Fiduciary Responsibilities Regarding External Investors in ESOP Companies

Richard May, David Light, Christopher Mackin, American Working Capital
Richard Pearl, McDermott, Will and Emery
August, 2019 – 080809

Recent developments in the US capital markets, including a new level of interest by a growing social-impact investment community,[1] have led to larger pools of external capital, particularly equity-like capital, in leveraged ESOP transactions.[2] This is a new and welcome development for ESOP transactions, which traditionally use ”seller” financing (see below). But it poses novel and important challenges for ESOP fiduciaries.

Although external capital likely will be used in 100% S-Corporation ESOP transactions, this article addresses fiduciary issues that arise when non-ESOP, external capital sources participate in any leveraged ESOP transaction. These new capital sources will need to familiarize themselves with the standards fiduciaries use to evaluate and approve ESOP transactions. ESOP Trustees will need to work with these new outside investors to ensure that transactions meet the ‘adequate consideration’ standard of ERISA's exemption for ESOP stock purchases.

Since the inception of S-Corporation ESOP designs in 1998,[3] capital to support conversions to 100 % ESOP ownership has been dominated by “seller” financing.[4] Seller financing is where the last (or most subordinated) tranche of capital is supplied by the “host” ESOP company's former owner(s).[5] Although there is no ERISA prohibition against using seller financing,[6] this form of

---

[1] Kesler, Erin, “Stocks from Employee-Owned Companies Outperform S&P: Brokerage Platform Created by NCEO Allows Investors to Focus on Businesses with Shared Ownership and Inclusive Workplace Cultures.” *Medium.* January 21, 2019. https://medium.com/fifty-by-fifty/stocks-from-employee-owned-companies-outperform-s-p-ac375706124b. Beyster, Mary Ann, “Impact Investing and Employee Ownership.” *Fifty by fifty Democracy Collaborative.* June 2017. https://democracycollaborative.org/sites/clone.community-wealth.org/files/downloads/impactinvestingandemployeeownership-updated.pdf.

[2] Walsh, Peter; Peck, Michael; Zugasti, Ibon. “Why the U.S. Needs More Worker-Owned Companies.” *Harvard Business Review*. August 8, 2018. https://hbr.org/2018/08/why-the-u-s-needs-more-worker-owned-companies. “Evergreen Cooperatives Launch fund for Employee Ownership.” *Fifty by Fifty.* November 14, 2013. https://medium.com/fifty-by-fifty/evergreen-cooperatives-launch-fund-for-employee-ownership-7256e9fe8051.

[3] Rosen, Corey, “Employee Ownership Update.” *National Center for Employee Ownership.* August 1, 1997 https://www.nceo.org/employee-ownership-update/1997-08-01.

[4] Rakin, Joe, “Why Private Equity is Investing in ESOP-Controlled Companies.” *The Business Journals.* August 29, 2017. https://www.bizjournals.com/bizjournals/how-to/growth-strategies/2017/08/why-private-equity-is-investing-in-esop-controlled.html. Dealy, Ty, “ESOP Financing… A Corporate Finance Option that Improves a Company's Cash-Flow While Strengthening Operational Performance.” *ABF Journal.* September 2013. https://www.abfjournal.com/articles/esop-financing-a-corporate-finance-option-that-improves-a-companys-cash-flow-while-strengthening-operational-performance/.

[5] Dealy, Ty, “ESOP Financing… A Corporate Finance Option that Improves a Company's Cash-Flow While Strengthening Operational Performance.” *ABF Journal.* September 2013. https://www.abfjournal.com/articles/esop-financing-a-corporate-finance-option-that-improves-a-companys-cash-flow-while-strengthening-operational-performance/.

[6] Employee Retirement Income Security Act of 1974 (ERISA) Prohibited Transaction Rules, 29 U.S.C. § 1106.

financing can introduce questions about whether fair market value was paid or whether the terms of the seller financing[7] affect the Trustee's fiduciary obligations to the ESOP, particularly an ESOP with a 100% ownership interest. The terms of seller financing have, with increasing frequency, become a focus of DOL and private-party claims for breached of fiduciary duty.[8]

In litigation cases, courts evaluate claims for breach of fiduciary duty by examining the process the trustee employed in implementing the subject ESOP transaction. In many litigation cases, plaintiffs challenge the fair market value of both the financial consideration received by the sellers and the stock purchased by the ESOP.[9] Plaintiffs often make the argument, which we believe is misguided, that privately negotiated transactions – even those negotiated at arms-length – ignore objective market standards. Although courts have accepted that ERISA requires the "fair market value" standard to be used for purposes of determining adequate consideration, the DOL has never published standards for determining fair market value, and the lack of guidance creates significant exposure for ESOP trustees. This paper suggests that the arrival of new external capital financing pools to fund leveraged ESOP transactions might introduce the added benefit of reducing the number of claims that accuse ESOP trustees of failing to negotiate at arm's-length.

Every ESOP fiduciary should be familiar with ERISA's adequate consideration exemption required to implement an ESOP through acquiring loans from the sponsoring company, i.e. by definition a "party in interest."[10] Historically, the established ESOP industry standards to meet the adequate consideration standard of ERISA were derived from IRS estate and gift tax regulations, Rev 59-60, the 1988 DOL proposed adequate consideration regulations, Federal court ERISA case findings of law, and more recently the DOL Settlement Agreements. The industry-accepted standards for both ERISA's due-diligence process requirement, the "prudent man" rule and economic-substance requirement, the fair market value as determined by the "willing buyer, willing seller" rule arise from the fact that in the most leveraged ESOP transactions a purchase process takes place – one that is characterized as "comparable" to auction-market purchase but lacks certain elements of an auction market. In a leveraged ESOP transaction, namely that the ESOP has no capital and must borrow virtually all of its capital from the sponsoring company or third-party capital sources [11] to fund its stock purchase. In

---

[7] Rodgers, Loren, "Employee Ownership Update." *National Center for Employee Ownership.* March 1, 2018. https://www.nceo.org/employee-ownership-update/2018-03-01.

[8] Daugherty, Greg, "Department of Labor Continues to Watch ESOP Valuations with Recent Trustee Settlements." *Benefits Law Report.com.* January 9, 2018. https://www.employeebenefitslawreport.com/2018/01/department-of-labor-continues-to-watch-esop-valuations-with-recent-trustee-settlements/.

[9]Congress of the United States letter to President Donald Trump. October 1, 2018. United States Congress. https://www.esopassociation.org/docs/default-source/advocacy-documents-library/trump_esop_dol_letter.pdf?sfvrsn=b3e4b386_4. "2018 ERISA Litigation and Significant Issues in Litigation." *Plans Benefits Security Division Office of the Solicitor. Department of Labor.* March 22, 2019.

[10] Employee Retirement Income Security Act of 1974 (ERISA) Exemptions from Prohibited Transactions, 29 U.S.C. § 1108.

[11] Hobbs, Joel, Maxwell, Gary, Heckler, Julie, "Employee Stock Ownership Plans, Including S Corporation ESOPs and Anti Abuse Measures." *Internal Revenue Service,* 2003. https://www.irs.gov/pub/irs-tege/epchd804.pdf.

these cases, which constitute the vast majority of ESOP leveraged transactions, the Trustee must determine not only the fair market value (FMV) of the stock being purchased, but also what terms and conditions meet a hypothetical market standard for the ESOP debt being used to buy the stock.[12] With the senior secured debt there are broad and deep markets for this needed capital and therefore its pricing and terms very seldom present fiduciaries with significant issues. However, with a very limited market to provide financing for the most subordinated tranche of debt, the synthetic equity, this financing is most often supplied by the sellers. That limited market negotiation can present fiduciaries with significant challenges regarding both the pricing of company's stock and derivative warrants, the synthetic equity terms and covenants and their impact on corporate governance.

Informed, disciplined, and reasonable buyers can, and often do, differ on the financial value of a company and the acceptable terms of an investment transaction. Using similar due-diligence procedures, examining the same historical and projected financial data and employing similar valuation methodologies, buyers often differ on a company's market value and acceptable terms and covenants for a given transaction. Historically, the DOL and class-action attorneys have questioned the adequacy of the Trustee's due diligence process, the valuation methodology, and the fairness conclusions, principally where actual financial outcomes differed from projected outcomes.[13] In these cases, it can often be an unforeseen internal or external event (e.g. exit of key engineering talent, or the arrival of a disruptive technological innovation, or unanticipated market performance) that causes the underperformance.

No amount of due diligence, experience, and discipline in valuation will result in perfect pricing. Underlying economic facts, which are used to price an asset, are never fully knowable at the time of pricing. More importantly, unanticipated events post-transaction will and very often do materially affect economic outcomes. But the entry of external auction market participants, and new pools of capital that have an appetite for the synthetic equity of leveraged ESOP transactions,[14] presents a promising opportunity to more fully realize direct market related

---

[12] "DOL Proposed Regulations Relating to the Definition of Adequate Consideration." *Department of Labor.* May 11, 1988.

[13] Congress of the United States letter to President Donald Trump. October 1, 2018. United States Congress. https://www.esopassociation.org/docs/default-source/advocacy-documents-library/trump_esop_dol_letter.pdf?sfvrsn=b3e4b386_4. Brundle v. Constellis (4th Cir.) (2018). Acosta v. Big G Express, Inc. (E.D. Tenn.) (2017). Acosta v. Wilmington Trust (S.D.N.Y.) (2017). Secretary v. Baum (E.D. Mich.) (2017). Perez v. Tobacco Rag Processors Inc. Employee Stock Ownership Plan (E.D. N.C.) (2017). Perez v. Zander Group Holdings, Inc. (M.D. Tenn.) (2017). Secretary v. Reliance Trust Company (D. Minn.) (2017). Acosta v. Cactus Feeders, Inc. (N.D. Tex.) (2016). Perez v. First Bankers Trust Services, Inc. (Sonnax Industries) (D. Vt.) (2016). Perez v. Potts (S.D. Ohio) (2016). Perez v. Bat Masonry (W.D. Va.) (2015). Perez v. BAT Masonry (W.D. Va.) (2015). Perez v. First Bankers Trust Services, Inc. and Vincent DiPano (D.N.J.) (2012).

[14] Kesler, Erin, "New Report: Opportunities for Impact Investing in Employee Ownership." *Fifty by Fifty.* June 1, 2017. https://medium.com/fifty-by-fifty/new-report-opportunities-for-impact-investing-in-employee-ownership-d807b88259b5.

evidence for both the company's stock price and the terms and covenants for the ESOP's synthetic equity financing for fiduciaries and the beneficiaries they protect.

ERISA requires that the ESOP pay no more than adequate consideration for the stock it purchases in an ESOP transaction.[15] Evidence of an auction market for stock has satisfied the DOL that the adequate-consideration test was met.[16] These new pools of capital qualify as auction-market participants when they invest in an ESOP transaction. A sponsoring company making use of this new source of capital can employ a selection process, which should materially mitigate concerns about the adequacy of the consideration. This is because the external investors will employ their own, external standards for due diligence, asset pricing, and terms setting.

In its Alpha Consulting Group settlement agreement the DOL directed that the fiduciary determine, "Whether both seller financing and financial institution financing was considered and whether the loans sought from financial institutions were within the amounts the financial institution was willing to loan."[17] It remains to be seen whether the arrival of this new source of potential financing will have a material effect on ability of fiduciaries to market test the pricing, terms and covenants of the "seller" financing or synthetic equity that have been the focus of DOL and private-party challenges. These include, for example, challenges to corporate-governance structures in place after a control ESOP transaction. Although many ERISA attorneys believe that Congress did not envision ESOP's exercising operating control of a company after a control transaction, plaintiffs often allege that the post-transaction goverenance structure was somehow not prudent for the ESOP or its participants. These new external sources of financing might demand changes to corporate governance structures that will be responsive to the scrutiny that has animated the DOL and private-plaintiffs.
There exists today a pool of over $2B of external-risk capital (i.e. synthetic equity) that has an appetite to participate in ESOP transactions.[18] Additional, substantial social-impact capital waits in the wings to add resources.[19] Subject to standards of ESOP Trustee control, particularly in control ESOPs, pool members can invest in both "control" and minority positions.[20] These investment pools are experienced and have records of successful investing.[21] They employ

---

[15] 29 U.S.C. § 1108(e); 29 U.S.C. § 1102(18).

[16] Thompson v. Avondale Industries, Inc. (E.D. Louisiana) (2003).

[17] Acosta v. Mueller, et. al., E.D.Wi., Civil Action No. 2:13-cv-1302-PP, consent order entered Dec. 27, 2017.

[18] Beyster, Mary Ann, "Impact Investing and Employee Ownership." *Fifty by fifty Democracy Collaborative.* June 2017. https://democracycollaborative.org/sites/clone.community-wealth.org/files/downloads/impactinvestingandemployeeownership-updated.pdf.

[19] Id.

[20] "The Employee Ownership Report." *National Center for Employee Ownership.* July-August 2019. https://www.nceo.org/Employee-Ownership-Report/id/46/.

[21] Beyster, Mary Ann, "Impact Investing and Employee Ownership." *Fifty by fifty Democracy Collaborative.* June 2017. https://democracycollaborative.org/sites/clone.community wealth.org/files/downloads/impactinvestingandemployeeownership-updated.pdf. Starr, Ira, "Impact Investing, ESOPS and Private Equity." *Long Point Capital. Rutgers School of Management and Labor Relations.* March 19, 2019.

current, private-market standards of due diligence, asset pricing, terms setting, and corporate governance.[22] ESOP professionals and the ESOP fiduciary community should actively seek out these new capital sources to see if they can mitigate exposure to three sources of risk; to the routine risk associated with due diligence and valuation processes, to judgments of adequate consideration applied to capital sources funding ESOP transaction, and finally to corporate governance and unexpected post transaction unanticipated events.

http://www.longpointcapital.com/site/assets/files/1295/rutgers_esops_and_impact_investing_summary_version_final_3-19-19.pdf.

[22] "Private Equity + ESOPS. The PE+ESOP Buyout. The Best Liquid Solution in Specific Situations?" *Long Point Capital. Rutgers School of Management and Labor Relations.* April 23, 2018.