it. The example does illustrate, however how the DOL's dollar for dollar approach is far too rigid in that it fails to take into consideration general market forces and the burden of the nonrecourse debt. Because the DOL's position does not reflect economic reality its aggressive assertion on audit could hinder corporate finance transactions for ESOPS. Tellingly, no court has yet adopted this approach.

§ 9.05 CONCLUSION

Performing as an ESOP trustee in a corporate financing transaction is often an exciting opportunity, particularly when the transaction solves problems for many stakeholders and has a potential for substantial social benefit. The provision of retirement benefits to participants and their beneficiaries may seem secondary to the opportunities for employee ownership and other non-retirement values that Congress so clearly intended. In the excitement of the transaction, the trustee must remember the following principles to help insulate itself from liability from those who may seek to second guess the trustee's decisions.

- The trustee must decide whether and how to participate in the transaction solely on the basis of its determination that the transaction will result in an acceptable financial return of retirement benefits to participants and their beneficiaries.
- The trustee should be independent. The independence has two prongs. The trustee should be free of conflicts of

[160] May & McDonald, *supra* note 143 at 101.

interest, and the trustee should exercise independent judgment as to every significant aspect of the transaction that could affect the ESOP's economic success.

- The trustee should exercise due diligence as to both historical and present facts and trends surrounding the proposed transaction. If the trustee engages others to determine facts, the trustee should question and review the determination.
- The trustee should be familiar with similar transactions. In the alternative the trustee should hire an independent investment advisor or other financial expert who is familiar with similar transactions.
- The trustee should engage expert advisors to advise it about specific relevant areas of specialized knowledge such as legal advice, accounting services, the determination of value, the determination of fairness and the extent and management of potential repurchase liability.
- The trustee should review the qualifications and experience of the experts and should question and review their conclusions.
- The trustee should document its procedures and conclusions thoroughly and contemporaneously.

A trustee who follows these principles need not be deterred by the threat of potential liability from participating in the exhilarating use of ESOPs in creative corporate finance transactions.