

IT'S A NEW WORLD FOR ESOPS: THE DOL/GREAT BANC FIDUCIARY PROCESS AGREEMENT AND RECENT COURT DECISIONS

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A Brief History

- 1974 – ERISA signed into law (40th anniversary)
 - ERISA 406(a) – prohibits transactions between plans and “parties in interest”
 - Definition of “party in interest” very broad and effectively prohibits almost all purchases of employer stock by ESOPs
 - ERISA 408(e)(2) – prohibited transaction exemption permits purchase of employer stock by plan from a party in interest if the purchase is for “adequate consideration.”
 - “Adequate consideration” defined as “fair market value as determined in good faith” pursuant to Sec.’s regulations
- 1988 – Adequate consideration regulation is proposed, but never became effective
- 2008-2014 – ESOPs become national project of EBSA, with particular focus on valuations.

The Role of Valuation in ESOP Cases

- Unique to ESOPs sponsored by privately held companies whose stock is not publicly traded
 - To determine stock's fair market value, must perform a valuation as of the transaction date
- Valuation is complex and requires retaining independent valuation advisor
- Valuation typically involves two methods:
 - projecting future financial performance
 - looking to values of comparable public companies

Fiduciary's Role in Valuation

- 408(e)(2): “Adequate consideration” is “the fair market value of the asset as determined in good faith by the trustee or named fiduciary”
- Debate over contours of this test, but a few things are clear:
 - Valuation advisor must be independent
 - Reliance by trustee on valuation advisor not a “complete whitewash” that satisfies 408(e)(2)
 - Trustee must ensure that valuation advisor has complete and accurate information
 - Reliance on valuation must be reasonable -- cannot ignore flaws/errors that are reasonably detectable

Valuation Problems in ESOP Cases

- Relying on unreasonable management projections of future performance
 - Projections that far outstrip recent performance
 - Projections based on unfounded business plan
 - Revenue projections that do not account for costs associated with expected growth
- Using comparable companies that are not comparable
 - E.g., comparable companies sell to luxury market, company being valued sells to Walmart

Valuation Problems in ESOP Cases

- Using discount rates that do not account for risks facing company
- Improper premiums for “control”
 - Applying control premium or reducing minority discount for unfounded reasons
 - Paying for control but not getting it (e.g., allowing sellers to still control Board of Directors)
- Relying on unreliable financial statements

Procedural Problems in ESOP Cases

- Cursory review of valuation and failing to question key assumptions
- Using unqualified or conflicted valuation advisor
 - Advisor has little or no experience in valuation
 - Advisor has questionable/criminal background
 - Advisor did prior work for sellers on other side of transaction to the ESOP
- Failing to negotiate with sellers over price

Fiduciary Process Agreement: Background

- 2012-2014 – DOL and GreatBanc Trust Company negotiate fiduciary process for ESOP transactions and ultimately enter into process agreement
- *“Others in the industry would do well to take notice of the protections put in place by this agreement.”* Phyllis C. Borzi , June 3, 2014.

Fiduciary Process Agreement: Goals

- Encourage bona fide negotiations between ESOP trustee and sellers through rigorous questioning of management projections
- Discourage blind reliance on valuation advisor
- Account for, if not eliminate, conflicts of interest
 - Conflicted valuation advisors
 - Conflicted management

Fiduciary Process Agreement: Goals

- Ensure that valuations have narrative consistency
 - E.g., weaknesses identified in text of report should be reflected in valuation
- Encourage consideration by trustee of all relevant factors and assumptions in valuation
- Encourage accountability on part of each individual involved in approving transaction

Fiduciary Process Agreement: Selecting a Valuation Advisor

- Trustee will hire a Valuation Advisor who is:
 - Independent
 - Not previously have performed work for the transaction on behalf of:
 - ESOP Sponsor.
 - Seller/counter-party or entity structuring the transaction
 - Not have a familial or corporate relationship with any of the above.

Fiduciary Process Agreement: Selecting a Valuation Advisor

- Trustee will hire a Valuation Advisor who is:
 - Qualified
 - Consider other advisors when appropriate.
 - Review the qualifications of the advisor.
 - Any civil or criminal actions involving the advisor.
 - Check references.

Fiduciary Process Agreement: Valuation Analysis

- Trustee will understand the information used to perform the valuation.
- Comparable Companies
 - Determine the comparability of the selected companies.
 - Size, customer concentration, earnings volatility.
 - Measure historical comparability.
 - Utilize specific metrics as applicable.
 - Measure projected comparability.
 - Identify any discounts to the public comparable multiples.

Fiduciary Process Agreement: Valuation Analysis

- Trustee will understand the information used to perform the valuation.
 - Weighting of the methods.
 - Repurchase Obligation.
 - The company's ability to repay debt.
 - Terms of the financing – commercially reasonable?
 - Overall impact of transaction on plan sponsor.
 - Fair to ESOP from financial point of view.
 - Fair to ESOP relative to all other parties.

Fiduciary Process Agreement: Financial Statements

- Financial statements with an unqualified audit are the gold standard.
- Unaudited financials will need further scrutiny.
- The trustee does not need to prepare an audit.

Fiduciary Process Agreement: Documentation by Trustee

- Trustee will document its review and consideration of the valuation report:
 - Fourteen specific components of valuation to review and consider.
 - Items common to most valuation reports.
 - Two “catch-all” items:
 - “Material assumptions” underlying valuation.
 - “Material considerations or variables” that could have significant effect on stock price.

Fiduciary Process Agreement: Documentation by Trustee

- Trustee will determine the prudence of accepting and relying on the valuation analysis
 - Identify and question assumptions in valuation report.
 - Make reasonable inquiry as to consistency of valuation report with due diligence information.
 - Determine that the conclusion is consistent with the data.
 - Determine that the valuation report is internally consistent.

Fiduciary Process Agreement: Documentation by Trustee

- Document Transaction Approval Process.
 - Identify individuals responsible for approving the transaction.
 - Identify points of discussion among fiduciary committee members and why the discussion ensued.
 - Identify if any individual concluded or expressed belief that the valuation report's conclusions were inconsistent with the data or internally inconsistent in material respects.

Fiduciary Process Agreement: Internal Consistency

If the Valuation Report's conclusions are not consistent with the data and analysis or the Valuation Report is internally inconsistent in material respects, then...

Trustee will NOT approve transaction.

Fiduciary Process Agreement: Miscellaneous

- Trustee will preserve all documents used in connection with a transaction
 - Document preservation for at least 6 years after transaction closes.
 - Signed certifications by individuals approving the transaction that they have read and understood the valuation report.

Fiduciary Process Agreement: Miscellaneous

- Fair Market Value
 - Face value of debt financing the transaction cannot exceed value of stock received.
- Claw-Back
 - Document consideration of arrangement to protect ESOP against possibility of adverse consequences in event of significant corporate event or changed circumstances.
- Other Professionals
 - May delegate fiduciary responsibilities to qualified professionals to aid trustee in exercise of duties as long as it is consistent with ERISA.

Last But Not Least

- ERISA Section 404 still applies:
 - A fiduciary must discharge 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.” (emphasis added)

Trickle-Down Effect

Fiduciary
Process
Agreement

- Written commitment by GreatBanc to follow procedures. For all other trustees, process requirements do not create any direct obligation, however...

Institutional
Trustees

-DOL expects all fiduciaries to adhere to these procedures even if not a direct obligation. And, while addressed to fiduciaries and the fiduciary process,

Valuation
Profession

- ...the agreement topics include the “VALUATION ADVISOR” and the “VALUATION REPORT” in an ESOP transaction.

Post-Agreement Trends

- Most institutional trustees were already doing many items
 - No real curveballs, more of a continuation of trends triggered by recent ESOP litigation over the past few years
- Trustees expect valuation advisor to follow relevant parts of process agreement
- Valuation reports already beginning to incorporate relevant parts of process agreement
 - Additional boilerplate language
 - More explanation and documentation

Post-Agreement Trends (cont'd)

- New or increased limitations by trustees on valuation advisors related to conflicts of interests
 - Transactions with two valuation advisors: one for ESOP trustee and one for counterparty
 - ESOP's valuation advisor does not perform feasibility analysis

Post-Agreement Trends (cont'd)

- Continued increase in the valuation advisor selection process due diligence by trustees
 - Trustee “approved list” of valuation advisors
 - Trustee questionnaire for valuation advisors
- Continued increase in the review of the valuation report by trustees
 - More questions, requests, documentation, and/or pushback

Important Issues

- Some areas in Fiduciary Process Agreement are not specific to the subject case
- Fiduciary Process Agreement covers many issues that are also seen in other recent ESOP litigation cases
- Topics covered in process agreement are not new issues

ESOP Valuation Advisor

- Valuation advisor is generally not named in ESOP litigation cases
- Currently, DOL has limited recourse against valuation advisors
- Typically held to standard of care under state law not ERISA
- DOL is expected to reintroduce proposed regulations related to expanding the definition of an ESOP fiduciary to include valuation advisors

ESOP Valuation Methodologies

- Fiduciary Process Agreement – documentation whether standard and accepted methodologies were used and bases for any departures
- Approaches (methods) to determine fair market value (“FMV”)
 - Income Approach (Discounted Cash Flow Method)
 - Market Approach (Guideline Public Company Method; Guideline Transaction Method)
 - Asset Approach
- ESOP litigation is generally focused on the discounted cash flow method and the guideline public company method

Discounted Cash Flow Method

- Discounted cash flow (DCF) method is the most common method applied in ESOP valuations
- DCF method is typically a focal point of ESOP litigation
- Disputes/litigation over DCF method include:
 - Reasonableness of projections
 - Discount rate applied (e.g., weighted average cost of capital or WACC)
 - Customer concentration
 - Controlling or Noncontrolling

Guideline Public Company Method

- Guideline public company (GPC) method is the second most common method applied in ESOP valuations
- GPC method is a common area of dispute in ESOP litigation
- Discussed in the Fiduciary Process Agreement
- Disputes/litigation over GPC method include:
 - Comparability of guideline public companies to the subject company
 - Selection of appropriate pricing multiples
 - Adjusting for differences in the guideline public companies and the subject company
 - Control premiums?

Reasonableness of Projections

- Issues over projections in almost all private ESOP litigation involving valuation
- Topic is covered extensively in Fiduciary Process Agreement
- Projections are typically prepared by management
- Who is responsible for projections due diligence?
- What level of due diligence for projections?

Reasonableness of Projections

- Dispute over the reasonableness of the projections covering one or more of the following:
 - Projected profit margins
 - Projected growth rates
 - Comparison to historical
 - Comparison to industry and/or comparable companies
 - Projected capital expenditures
 - Projected owner compensation
 - Customer concentration

Discount Rate

- The present value discount rate used in the DCF is often a critical issue in ESOP litigation (Bruister, Tharaldson, Rembar, Sierra Aluminum)
- Typically not discussed in the complaint, but brought up by plaintiff expert
- Battle of the experts
- Discount rate is briefly touched on in Fiduciary Process Agreement

Control Premiums

- The issue is whether an ESOP should pay a control premium (an enhancement to the stock's value) when it acquires stock
- A common issue in ESOP litigation (AIT Laboratories, Tharaldson, Rembar, Sierra Aluminum, Omni Resources, Trachte)
- Briefly mentioned in Fiduciary Process Agreement

Dudenhoeffer and Tatum:
Their Potential Impact on Closely
Held ESOPS

Fifth Third Bancorp v. Dudenhoeffer – Background

- *Dudenhoeffer* involved an ESOP that held publicly traded employer stock of a large bank. Plaintiffs alleged that investments in Fifth Third's stock became imprudent, overvalued and excessively risky by July 2007 for two separate reasons:
 - First, public information gave early warning that Fifth Third's business in subprime lending was headed to a collapse.
 - Second, inside information indicated that Fifth Third's officers deceived the market by making material misstatements about the company's financial prospects, causing the stock to be overvalued.

Fifth Third Bancorp v. Dudenhoeffer – Background

- The Supreme Court held that fiduciaries were not entitled to a special presumption of prudence favoring fiduciaries who invest in employer stock.
 - In response to concerns that litigation would deter companies from offering ESOPs, the Court held that a presumption of prudence was not necessary to weed out meritless claims.
 - Instead, this “important task can be better accomplished through careful, context specific scrutiny of a complaint’s allegations.”
 - The Supreme Court set forth standards that differed based on whether the imprudence claim was based on public or non-public information.

Fifth Third Bancorp v. Dudenhoeffer – Potential Impact on Closely Held ESOPs

Dudenhoeffer involved publicly traded stock and did not involve prohibited transaction claims.

But *Dudenhoeffer* may have some relevance to decisions and issues for fiduciaries of closely-held companies.

Fifth Third Bancorp v. Dudenhoeffer – Potential Impact on Closely Held ESOPs

- First, the Court held that the non-pecuniary goal of employee ownership does not alter the fiduciary's duty to manage an ESOP for the purpose of providing retirement benefits.
 - If someone offers to buy an ESOP-owned company, goals of employment and employee ownership cannot trump maximizing retirement benefits.
 - How does a fiduciary factor in sale's impact on rights of participants to what would have been future ESOP accruals?

Fifth Third Bancorp v. Dudenhoeffer – Potential Impact on Closely Held ESOPs (cont.)

- Second, the Court held that plaintiffs must show an alternative course of conduct that would not have violated securities laws and would have avoided the losses.
 - Violating the securities laws is not an issue with closely held ESOPs.
 - But closely held ESOPs have shareholder rights and fiduciaries may have a duty to exercise those rights to protect the ESOP if action is likely to be successful.
 - ESOP participants may have pass-through voting rights when the company is engaged in a take-over fight.
 - What obligation does fiduciary have to determine future benefits if company sold?
 - May not be a market for a dying company. Would a “fire sale” be imprudent?
- Defense perspective: Supreme Court emphasized that plaintiff must show how fiduciary could have avoided the loss as a means to protect and encourage investment in employer stock. *Cf. Tatum*, where it appears ***defendant*** had to prove its actions caused no loss.

Tatum v RJR Pension Inv. Comm. – Background

- RJR spun off the Nabisco food business, which resulted in a **non**-employer single stock fund in its 401(k) plan.
- A staff working group met for an hour and decided to freeze and liquidate the Nabisco stock fund, in part because of diversification concerns.
- Tatum complained and asked RJR to reconsider, *e.g.*, the driver for the spin-off was to remove the tobacco taint from Nabisco stock – which was then likely to go up.
 - Nabisco stock goes up after liquidation and Tatum sued.

Tatum v RJR Pension Inv. Comm. – Causation and Substantive Prudence Defense

Both district and appellate courts found RJR (the plan's investment committee) failed to engage in a prudent decision making process. That left defense of “substantive prudence”:

- Fourth Circuit held burden was on defendant to prove its breach did not cause loss to the plan.
- Fourth Circuit held RJR had to show that an objectively prudent fiduciary **would have** made the same decision, not that it **could have**.

Tatum v RJR Pension Inv. Comm. – Potential Impact on Fiduciary Exposure for Closely Held ESOPs

- Difference between “would” and “could” is significant: Means proof that a fiduciary could have chosen that option as one of several prudent ones is insufficient.
- Puts pressure on documenting and getting the process right on any significant fiduciary decisions.
 - Substantive prudence (that the decision was prudent regardless of process) is impaired as a defense, at least in the Fourth Circuit.
 - If it is a complex decision for a closely held ESOP (e.g., whether to buy, to refinance, or to sell), there is a good chance it will have more than one right answer. Not sure how this causation “would have” rule will apply in that context.

Questions

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