ERISA EXPERT SERVICES

CLOSELY HELD ESOPS: FIDUCIARY DUTIES AND RISK MITIGATION

A White Paper
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Introduction

By definition, an employee stock ownership plan ("ESOP") is a retirement plan designed to invest primarily in qualifying employer securities. Accordingly, an ESOP can be a great way to provide employees with an equity stake in their employer while also serving as a method of corporate finance. Indeed, almost 40 years ago, Senator Russell Long—widely regarded as the "father of ESOP legislation"[1]—explained:

> Just as in 1862, when Congress passed a law to allow Americans who had very little money to own and develop up to 160 acres of land, we should now give Americans the opportunity to become owners of our growing frontier of new capital (stock). The way to do this is through laws which encourage the development of programs like ESOP[s].[2]

But no prudent person would ignore the risks associated with ESOPs and the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), is not forgiving to those charged with protecting the interests of participants and beneficiaries of retirement plans. Subject to a standard that is "the highest known to the law"[3] and faced with an evolving legal landscape, ESOP fiduciaries have good reason to think carefully about how best to protect their plans from risk.

This paper begins by focusing on general ERISA requirements, including the duty of prudence and the duty of loyalty with an emphasis on insiders who serve as ESOP fiduciaries. It then explores recent developments in the law relating to ESOPs sponsored by closely held companies. The risk of catastrophic loss associated with ESOPs is considered thereafter. This paper concludes with a discussion of a new mechanism to protect ESOPs from the risk of large losses—the ESOP Protection Trust.

ERISA Imposes Strict Standards of Conduct on ESOP Fiduciaries

ERISA was enacted to protect the interests of participants and beneficiaries in employer-sponsored retirement and health and welfare plans.[4] The statute does so, in part, by establishing strict standards for persons responsible for the management and administration of employee benefit plans, including the management or disposition of plan assets.[5] These persons are known as fiduciaries and, under ERISA, they can be held personally liable for losses to a plan resulting from their breaches.[6]

A fiduciary has duties of loyalty and prudence and a duty to follow the documents and instruments governing a plan unless they are inconsistent with ERISA. Normally, a fiduciary

also has a duty to diversify investments unless clearly prudent not to do so. However, ESOPs are a special variety of retirement plan. Because ESOPs are designed to invest primarily in employer securities, fiduciaries are exempt from the diversification requirement when investing in employer stock as well as ERISA's prudence requirement to the extent that it mandates diversification.[7]

While much could be written on each of ERISA's fiduciary duties, the duty of prudence illustrates how rigorous they are. ERISA requires that a fiduciary carry out his or her 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."[8] Some commentators refer to this prudence standard as the prudent expert rule because of its emphasis on a prudent person "familiar with such matters."[9] However, at least one court has rejected the prudent expert characterization and explained that "the level of knowledge required of a fiduciary will vary with the nature of the plan."[10]

Regardless of how ERISA's prudence standard is characterized, it is unquestionably a demanding standard. Procedural prudence—often a primary focus of the courts—and substantive prudence both are required. Procedural prudence focuses on the investigation performed by a fiduciary in reaching a decision.[11] Thus, documenting a prudent process serves to protect fiduciaries against allegations of breach and is recommended by ERISA attorneys. Often times, prudent conduct will require the retention of professionals to advise a fiduciary. Nonetheless, reliance on the advice of professionals is not a complete defense to allegations of fiduciary breach.[12]

Substantive prudence focuses on the soundness of a fiduciary's decision after a prudent investigation.[13] Embedded in the concept of substantive prudence is the rejection of a good faith standard: "[A] pure heart and an empty head are not enough."[14]

Despite this high standard, fiduciaries are not guarantors of plan investments—prudence is to be judged at the time of the decision, not from the benefit of hindsight.

ERISA's fiduciary standards draw largely from the common law of trusts and trust law is a good place to start when the statute is unclear. However, one area where the statute significantly deviates from trust law is its creation of prohibited transactions and self-dealing violations. ERISA prohibits a variety of transactions between a plan and a party in interest.[15] A party in interest is defined to include nine categories of persons with a relationship to the plan,

employer, employee organization, or plan service providers, including plan fiduciaries, employees, officers, directors, service providers, and individuals and entities that exceed certain ownership thresholds.[16]

In addition, ERISA prohibits three different types of transactions between plans and plan fiduciaries, generally referred to as self-dealing violations.[17] The first, itself known as self-dealing, prohibits a fiduciary from dealing with plan assets in his or her own interest. The second prohibits a fiduciary from acting on both sides of a transaction between a plan and a party with interests adverse to a plan or participants or beneficiaries. And the third prohibits a fiduciary from accepting kickbacks relating to transactions involving plan assets. The first and third self-dealing prohibitions involve plan assets whereas the second, by its plain language, does not require plan assets for a breach to occur.

ERISA's prohibited transaction and self-dealing provisions are *per se* violations—the fact that a covered transaction might benefit a plan is not enough to avoid a violation of the law. This is not to say, however, that no exemptions exist to prohibited transactions and, to a much more limited extent, self-dealing prohibitions. Indeed, ERISA's prohibited transaction provisions are so broad that exemptions are required to allow plans to engage in normal operations, and ESOPs are no exception. But, since the prohibitions are *per se*, the burden of demonstrating that an exemption is applicable rests with the party seeking to fall under the exemption[18] thereby making it more difficult for fiduciaries to defeat lawsuits when prohibited transactions are at issue.

A key exemption for ESOPs, ERISA § 408(e), permits the purchase or sale of qualifying employer securities if the transaction is for "adequate consideration." Qualifying employer securities are defined to include employer stock.[19] Where there is no generally recognized market for qualifying employer securities, adequate consideration means "the fair market value" of the security "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."[20] In 1988, the Department of Labor (the "DOL") proposed a regulation relating to the definition of "adequate consideration."[21] Among other things, the proposed regulation describes the content required for written valuations that form the basis of fair market value. While the proposed regulation has never been finalized, practitioners continue to rely on it for guidance relating to valuation of closely held stock. If satisfied, the adequate consideration exemption applies to prohibited transactions and self-dealing violations, with the exception of the prohibition against kickbacks.[22] However, satisfying the ERISA § 408(e) exemption does not excuse an ESOP fiduciary from his or her duties of prudence and loyalty and the duty to follow plan documents.[23]

While the above summarizes several important ERISA concepts, two more should not be overlooked. ERISA makes the appointment of fiduciaries and the selection of service providers a fiduciary function and requires fiduciaries who appoint other fiduciaries or select service providers to monitor such fiduciaries and service providers. ERISA also imposes a set of co-fiduciary duties that can make fiduciaries liable for actions or omissions of other fiduciaries under certain circumstances.[24]

Thus, an ESOP fiduciary is held to an extremely high standard when purchasing, holding, and selling employer stock, as well as when performing other fiduciary activities. This is the result of ERISA's demanding fiduciary standards and its prohibited transaction and self-dealing provisions.

The Duty of Loyalty and Insiders as ESOP Fiduciaries

Like the duty of prudence, the duty of loyalty establishes a high bar for ERISA fiduciaries. The duty of loyalty requires a fiduciary to perform his or her functions in the sole interest of plan participants and beneficiaries and for the exclusive purpose of providing benefits and defraying appropriate expenses of a plan.

Although ERISA permits a corporate officer to wear two hats—that is, serve as an officer while also serving as a fiduciary—this situation can be particularly problematic for fiduciaries of closely held companies that sponsor ESOPs. While a fiduciary may wear two hats, he or she must wear the fiduciary hat when carrying out fiduciary functions.[25] As the Second Circuit Court of Appeals explained over 30 years ago, fiduciary "decisions must be made with an eye single to the interests of the participants and beneficiaries."[26]

When a company insider who is also a fiduciary is placed in a situation where he or she may benefit from a course of action taken by a plan (separate from the benefits that may be conferred on participants), courts have reviewed fiduciary decisions with heightened scrutiny.[27] Perhaps the Seventh Circuit Court of Appeals put it best in *Leigh v. Engle* when it described two avenues that a court might follow when evaluating an alleged breach of the duty of loyalty:

> The first avenue focuses on the potential for conflicts of interest between the fiduciaries and the plan beneficiaries. Where the potential for conflicts is substantial, it may be virtually impossible for fiduciaries to discharge their duties with an "eye single" to the interests of the beneficiaries, and the fiduciaries may need to step aside, at least temporarily, from the management of assets where they face potentially conflicting interests. The second avenue involves a broader inquiry into the fiduciaries' actions where they may have substantial interests . . . Where it might be possible to question the fiduciaries' loyalty, they are obliged at a minimum to engage

> in an intensive and scrupulous independent investigation of their options to insure that they act in the best interests of the plan beneficiaries.[28]

Company insiders serving as ESOP fiduciaries may be confronted with various conflict situations. For example, an owner of a closely held ESOP who desires to sell his or her shares might also serve on the committee responsible for determining the price to pay for the purchase of shares by the ESOP.

A fiduciary with a conflict should carefully consider how to proceed. In some conflict situations, the best course of action may be to appoint an independent fiduciary. In other conflict situations, a fiduciary might decide to recuse himself or herself from participation in the relevant ESOP decision.[29] This may be appropriate with regard to the example above when the fiduciary/owner is only one member of the committee voting on the decision. However, other ESOP fiduciaries serving on such a committee should consider whether their ability to act in the sole interest of participants is affected by their relationship with the owner.[30]

Duties of ESOP Fiduciaries Have Been Interpreted Through Litigation

Not surprisingly, since 1974 when ERISA was passed, litigation has clarified the duties of ESOP fiduciaries. Although significant guidance has been provided, the facts and circumstances will often shape the precise nature of conduct required of an ESOP fiduciary and the law continues to evolve.

Alleged improper valuation of company stock has been the focus of a number of seminal ESOP decisions.[31] A good example of the standard that courts apply to ESOP valuations is provided by *Reich v. Valley National Bank of Arizona*, a federal case decided in 1993. There, the Secretary of Labor sued the trustee of an ESOP that had been created to finance a leveraged buyout that took the sponsor of the ESOP private. In a multi-investor transaction, the ESOP purchased employer stock with the proceeds of a $35.5 million employer loan. The ESOP repaid $17.5 million of the loan, but the employer went bankrupt a few years later and the ESOP sold its stock for a mere $250,000. The valuation of company stock cited by the trustee as a defense to allegations of fiduciary breach relied on company representations about its finances without independently verifying such representations. After citing an earlier ESOP appellate decision explaining that "[a]n independent appraisal is not a magic wand that fiduciaries may simply wave over a transaction to ensure that their responsibilities are fulfilled,"[32] the court held that a fiduciary cannot passively accept an appraiser's valuation.[33] For this reason and others, the court held that the trustee was liable for breach of fiduciary duty.

Despite the rigorous standard reflected in cases like *Valley National Bank*, prior to 2014, ESOP fiduciaries could rely upon at least one favorable legal standard. Specifically, multiple appellate courts had adopted a presumption of prudence applicable to ESOP fiduciary decisions to invest in or hold employer securities. The presumption, known as the *Moench* presumption after *Moench v. Robertson*[34] decided by the Third Circuit Court of Appeals, was not always expressed the same way by the appellate courts. In its strong form, the presumption of prudence required plaintiffs challenging the decision of an ESOP fiduciary to buy or hold employer stock to "make allegations that clearly implicate [] the company's viability as an ongoing concern or show a precipitous decline in employer's stock . . . combined with evidence that the company is on the brink of collapse or is undergoing serious mismanagement."[35]

But, in *Fifth Third Bancorp v. Dudenhoeffer*, the Supreme Court rejected the *Moench* presumption and held that ERISA's prudence standard applies to all ESOP fiduciaries, except that prudence does not require diversification to the extent that an ESOP invests in qualifying employer securities.[36] The Court made clear that the nonpecuniary goal of promoting ownership and other potential benefits of investing in employer stock that do not relate to achieving financial retirement security for participants are not appropriate considerations when evaluating the duty of prudence. As discussed further below, some ESOP commentators believe that employee ownership of company stock can contribute to increased productivity and promote a positive company culture[37]—*Dudenhoeffer* puts to rest any arguments that such benefits might constitute a defense to allegations of imprudence.

While the Supreme Court articulated a favorable pleading standard for fiduciaries when publicly traded stock is at issue,[38] for closely held ESOP companies, the retirement of the *Moench* presumption increases potential fiduciary liability and makes it more difficult to dismiss litigation. This is because some appellate courts had applied the *Moench* presumption at the pleading stage of litigation.[39] Notably, respected commentators have contended that *Dudenhoeffer* will have little impact on ESOPs sponsored by closely held companies because disputes relating to such companies typically focus on the valuation of company stock where no presumption had been applied by courts to disputes over the determination of adequate consideration.[40] However, at the very least, *Dudenhoeffer* signals the faithful adherence by the Supreme Court to a strict interpretation of the fiduciary standards imposed by ERISA on ESOP fiduciaries.

Another significant development in 2014 relates directly to the valuation of closely held company stock. After two years of litigation, the DOL settled a lawsuit with GreatBanc Trust Company ("GreatBanc") involving alleged ERISA violations. According to the DOL,

GreatBanc allowed the Sierra Aluminum Company ESOP to purchase employer stock from insiders for more than adequate consideration. GreatBanc allegedly failed to satisfy its fiduciary duties to investigate an appraisal that relied upon inappropriate financial projections by Sierra Aluminum Company. GreatBanc and the DOL entered into a settlement agreement that obligates GreatBanc to comply with various conditions relating to GreatBanc's trustee services involving private ESOPs. In an attachment to the settlement agreement, the DOL outlines procedures that broadly apply to situations where GreatBanc acts as a fiduciary to any private ESOP and the ESOP is selling or purchasing, considering selling or purchasing, or has received an offer to sell or purchase employer securities.

The attachment is notable for the detailed requirements that it imposes. It sets forth general requirements relating to the selection and use of valuation advisors ("Appraisers"), conflicts of interest of Appraisers that would preclude GreatBanc from selecting them (including former work on behalf of the employer), and requirements to document the process used by GreatBanc in selecting Appraisers. The attachment describes nine items that GreatBanc must request that Appraisers document in valuation reports, many of which focus on whether company financial projections are reasonable and reliable. It obligates GreatBanc to seek audited unqualified financial statements relating to the employer and to carefully consider and document any decision to proceed with a transaction if only unaudited or qualified financial statements are made available. The attachment also outlines conditions that GreatBanc must follow in reviewing information that it receives and the Appraiser's valuation report, and the attachment requires GreatBanc to keep extensive documentation relating to its review process. Moreover, the attachment requires GreatBanc to preserve records for at least six years and sets forth conditions relating to debt financing of ESOP transactions, claw-back arrangements, and the retention of other professionals.

Finally, despite its level of detail, the attachment indicates that it should not be interpreted to be a list of all of GreatBanc's obligations and that compliance with the attachment does not relieve GreatBanc of any of its other duties under ERISA.

The GreatBanc settlement received particular attention because of comments of Phyllis Borzi, the Assistant Secretary of Labor of the Employee Benefits Security Administration ("EBSA"), indicating that the ESOP industry should take notice of the protections that GreatBanc is required to institute due to the settlement.[41] Assistant Secretary Borzi's comments also resonate because ESOPs have long been an enforcement priority for the DOL and the DOL has recently increased its enforcement efforts. According to a recent Wall Street Journal article,

Timothy Hauser, Deputy Assistant Secretary for Program Operations of EBSA, stated that "valuation is the first, second, third and fourth problem" relating to ESOPs.[42]

Risk Associated With a Concentrated Stock Position

The high standard imposed on pension plan fiduciaries is intended to protect retirement assets of participants and beneficiaries. But even when fiduciaries fulfill their duties, there is significant risk associated with typical ESOP holdings.

Because ESOP fiduciaries are exempt from ERISA's diversification requirement, ESOPs are permitted to hold a concentrated position in employer stock. Armed with modern portfolio theory, most investors look at diversification as the best method to achieve the least risk for a given return. Thus, one can question whether ESOPs are good vehicles at all to efficiently maximize investment returns.[43]

And perhaps a larger concern for retirement plans and their fiduciaries should be catastrophic stock risk. Large losses are devastating to participants who rely on the value of plan assets to provide sufficient retirement income. The Internal Revenue Code requires qualified ESOPs to permit participants to diversify as they approach retirement.[44] However, this does not protect the entire population of participants in an ESOP with a concentrated stock position from losses from which a company never adequately recovers.

A fascinating report from J.P. Morgan Asset Management—in which ESOP fiduciaries and investors in general should take interest—examines the pervasiveness of "catastrophic loss" in Russell 3000 companies.[45] "Catastrophic loss" is defined as "a decline of 70% or more in the price of a stock from its peak, after which there was little recovery such that the eventual loss from the peak is 60% or more."[46] According to the report, from 1980 to 2014, 40% of all stocks that had been a part of the Russell 3000 suffered a catastrophic loss. The same report also highlights how even the largest public companies are susceptible to large losses—320 companies have been deleted from the S&P 500 since 1980 due to significant distress.[47]

The J.P. Morgan report describes 10 factors, including government policy changes and technological innovation, that are effectively outside of the control of management and can jeopardize the ongoing viability of companies. The report concludes with the following profound observation: "The factors outside management control . . . are a formidable list, and have grown in complexity since we first drafted this report 10 years ago. This is perhaps the most important epiphany we gained from the study: that exogenous forces may overwhelm the

things we can control."[48] And because the Russell 3000 measures a broad segment of the public equity market in the United States, it is reasonable to assume that the risk of catastrophic loss is greater for closely held companies. Thus, it is safe to say that ESOP investment in employer stock is a risky venture.

All of this is also significant because, as discussed in more detail below, fiduciaries of ESOP companies with significant declines in stock value become targets for ERISA lawsuits. Indeed, the ERISA defense bar routinely (and pejoratively) refers to cases alleging fiduciary breach after large declines in stock prices as "ERISA stock drop cases."[49]

The Benefits of ESOPs Do Not Alter Fiduciary Duties or Mitigate Concentrated Stock Risk

Advocates of ESOPs focus on a number of benefits to employees and employers relating to such plans. They emphasize that ESOPs are funded with employer money and that there is a correlation between larger total employer retirement plan contributions and ESOPs.[50] They point to data indicating that many companies offer a diversified retirement plan along with an ESOP.[51] Further, they contend that ESOPs are associated with increased employee productivity, that ESOP companies are less likely to lay off employees, and that ESOPs generally can contribute to a positive "ownership culture."[52] While all of these points may have merit, none alters ERISA's fiduciary duties or adequately addresses the issue of concentrated stock risk.

Initially, it is important to recognize that fiduciaries are not insulated from their ERISA duties to participants and beneficiaries or from exposure to personal liability because a plan is funded by employer contributions.[53] A fiduciary has a duty to protect plan assets regardless of the source of contributions to a retirement plan. The gratuity theory of pensions—positing that retirement benefits are provided gratuitously by employers and can be taken away at the will of employers notwithstanding the accrued or vested status of benefits[54]—was expressly rejected with the passage of ERISA.[55] As the Seventh Circuit Court of Appeals aptly explained in an ESOP lawsuit: "[T]here are no free lunches; any benefit that an employer confers on an employee is reckoned by the employer as a cost and so affects the overall level of compensation that [it] is willing to pay."[56] The DOL likewise would be unsympathetic to an assertion that somehow responsibility is lessened because an ESOP is funded with employer contributions.

Similarly, offering multiple retirement plans does not reduce exposure to ERISA liability. For example, if an ESOP is offered along with a 401(k) plan and the ESOP suffers losses caused by fiduciary breach, 401(k) gains, if any, cannot be used to offset ESOP losses or reduce

personal liability for fiduciary breach. With regard to losses, fiduciaries should also be aware that courts have held that "doubt or ambiguity" relating to losses attributable to fiduciary breach generally is resolved against the fiduciary.[57]

Moreover, a 401(k) plan paired with an ESOP is highly unlikely to bring concentrated stock risk to an acceptable level from the standpoint of modern portfolio theory. A study focusing on ESOPs offered by companies in the State of Washington found that employees who participated in a company ESOP and another retirement plan still averaged 60% of total retirement assets in employer stock.[58] According to one scholar, "[l]eading ESOP advocates concede that anything more than 20 percent is probably too much concentration in a single asset."[59] Furthermore, any effort to shift employer retirement contributions to a diversified plan to reduce the percentage of total retirement assets held in employer stock to 20% or less would likely diminish the benefits of the ownership culture touted by ESOP advocates.

And as to the contention that ESOPs are correlated with improved productivity and job security and that they help create a positive ownership culture, of course, none of these points addresses the issue of concentrated stock risk.

Potential Fallout From Large Declines in the Value of Employer Stock

Assume that an ESOP company loses 85% percent of its value and that the majority of the retirement portfolios (the total retirement assets held in all plans sponsored by the employer) of participants is held in employer stock. What would likely happen next?

Depending on the dollar figure of the decline, it is likely that ERISA plaintiffs' lawyers would take a close look at the facts and circumstances. ERISA creates a statutory cause of action that allows participants and beneficiaries, the Secretary of Labor, and fiduciaries to bring suits for fiduciary breach.[60] Participant complaints serve as a common source of lawsuits filed by private attorneys (including class actions) and the DOL. As demonstrated by the onerous requirements set forth in the GreatBanc settlement and other guidance, complying with fiduciary duties in connection with the valuation of closely held stock is no easy task.[61] Thus, one of the first areas of conduct that is typically scrutinized is fiduciary acceptance of the valuation of company stock. The smaller the decline or the more that a decline can be mitigated, the less likely a lawsuit is to be filed, especially by private lawyers.

Even if no lawsuit follows a decline in value, the benefits of an ownership culture frequently cited by ESOP advocates likely would be eliminated if such a decline remains

unmitigated. After all, an employee who has spent years working at an ESOP company only to learn that not only are there serious questions about his or her job security, but that most of the value of his or her retirement assets has been erased is not likely to be a motivated employee. This conclusion is bolstered by evidence that indicates that "workers who participate in ESOPs tend to have little or no capital investment outside their homes and retirement plans."[62] Therefore, ESOP participants likely do not have a high risk tolerance for large declines in the value of employer stock when so much of their ability to retire comfortably depends on the value of their ESOP assets.

Mitigation of Risk for Closely Held ESOPs

With the above in mind, obviously it is important for an ESOP fiduciary to carefully attend to his or her duties. But how can built-in risk be reduced while still remaining faithful to the purpose of ESOPs?

Recently, a new method to mitigate risk, known as the ESOP Protection Trust (the "EPT"), has become available. The EPT is a concept designed to protect ESOPs from large losses offered by StockShield, LLC and Dowling Hales. The EPT relies on diversification and insurance principles to achieve its purpose. It produces a payout to an ESOP when there is a decline of greater than 50% of the value of company stock owned by an ESOP.

The EPT typically protects a $10 million position in company stock (although a company may be permitted to participate in more than one EPT if additional protection is desired). A group of 10 to 20 ESOP companies contributes annually to fund the EPT. If there is no decline in excess of 50% of the value of company stock of any participating company over the 10-year life of the EPT, then no funds are paid out to any ESOP and 70% of the EPT proceeds are returned to the contributing companies. The remaining proceeds are payable to the EPT sponsors as a 30% success fee. If there is a decline of greater than 50% in the stock value of one or more participating companies, then EPT assets are paid to the affected ESOP or ESOPs to help restore the lost value. Any remaining EPT assets are returned to the contributing companies that did not suffer a greater than 50% decline in stock value less fees and expenses. The maximum payout from the EPT to any ESOP sponsored by a contributing employer is $5 million. Payouts cannot exceed the total assets held by the EPT. Reimbursement to ESOPs of participating companies is made on a pro rata basis if there are eligible declines in the value of company stock owned by more than two ESOPs that would otherwise exceed the total assets held by the EPT.

There are a few additional characteristics of the EPT that merit attention. Based on eligibility criteria, each company is approved for participation prior to being permitted to contribute. Among other things, the financial strength of the company, history of earnings, and the quality of management are evaluated. EPTs may consist of groups of industry-focused companies or industry-diverse companies. Information relating to the ESOP sponsored by the proposed company is also evaluated, including company valuations and recent DOL investigations. Potential participants in the EPT can decline to join the EPT within a specified time frame if not satisfied with other proposed participants. Contributions to the EPT are invested in a managed portfolio of U.S. Treasuries maturing at the approximate time when the EPT is set to terminate.

Finally, compensation of the EPT sponsors (StockShield, LLC and Dowling Hales) is tied to the amount of excess assets remaining upon termination of the EPT—there is a direct reduction in compensation whenever there are any eligible losses. There would be no incentive compensation whatsoever whenever there is any eligible loss of $3 million or more on any $10 million pool. This compensation arrangement incentivizes the selection of the best group of contributing companies.

In light of ERISA's fiduciary standards and the risk of concentrated stock positions, the EPT does all of the following:

- Reduces the risk of large ESOP losses thereby increasing the retirement security of ESOP participants;

- Reduces the risk of ERISA litigation—large losses are reduced and the EPT demonstrates that the company carefully considered how to mitigate ESOP risk;

- Provides cost-effective protection for ESOP participants and beneficiaries because contributions to the EPT are made by the company rather than the ESOP; and

- Permits the company to recoup contributions less fees and expenses in the event that there are no losses or there are eligible losses under $10 million.

The author is aware of no similar method of protection for closely held ESOPs.

Conclusion

ERISA imposes demanding standards that are particularly acute for fiduciaries of ESOPs sponsored by closely held companies. Even when ESOP fiduciaries fulfill their duties, they face substantial risk associated with concentrated stock positions.

The ESOP Protection Trust is a new mechanism that mitigates concentrated stock risk and the potential for fiduciary breach litigation. Indeed, it may be the best option for companies that want to ensure that retirement assets are sufficiently protected while at the same time reaping the benefits of widespread employee stock ownership.

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[1] 1 Robert W. Smiley, Jr., et al., *Employee Stock Ownership Plans: ESOP Planning, Financing, Implementation, Law and Taxation* xvii (2006 ed.).
[2] Staff of Senate Comm. on Finance, 95th Cong., 2d Sess., *ESOPs: An Explanation for Employees* 9 (Comm. Print 1978).
[3] *Donovan v. Bierwirth*, 680 F.2d 263, 272 n.8 (2d Cir. 1982) (citation omitted).
[4] ERISA § 2(b), 29 U.S.C. § 1001(b).
[5] *See* ERISA §§ 3(21)(A)(i) & (iii), 29 U.S.C. §§ 1002(21)(A)(i) & (iii).
[6] ERISA § 409, 29 U.S.C. § 1109.
[7] ERISA § 404(a)(2), 29 U.S.C. § 1104(a)(2).
[8] ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B).
[9] *See Donovan v. Cunningham*, 716 F.2d 1455, 1467 n.26 (5th Cir. 1983) (citation omitted).
[10] *Id.*
[11] *Bierwirth*, 680 F.2d at 271 ("careful and impartial investigation" is required); *Cunningham*, 716 F.2d at 1467; *Donovan v. Mazzola*, 716 F.2d 1226, 1232 (9th Cir. 1983) (proper inquiry is whether fiduciaries "employed the appropriate methods to investigate the merits of the investment and to structure the investment").
[12] *Mazzola*, 716 F.2d at 1234.
[13] *GIW Indus., Inc. v. Trevor, Stewart, Burton & Jacobsen, Inc.*, 895 F.2d 729, 732-33 (11th Cir. 1990); *Howard v. Shay*, 100 F.3d 1484, 1488 (9th Cir. 1996).
[14] *Cunningham*, 716 F.2d at 1467.
[15] ERISA § 406, 29 U.S.C. § 1106.
[16] ERISA § 3(14), 29 U.S.C. § 1002(14).
[17] ERISA §406(b), 29 U.S.C. § 1106(b).
[18] *E.g.*, *Cunningham*, 716 F.2d at 1464-65, 1467-68; *Reich v. Valley Nat'l Bank*, 837 F. Supp. 1259, 1272 (S.D.N.Y. 1993).
[19] 29 C.F.R. § 2550.407d-5(a).

[20] ERISA § 3(18)(B), 29 U.S.C. § 1002(18)(B).
[21] *See* 53 Fed. Reg. 17632 (5/17/88).
[22] 29 C.F.R. § 2550.408e(a).
[23] *See* DOL Advisory Opinion 2002-04A.
[24] *See* ERISA § 405, 29 U.S.C. § 1105.
[25] *Pegram v. Herdrich*, 530 U.S. 211, 225 (2000).
[26] *Bierwirth*, 680 F.2d at 271 (citations omitted).
[27] *See Leigh v. Engle*, 727 F.2d 113, 125-26 (7th Cir. 1984).
[28] *Id.* (citation omitted).
[29] *See* Corey Rosen, et al., *The Inside ESOP Fiduciary Handbook* 21 (2d ed. 2012).
[30] *See* Robert E. Brown, et al., *Basic Fiduciary Guidance for the ESOP Trustee in Corporate Finance Transactions* § 9.03.
[31] *See* Jared Kaplan, et al., *BNA Tax Management Compensation Planning Portfolio 354-7th: ESOPs* § IV.D.3 (2006).
[32] *Cunningham*, 716 F.2d at 1474.
[33] *Valley Nat'l Bank*, 837 F. Supp. at 1274.
[34] 62 F.3d 553 (3d Cir. 1995).
[35] *Quan v. Computer Scis. Corp.*, 623 F.3d 870, 882 (9th Cir. 2010) (internal quotations and citations omitted).
[36] *Fifth Third Bancorp v. Dudenhoeffer*, 134 S. Ct. 2459, 2467 (2014).
[37] NCEO, *Creating the Ownership Edge at Your ESOP Company*, http://www.nceo.org/articles/ownership-edge-esop-company (last visited May 10, 2015); Sean M. Anderson, *Risky Retirement Business: How ESOPs Harm the Workers They Are Supposed to Help*, 41 Loy. U. Chi. L.J. 1, 25 (2009); NCEO, *Are ESOPs Too Risky to Be Good Retirement Plans? Research Shows That ESOPs Provide Retirement Benefits that Are Both Much Larger and Much More Equitably Distributed than Most Other Retirement Plans*, https://www.nceo.org/articles/esops-too-risky-be-good-retirement-plans (last visited May 10, 2015).
[38] *Dudenhoeffer*, 134 S. Ct. at 2471-73.
[39] *See, e.g.*, *White v. Marshall & Ilsley Corp.*, 714 F.3d 980, 991 (7th Cir. 2013).
[40] *See* Loren Rodgers, et al., *What the Supreme Court's Dudenhoeffer Decision Means for ESOPs*, NCEO, http://www.nceo.org/articles/supreme-court-dudenhoeffer-esops (last visited May 10, 2015).
[41] *News Release: US Labor Department reaches $5.25M settlement with GreatBanc Trust*, U.S. Department of Labor (June 3, 2014), http://www.dol.gov/opa/media/press/ebsa/EBSA20141043.htm.
[42] Ruth Simon & Sarah E. Needleman, *U.S. Increases Scrutiny of Employee-Stock-Ownership Plans: Transactions That Cheat Workers Have Drawn Attention to Plans Millions Rely on*, Wall St. J. (Updated June 22, 2014, 8:52 p.m. ET), http://www.wsj.com/articles/u-s-increases-scrutiny-of-employee-stock-ownership-plans-1403484135.
[43] *See* Sean M. Anderson, *Risky Retirement Business: How ESOPs Harm the Workers They Are Supposed to Help*, 41 Loy. U. Chi. L.J. 1, 8-10 (2009).
[44] Internal Revenue Code § 401(a)(28)(B), 26 U.S.C. § 401(a)(28)(B).
[45] Michael Cembalest, *The Agony and the Ecstasy: The Risk and Rewards of a Concentrated Stock Position*, Eye on the Market Special Edition, J.P. Morgan 4-36 (2014).
[46] *Id.* at 4 (emphasis in original altered).
[47] *See id.* at 3.
[48] *Id.* at 36 (emphasis in original altered).
[49] *E.g.*, Mike Reilly, *Watch for a New Wave of ERISA Stock Drop Cases*, Boom: The ERISA Law Blog, (Nov. 11, 2014), http://www.boomerisablog.com/2014/11/11/watch-for-a-new-wave-of-erisa-stock-drop-cases/.
[50] NCEO, *Are ESOPs Too Risky to Be Good Retirement Plans? Research Shows That ESOPs Provide Retirement Benefits that Are Both Much Larger and Much More Equitably Distributed than Most Other*

Retirement Plans, https://www.nceo.org/articles/esops-too-risky-be-good-retirement-plans (last visited May 10, 2015).
[51] *Id.*; Anderson, *supra* note 43, at 10-11.
[52] NCEO, *Creating the Ownership Edge at Your ESOP Company*, http://www.nceo.org/articles/ownership-edge-esop-company (last visited May 9, 2015); Anderson, *supra* note 43, at 26; NCEO, *supra* note 50.
[53] Fiduciary liability insurance would provide a source of recovery for ERISA breaches, but it would not mitigate losses resulting from concentrated stock risk in the absence of a fiduciary breach or a settlement of litigation.
[54] *See* Patricia E. Dilley, *The Evolution of Entitlement: Retirement Income and the Problem of Integrating Private Pensions and Social Security*, 30 Loy. L.A. L. Rev. 1063, 1114 (1997).
[55] *See* ERISA § 203(a), 29 U.S.C. § 1053(a); S. Rep. No. 93-127 (1973), *reprinted in* 1 *Legislative History of the Employee Retirement Income Security Act of 1974, Pub. L. 93-406 (ERISA)* 595 (2000) ("[T]he issue [of vesting] basically resolves itself into whether workers . . . should be denied benefits they have earned as deferred compensation and which have been placed for them in a fund for retirement purposes.").
[56] *Steinman v. Hicks*, 352 F.3d 1101, 1103 (7th Cir. 2003).
[57] *E.g.*, *Donovan v. Bierwirth*, 754 F.2d 1049, 1056 (2d Cir. 1985) (citations omitted).
[58] Peter A. Kardas, et al., *Wealth and Income Consequences of Employee Ownership: A Comparative Study from Washington State*, http://dept.kent.edu/oeoc/publicationsresearch/Sum1999/WealthSum1999.html (last visited May 9, 2015).
[59] Anderson, *supra* note 43, at 11.
[60] ERISA § 502(a)(2), 29 U.S.C. § 1132(a)(2).
[61] *See* Shannon P. Pratt, et al., *Valuing a Business: The Analysis and Appraisal of Closely Held Companies* 698 (4th ed. 2000) ("ESOP transactions are complex because they encompass the incorporation of knowledge of various disciplines," including valuation, regulatory and legal issues, administration of qualified plans, finance, and fiduciary issues.).
[62] Anderson, *supra* note 43, at 5 (citation omitted).

About the Author

Joseph A. Garofolo is a principal with ERISA Expert Services, LLC, a company that provides expert witness and independent fiduciary services. He began his career in the field of employee benefits in 1999 with the U.S. Department of Labor, Pension and Welfare Benefits Administration (now the Employee Benefits Security Administration). At the Department of Labor, he performed research and analysis relating to government investigations of alleged ERISA violations in the Detroit District Office.

After graduating from the University of Michigan Law School, he was an associate at a large international law firm focusing his practice primarily on employee benefits before starting his own law firm in 2003.

From 2003 to 2010, in addition to practicing law, Mr. Garofolo served as a principal with ERISA Consulting Group, a company that provides independent fiduciary, expert witness, and consulting services. Some of the independent fiduciary engagements in which he was involved include the following: i) a transaction for the sale of closely held shares by an employee stock ownership plan; ii) the acquisition of real property by a collectively bargained plan; and iii) the evaluation of the reasonableness of plan expenses and expense allocation among related parties and service providers.

As an attorney, Mr. Garofolo has advised clients with respect to fiduciary compliance, service provider arrangements, and various other issues relating to the design, management, and administration of employee benefit plans. He has served as counsel for plan sponsors, participants, service providers, medical providers, and others. Mr. Garofolo has represented clients involved in ERISA litigation in federal courts across the country.

In 2012, Mr. Garofolo was selected by *California Lawyer* magazine as a recipient of the California Lawyer Attorneys of the Year (CLAY) Award in the field of employee benefits. CLAY Awards recognize attorneys who "have changed the law, substantially influenced public policy or the profession, or achieved a remarkable victory for a client or for the public."

Mr. Garofolo has been retained as an ERISA expert witness in federal and state court litigation.