Do Fiduciaries in Closely Held ESOP Companies Have Plausible Alternatives in the Face of Stock Decline?

In *Fifth Third Bancorp v. Dudenhoeffer,* the Supreme Court struck down the rule on the presumption of prudence for ESOP fiduciaries (the so-called *Moench* presumption) and replaced it with a series of alternative tests to determine if "special circumstances" would mean the fiduciaries should have sold shares in the trust, removed them as an investment option for employees, and/or not purchased shares at a certain price.

One result of this ruling, so far, has been to make it more difficult for plaintiffs to prevail in ESOP and 401(k) stock plan lawsuits in public companies.

At first, it appeared the ruling would have little impact on closely held companies, but in a recent case, *Hill v. Hill Brothers Construction,* a district court applied the standard to closely held companies. Plaintiffs in that case argued that they did not have to plead special circumstances because the *Dudenhoeffer* ruling applied only to public companies. But the court said it did apply, and ruled for the defendants, saying the plaintiffs needed to plead that the fiduciaries had a plausible alternative course of action they could have taken instead of simply watching the value of the company stock in the ESOP sink to zero.

It remains to be seen if this approach will be adopted by other courts and, although in this case it benefited the defendants, to see what impact it would have. If other courts do adopt it, that would raise an important issue for ESOP fiduciaries. If they face the threat of a significant decline in stock value (as all companies do from time to time), do they have a plausible alternative course of action that would do more good than harm?

Public company ESOP fiduciaries can easily sell shares, refrain from buying them, or stop offering them, but private company fiduciaries cannot easily sell shares. It would be difficult to attract an investor willing to buy a minority interest at anything less than a steep discount, and selling the whole company in these circumstances is likely to create a fire sale situation. They can choose not to buy more shares, of course, but many ESOPs are already 100% ESOP owned, and valuation rules should cover this issue in any event.

So could plaintiffs argue there are other courses of action fiduciaries could have taken? There are a few possibilities. One or more of these may be worth adopting on its own merits to help protect employees against downside risk and make the case to courts and the DOL that the fiduciaries were doing all that could be done.

Offer Earlier Diversification: If employees can diversify earlier, that can protect them from downside risk. If this is initiated when the stock price is under pressure, it creates a greater cash flow problem for the company at what may be just the wrong time. Offering early diversification before a crisis hits can provide more manageable protection.

Put More Cash in the Plan: Many ESOPs do accumulate some cash over time, whether for cash distributions paid on shares or company cash contributions used to keep contribution levels steady after all the shares are bought out. Companies often use the latter strategy to build ESOP cash reserves to handle repurchasing, account segregation, and rebalancing needs. Having greater diversification provides a strong argument for fiduciary prudence, but, again, also requires strong cash flow.

Hedge Stock Risk: Wealthy investors with concentrated holdings in one or just a few investments often create hedging strategies to limit their risk. That is easy to do for publicly traded securities, as there are multiple products and strategies available. Hedging closely held company stock has not historically been possible. There is a product now available that provides protection against declines of over 50%

in stock value, measured at the end of a 5- or 10-year period. If it succeeds, other products might develop and, if reasonably priced, could provide practical alternatives, and the failure to provide them could then be seen as a strong argument for plaintiffs. Conversely, providing this kind of loss protection could represent a strong argument for potential defendants, and could deter litigation alleging fiduciary breaches under ERISA.

What to Do Now

We are still early on in seeing how the alternative course of action issue will work out in the courts and DOL investigations. It could be that the standard will prove too high to be met, but it is also possible that it will become a more robust argument. ESOP fiduciaries and sponsors certainly should not be concerned that this will represent an existential threat to ESOPs, but, as with any fiduciary matter, fiduciaries should be able to document that on a continuing basis they monitor the value of plan assets, and consider whether there are, in fact, alternative courses of action they can take to protect their ESOP against large losses. ■

NCEO founder Corey Rosen, who wrote this article, serves in a non-endorsing, advisory capacity on the board of the company described above that provides the risk protection product. Neither he nor the NCEO currently receive compensation for his service on the board.