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A Step Towards Guidance Instead of Regulation by Litigation in the ESOP Space

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In this article, the authors discuss a commitment by the U.S. Department of Labor to move forward with public notice-and-comment rulemaking to establish a clear definition regarding the “adequate consideration” requirement for employee stock ownership plan acquisitions.

Employee stock ownership plans (ESOPs), their sponsors and participants and other industry players will welcome the news¹ announced recently by the ESOP Association that the U.S. Department of Labor (DOL) has committed to move forward with public notice-and-comment rulemaking to establish a clear definition regarding the “adequate consideration” requirement for ESOP acquisitions.² This long-awaited announcement follows the passage of bipartisan legislation late last year, which included the SECURE 2.0 Act of 2022 (SECURE 2.0 Act). The SECURE 2.0 Act includes provisions seeking to establish a more conducive environment for ESOP creation and maintenance. Specifically relevant to ESOPs³ – of which there are nearly 6,500, with more than 13.9 million participants investing over \$1.6 trillion as of 2020⁴ – was the WORK Act (Section 346 of the SECURE 2.0 Act).

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This commitment from the DOL is in response to the passing of the SECURE 2.0 Act as well as an Administrative Procedure Act petition submitted by the ESOP Association to the DOL last year, which specifically requested that the DOL not only define adequate consideration but do so through a formal notice-and-comment rulemaking process. The DOL's commitment should ensure the issuance of a rule consistent with the WORK Act's requirement⁵ that it "issue formal guidance" for "acceptable standards and procedures to establish good faith fair market value for shares of a business to be acquired by an employee stock ownership plan."⁶

Decision-makers for ESOPs, including those responsible for ESOP valuations or for responding to DOL inquiries, have long awaited this kind of guidance. While ESOP transactions are inherently prohibited transactions in violation of the Employee Retirement Income Security Act of 1974, as amended (ERISA), they are permitted as long as the transaction meets the adequate consideration exemption. In order for an ESOP transaction to meet the adequate consideration exemption,⁷ an ESOP must not pay more than "fair market value of the [shares] as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and *in accordance with regulations promulgated by the Secretary*."⁸

However, before this commitment, the DOL had never provided or agreed to provide formal regulations or guidance for the valuation process. Even after the U.S. Court of Appeals for the Fifth Circuit reprimanded the DOL in *Donovan v. Cunningham*⁹ for failing to promulgate such regulation, the closest the DOL had come to doing so was the issuance of proposed regulations in 1988. These proposed regulations were never finalized, and many industry insiders said the regulations did not provide clear guidance on what would be deemed adequate consideration.

SEEKING STANDARDS

The industry has been seeking clear standards on the necessary process to ensure that an ESOP transaction is for no more than fair market value, as required to meet the adequate consideration exemption under ERISA. In the absence of the type of formal guidance that the DOL has now committed to providing, the industry has had to look for insights in the terms of settlement agreements that the DOL entered into regarding ESOP-related processes and practices.

In 2014, the DOL reached a settlement agreement with GreatBanc Trust Company (GreatBanc) following an investigation relating to GreatBanc's role as trustee in a transaction for the Sierra Aluminum ESOP. While the case was resolved without the filing of a public

lawsuit, the DOL made the GreatBanc settlement agreement public as it set forth what the DOL considered to be best ESOP valuation. The GreatBanc settlement agreement was the first time the DOL used this strategy as a way of advising the industry of its preferred process standards.

Since the GreatBanc settlement, the DOL and specific fiduciaries providing process standards have entered into five publicly available settlement agreements.¹⁰ These agreements are the result of facts particular to each case and binding only on the parties involved, and they create a patchwork of standards that is not entirely consistent. The inconsistencies among the terms of various agreements have created uncertainty as to what the DOL requires, recommends, or prohibits. This in turn has left ESOPs and their fiduciaries susceptible to expensive investigations and possible litigation.

REGULATION BY LITIGATION

Despite the lack of consistent or official guidance, the Employee Benefits Security Administration (EBSA), the enforcement arm of the DOL, has placed “particular investigative emphasis” on ESOPs for over a decade, designating them a national enforcement project continuously since 2005.¹¹ This prioritized approach has resulted in regulation by litigation.

From 2018 to 2022, the DOL filed at least nine lawsuits related to ESOP transactions. In most instances, these lawsuits involved challenges to various aspects of the valuation process or methodology relied on in valuing the shares purchased by the ESOP.¹² In 2021 and 2022 alone, the DOL obtained settlements in six investigations that were resolved short of litigation related to ESOP transactions for a total of over \$149 million in settlement values. These settlements resulted in the payment of at least \$14.6 million in Section 502(I) penalties.

The absence of formal valuation guidance has proved challenging not just for plan fiduciaries but even for the DOL itself, as its own expert witness’ valuation methodology was rejected by the court in the recent case of *Walsh v. Bowers*. The *Bowers* court ruled in favor of the defendant that it did not cause the ESOP to overpay in purchasing the company’s stock, while disagreeing with several of the DOL’s expert’s valuation calculations for failing to take into consideration certain items.¹³ Official guidance making valuation processes and standards clear could likely prevent disputes such as this, and the attendant costs. Despite the favorable ruling for the defendant, the case still lasted three years, proceeded through discovery to trial, and resulted in related defense costs (which the defendants are seeking to recover in an appeal to the Ninth Circuit).¹⁴

This ever-present risk of costly enforcement actions¹⁵ has created fear and uncertainty for ESOP sponsors and fiduciaries.¹⁶ From 2014 to 2020, despite Congress' stated goal of increasing ESOP growth,¹⁷ the number of ESOPs decreased annually, and the growth rate¹⁸ of new entrants stagnated.¹⁹ The DOL's enforcement initiatives and the lack of formal guidance have likely had the effect of deterring companies from creating ESOPs due to the associated risks.

Similarly, the risk landscape appears to be contributing to a downward trend of institutional trustees willing to serve as trustees for ESOP transactions. The expense and risk that trustees can incur in responding to DOL inquiries and defending investigations and litigation can, for some, outweigh the financial benefit of serving as fiduciaries for these transactions.

CONCLUSION

Although there are several steps before a final regulation will be promulgated, this DOL commitment to begin the long-awaited process of official notice-and-comment rulemaking brings hope that the DOL will work with the industry and issue clear and fair standards for ESOP valuations that will provide for a more attractive environment for the growth of ESOPs. This formal guidance that fiduciaries, trade associations, and legislators have been clamoring for can provide real guidance for ESOP sponsors and fiduciaries and potentially reduce the risks, uncertainty, and expense that are currently associated with making an ESOP available to employees.

NOTES

1. <https://www.esopassociation.org/articles/department-labor-agrees-notice-and-comment-rulemaking-adequate-consideration-exemption>.
2. DOL Commits to Provide Long-Sought Regulatory Clarity with Stakeholder Input on the Valuation of Company Shares to be Bought by an ESOP, ESOP Association, April 14, 2023.
3. <https://www.nceo.org/articles/employee-ownership-by-the-numbers#:~:text=In%20total%2C%20there%20are%20approximately,company%20may%20sponsor%20multiple%20plans>.
4. Employee Ownership by the Numbers, NCEO, February 2023.
5. <https://www.appropriations.senate.gov/imo/media/doc/JRQ121922.PDF>.
6. Consolidated Appropriations Act, 2023, HR 2617, 117th Cong. § 346, (2022).
7. <https://www.govinfo.gov/content/pkg/COMPS-896/pdf/COMPS-896.pdf>.

8. Emphasis added. Employee Retirement Income Security Act of 1974, PL 93-406, 93d Cong. § 407(d)(6)(B) (1974).
9. *Donovan v. Cunningham*, 716 F.2d 1455 (5th Cir. 1983).
10. *Perez v. GreatBanc Trust Co.*, No. 5:12-cv-01648-R-DTB, (C.D. Cal. 06/02/2014) (GBTC); *Acosta v. First Bankers Tr. Servs., Inc.*, No. 1:12-cv-08648-GBD (S.D.N.Y., 09/21/2017) (FBTS); *Acosta v. BAT Masonry*, No. 6:15-cv-00028-EKD-RSB (W.D. Va., 09/29/ 2017) (Joyner); *Acosta v. Mueller*, No. 2:13-cv-1302-PP (E.D.Wisc., 12/27/2017) (Alpha Inv. Consulting Grp., LLC); *Acosta v. Cactus Feeders, Inc.*, 2:16-cv-00049-J (N.D. Tex., 05/4/2018)(Lubbock); *Scalia v. Farmers Nat'l Bank of Danville*, No. 1:20-cv-674 (S.D. Ind. Feb 28, 2020) (FNB).
11. Enforcement, Employee Benefits Security Administration, <https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/enforcement> (last visited March 6, 2023).
12. See, for example, *Walsh v. Reliance Trust Company*, 2023 WL 1966921(D. Ariz. Feb. 13, 2023); *Walsh v. Peterson*, 4:21-cv-00867 (E.D. Tex. Oct. 29, 2021); *Glynn v. Maine Oxy-Acetylene Supply Co.*, 2022 WL 17617138 (D. Maine Dec. 13, 2022).
13. *Walsh v. Bowers*, 561 F. Supp. 3d 973, 977 (D. Haw. 2021).
14. *Walsh v. Bowers*, 22-15378 (9th Cir. 2022).
15. <https://www.benefitspro.com/2022/10/07/the-esop-association-petitions-u-s-dol-for-change/?slreturn=20230418145617>.
16. Michael Popke, *The ESOP Association Petitions U.S. DOL for Change*, ALM Benefits Pro, October 7, 2022.
17. Promotion and Expansion of Private Employee Ownership Act of 2021, H.R. 4141, 117th Cong. § 2 (2021); Promotion and Expansion of Private Employee Ownership Act of 2021, S. 1300, 117th Cong. § 2 (2021).
18. <https://www.nceo.org/articles/employee-ownership-by-the-numbers#:~:text=In%20total%2C%20there%20are%20approximately,company%20may%20sponsor%20multiple%20plans>.
19. *Employee Ownership by the Numbers*, NCEO, February 2023.

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