Best Practices

Q&A with Tim Hauser of the U.S. Department of Labor

Frank (Chip) Brown, CPA

As part of a national enforcement project centered on ESOPs, the U.S. Department of Labor (DOL), through its Employee Benefits Security Administration (EBSA) agency, has increased its level of scrutiny of ESOP employer stock valuations relied on by fiduciaries in ESOP stock purchase or sale transactions. This increased scrutiny has led to an increase in the number of ESOP-related suits filed by the DOL. Tim Hauser is the Deputy Assistant Secretary for Program Operations of EBSA at the DOL, and as such is the chief operating officer of the agency. His responsibilities include overseeing the EBSA regulatory and enforcement of ESOPs and other welfare benefit plans. The purpose of this interview with Tim is to provide a regulatory perspective on ESOP employer stock valuation and related enforcement. The topics discussed in this interview range from his opinion on the areas for improvement in ESOP valuations to his thoughts on current enforcement efforts. The author hopes this interview not only provides insights on important ESOP-related issues, but also illustrates that a continued dialogue between all parties (e.g., ESOP practitioners and the DOL) may result in a common perspective that reduces litigation in the future.

1. Can you give an overview of your role and your division within the framework of the U.S. Department of Labor (DOL)?

I am the deputy assistant secretary for program operations of the Employee Benefits Security Administration (EBSA). EBSA is the DOL agency that enforces the Employee Retirement Income Security Act (ERISA) and protects the interests of benefit plan participants, private retirement plans, health plans, and other welfare benefit plans.

In my role, I serve as the chief operating officer of EBSA. My responsibilities include overseeing the agency's regulatory, enforcement, and reporting activities. I am part of our national office in Washington D.C.

We also have 10 regional offices, which are staffed with field investigators as well as benefit advisers who are available to provide direct assistance to the public.

2. How has your current role changed from your previous position at the DOL?

Until December 2013, I was the associate solicitor of the Plan Benefits Security Division (PBSD) of the Office of the Solicitor at the DOL. PBSD staffs the attorneys in Washington, D.C., who represent EBSA. In moving from PBSD to EBSA, I have gone from being the lawyer to being the client.

3. In general, do you think that employee stock ownership plans (ESOPs) are good for employees, if implemented and administered properly?

ESOPs are written right into the law and they can serve an important set of social goals. ESOPs can promote worker ownership and worker engagement. ESOPs also can provide valuable retirement benefits to people. Our enforcement program is intended to protect these retirement benefits.

4. **In general, why has there been such an increase in ESOP-related litigation and enforcement efforts by the DOL?**

We believe there is a chronic problem with ESOP appraisals. To address this problem, we have increased the level of scrutiny of ESOP appraisals. When we go in and open an ESOP case, I ask my field people to take a close look at the appraisal. And we often review the appraisal at the national office as well.

The number of suits that we have filed to recover ESOP losses simply reflects the number of egregious cases that we have seen. The cases we have brought are only those that we thought were bad enough to merit litigation and that we could not resolve by other means (including settlement).

The bottom line is that we want ESOP transactions to occur at the right price and be in the best interest of the plan.

Ultimately, my hope is that the quality of appraisals and fiduciaries' consideration of those appraisals improves. But, I'm afraid that, for the short term, I expect to see more litigation and more cases in this area because I do not think we are there yet.

5. **Did the unexpected great recession and downturn in the economy/markets contribute to the increase in litigation?**

We have not filed suit against anyone for failing to predict the 2008 downturn. Our focus is on whether parties acted prudently, loyally, and in good faith at the time of the transaction.

It is not based on hindsight. In the transactions that are the subject of our lawsuits, the imprudent conduct occurred irrespective of whether the markets subsequently went up or down.

6. **How do you determine which cases to pursue or investigate?**

We look at each matter on a case-by-case basis. Sometimes what happens is you start to see patterns. You see the same names popping up again and again in transactions that look problematic to us. At some point you say, I keep seeing this person, maybe I need to look at the deals that person is doing. But really, it's more case-by-case.

We also have a national enforcement project centered on ESOPs. We have criteria to evaluate those cases and what we were looking for. Then we make decisions based on the inventory of cases and our resources.

7. **You mentioned the national enforcement project centered on ESOPs. Can you talk more about that project?**

There are a series of problems in the marketplace that we regulate. There are certain areas that we choose to focus on as enforcement priorities. We make a dedicated effort to find violations and to correct them. ESOPs are one of our longstanding national enforcement priorities.

For ESOPs, two common violations seem to arise with greater frequency than others. The most common violation involves parties relying on an unreliable appraisal in deciding whether to move forward with a transaction at a particular price.

In these cases, our allegation is that the fiduciaries failed to exercise adequate diligence in obtaining and reviewing the appraisals as part of the transaction process.

The other common violation arises where the plan effectively owns the company (or owns a substantial part of the company), but the plan is not exercising any of its ownership rights to protect its interest in the company. For example, while management is looting the company of its value, the fiduciaries are asleep at the wheel and doing little or nothing to protect the stock's value.

Outside of enforcement, I'm really interested in making an effort for more concerted outreach to the ESOP community and in seeing if there are other ways we can address the major issues EBSA has seen in order to prevent abuses and violations from happening in the first place. I have made an effort to talk more with ESOP industry associations and groups and to attend ESOP events.

8. **Can you talk about the common issues that you are focusing on with respect to ESOP appraisals?**

If you look at our recent litigation, a common problem is reliance on unrealistic projections of future performance in determining value. ESOP appraisals are often based on management projections.

An issue can arise when the projections are too rosy. This can result in an inflated appraised value and an overpayment by the ESOP in the transaction. I see the use of aggressive and unrealistic projections as a chronic problem with ESOPs.

In many cases we investigate, these "management projections" are essentially prepared by the counterparty to the ESOP in the transaction. It is not uncommon for the projections to be prepared by the very people who are selling the stock to the ESOP or who are subordinates of the sellers.

So you have parties to a transaction (that is supposed to be an arm's-length deal) who are just

> **"If you were investing your own money, you wouldn't just go through the motions. . . . You would be kicking the tires and making sure that the deal made sense. . . ."**

plugging in whatever their counterparty told them will be the future performance of the company.

In these cases, ESOP fiduciaries are accepting projections without asking themselves about how realistic the projections are. They are not asking questions such as: How do the projections compare to the performance and projections of the company's peers? How do the projections compare to the historical performance of the company?

How plausible is it that the company could really go forward with these projections? How volatile or sensitive are the projections to various assumptions? What happens if the projections are off by a couple of percentage points? Or what happens if there is a recession?

Will the company be able to service the debt in these types of downside scenarios? What will happen to the company's value as competition drives down profits, or as performance reverts to the mean?

People need to think hard and perform some level of scrutiny related to the projections. And in the cases we bring, we just don't see that.

We just see management projections getting plugged right in to the ESOP appraisal without a critical review. Everybody moves on and does their math based on these management projections without "kicking the tires."

We typically see a standard disclaimer in the appraisal report that it's based on management's projections. The appraisers assert that they don't vouch for what management told them and that their conclusions are solely a reflection of those numbers, but then the fiduciaries don't scrutinize the numbers either.

Essentially the appraisal presupposes the accuracy of the financial records and the projections provided to the appraiser. But, I really think fiduciaries need to insist on more than that.

If the projections are prepared by the appraiser instead of management, the fiduciary needs to ask the appraiser to do a critical analysis of the reasonableness of the projections. The fiduciary needs to then talk to the appraiser about the projections and ask questions along the lines of those I mentioned earlier. Critical thinking is really important here.

Another problem that we see with ESOP appraisals is out-of-date financials. That's pretty common and that's a killer too. It's an issue that is relatively straightforward.

You are not arguing about the precise amount of the company-specific risk in your discount rate, or some technical issue involving valuation arcana. It's simply that you were relying on data that was months and months old—and things have changed at the company since then.

Another appraisal issue in some of the cases we have filed is the use of control premiums on plans not really buying control. The stock value is getting a boost based on a control premium. But then you look at the various documents (stock purchase agreements, the various covenants on the finance agreements) and see that the plan is not really getting control.

There can also be an issue where the plan pays for the full value of stock but does not get all of the upside because of dilution. For example, when a plan is buying 100% of the equity in the company, but it doesn't get 100% of the upside due to various dilutive items such as warrants, options, or earnouts that are not considered in determining adequate consideration. The result is that the plan will be overpaying for the stock.

I could give you a laundry list of issues with ESOP appraisals. I keep a running list of the different things I have seen. People are always coming up with new things I haven't thought of.

9. **Separate from the appraisal, are there any other areas related to ESOP transactions that you want to comment on?**

Moving apart from the appraisal issues, another big problem I sometimes see is a lack of seriousness about these transactions. If you are the person with the authority to make a multimillion-dollar decision, you really should be acting more like a private investor who is putting his own money on the line.

You should act as if this is your retirement security at stake. Act as if you are investing 100 percent of your retirement. What process would you employ if that were the case? I guarantee you that the process you would employ would not be a checklist, pro-forma type of thing.

If you were investing your own money, you wouldn't just go through the motions. You wouldn't just hire the appraiser to make sure you got the opinion you wanted.

You would be kicking the tires and making sure that the deal made sense both from a process stand-

point and a substantive standpoint. I'm not saying this isn't the way it usually works, but in the cases we bring, it's never how it works.

Another issue we have seen in our cases that's troubling is that we don't actually see negotiations. If we do see negotiations, they are very marginal and generally regard some very minor provisions of the purchase agreement that do not result in increasing or protecting the benefits the ESOP is supposed to provide participants.

We do not see a lot of haggling over price. We do not see a lot of pushing back. Indeed, in some cases, we see trustees actively working with the seller to come up with ways to maximize tax benefits for the seller to the detriment of the plan.

10. What could ESOP practitioners, such as attorneys, appraisers, and institutional trustees, do to help improve these issues that you are seeing?

We recently entered into a settlement agreement in the Sierra Aluminum case. If people follow the document as best practices, we all would be hugely better off. I think the transactions would be much better if people really took the provisions in this agreement to heart and followed them.

Obviously the agreement was structured with a particular case and a particular set of parties in mind. So, to some degree, it is tailored to the problems we identified in a particular case. But there is a lot in the agreement that is broadly applicable to everybody.

11. Given that the settlement agreement is based on one transaction in a particular case, is there anything that you would add to the document in terms of best practices?

I probably would say more about earnout agreements and add information on warrants/options as well as indemnification. There are probably some other items and information that I'd cover if I really went through my list.

12. Is there a higher level of scrutiny for complex ESOP transactions as opposed to more basic structured ESOP transactions?

I'd say our antennae are going to go up more if we see a lot of complexity. At some point we have to wonder if all the complexity is there because it's good for the plan or if it is there for some other reason. Usually, you can do a transaction where the plan purchases shares of common stock and pays fair market value without too much complexity.

The overall point I would make is that in determining the structure of the transaction, the fiduciary is obligated to make sure that the interests of the ESOP participants are taken into account. That is, the trustee has to consider how that transaction and its structure could help or hurt participants.

13. In general, what due diligence should be performed in regards to the reasonableness of management projections used in the valuation?

I would point to the portions of the Sierra Aluminum settlement agreement that cover the topic of projections. You will see that projections were an issue in that case.

So, we took some care in spelling out how plan fiduciaries should look at projections. Basically, we think you should consider the source of the projections.

Are these projections coming from someone who is essentially on the opposite side of the deal from the plan? If the answer is yes, the plan representatives should be skeptical about those projections. We also think you should compare the projections with historical results and the company's peer group.

You should ask yourself what the projections mean for the company in the future. If the company is projecting ever increasing performance and the sky's the limit, ask yourself exactly what market share you are anticipating that the company is going to have ten years from now—is that kind of performance realistic?

You should be asking yourself about what happens if the company misses projections. What are some reasonable scenarios where the company might miss the projections? What would that mean for the company?

Given the amount of debt in some of these transactions, it often is the case that if the company misses projections by even a little bit, then all of sudden it can't meet the loan payments.

14. It is my understanding that Section 3(18) of ERISA contemplates that the DOL would promulgate regulations to guide valuations of closely held stock of ESOP sponsor companies. Given that there are no such regulations (at least not finalized), what guidance would you encourage or suggest that plan fiduciaries consider in valuing securities for which there is not a generally recognized market?

The Sierra Aluminum settlement agreement lays out a lot of factors or guidance. And you can look to various professional standards for appraisers. There is also quite a bit of case law such as *Donovan v. Cunningham*, *Chao v. Hall Holding*, and *Howard v. Shay*.

"We do not, as a rule, bring lawsuits for close judgment calls. We are looking at abusive transactions."

The law is fairly well developed. But what we are talking about in these cases is very common-sense. We do not, as a rule, bring lawsuits for close judgment calls. We are looking at abusive transactions. Typically, these aren't situations where professional appraisers should have needed a lot of guidance from us.

15. You touched on this earlier, but what are your thoughts on control premiums for ESOP transactions?

The decision on whether to pay for control is always the trustee's decision. The trustee may be getting advice from an appraiser. But the trustee is the one who is going to be on the hook. The trustee is the one who needs to look out for the plan's interests.

And with control premiums, from my standpoint, the trustee needs to question and consider whether the plan is actually getting control. Is it going to be the exact same people running the company? Are they going to be running it exactly the same way?

Has the trustee fully considered the issue where, under the terms of the agreement, the plan does not even have a right to control who manages the company or how it's managed? In such a case, the plan should not be paying for control.

Even if the plan is acquiring the ability to run the company, I think the trustee needs to think hard about whether to a pay a control premium. Because normally when you think of somebody in the private market paying a control premium, they are doing it because they think they have some way to restructure, change the business plans, alter management to reduce costs, or increase revenue.

That is not typically the case when a plan acquires control. I just don't normally see that.

16. Can you discuss in general what you consider to be an independent appraiser? Does work performed by an appraiser for other related parties prior to the transaction impair independence?

The Sierra Aluminum settlement agreement goes into this in some detail.

We do not think you should hire an appraiser that is picked out by your counterparty. We don't think you should use an appraiser that's been doing work for the counterparty, including any affiliates, friends, or relatives of the counterparty.

You really want your own independent adviser. What is of concern in a lot of the transactions where we brought lawsuits is a sense that the "fix was in." That is, the process and its outcome were rigged by the counterparty.

The counterparty essentially took the appraiser out for a test drive prior to the transaction. The counterparty got a feel for whether or not the appraiser was likely to come in at a good price for the counterparty, not the plan. Then the trustees—whose job is to look out for the plan—just go with that same appraiser for the ESOP.

Fast-forward to the closing, and the transaction price is the price that's right for the seller, not the plan.

That is not what you want if you are trying to make a decision on what is in the plan's best interest. You want your own independent appraiser who does not owe anything to the seller. You do not want to be worried about whether the appraiser has any sense of duty to the other guy on the opposite side of the deal from you.

17. In general and at a high level, what should be done to assess the work of an appraiser?

The Sierra Aluminum settlement agreement discusses this. You need to make sure that you select and hire the appraiser prudently. You need to make sure the appraiser has complete current and accurate information.

You need to verify for yourself that it is reasonable to rely on the appraisal. This means you actually have to read the appraisal, understand what the assumptions are, and consider sensitivities in the analysis.

18. What are your thoughts on a fiduciary considering the fair market value of seller notes, which may be lower than the face amount, in determining if an ESOP paid more than adequate consideration for sponsor company shares?

The trustees need to recognize that they have an obligation to get the price right and to report the price correctly both in the plan's filings with the government and in the information provided to participants.

And, they have a distinct obligation to get the financing right. They have to do all these things, not just some. The financing might be good, but that does not get the trustee off the hook if he sets the price too high.

19. What does it take for the DOL to file suit against an appraiser? Typically, the appraiser is not named as a defendant in DOL suits.

The chief way we regulate the plan universe is through fiduciaries. Fiduciaries have a duty of undivided loyalty to the plan. They have a duty to be prudent. They are obligated to refrain from prohibited transactions. And if they run afoul of those duties, we can bring a lawsuit. We can compel them to correct their breaches. We can hold them accountable for all of the losses caused by their misconduct.

If you are not a fiduciary, we have very limited remedies. We may be able to bring suit against nonfiduciary service providers for knowing participation in an ERISA violation. We may be able to get them to disgorge fees.

We can maybe get some species of injunctive relief. But, after that, a nonfiduciary is not obligated under ERISA to be prudent, loyal, to refrain from conflicts of interest, or to act in the plan's interest. They just don't have those obligations.

And, we really don't have the same means for holding them accountable. Usually appraisers are not ERISA fiduciaries under our current regulations. And so, usually, we do not bring lawsuits against them.

The exception is when the conduct is so egregious and it falls so short of the norms that we think we need to bring suit despite ERISA's remedial limitations. In those instances, even though we have such limited monetary remedies, the courts may say that this is a person who should not be doing business with employee benefit plans anymore. In that type of case, we have brought, and are prepared to bring, lawsuits against a nonfiduciary appraiser.

The remedial limitations are frustrating because a lot of times, in my experience, the service providers, the consultants, the appraisers, are often the engines that make these transactions go.

Nobody would have ever entered into the deals, in the first place, but for the opinion of the appraiser. Nobody will enter into the transactions at a specific price unless the appraiser first says the price is OK.

And, if something goes wrong and there are losses to the plan because of a bad appraisal, the trustees typically do not file state-law claims against the appraiser to recover losses. The reasons this does not happen are two-fold.

First, the trustees as a rule are the people who signed off on the deal the appraiser provided an opinion on, such as an appraisal opinion of value or a fairness opinion saying the deal is fair. So if you think about it from a self-interest standpoint, the trustees probably feel like they are putting themselves in the crosshairs a bit if they sue the person who prepared the appraisal on which they relied.

That is, if they go after the appraiser they have to say, basically, you did a really bad job and I relied on your bad job and as a result the plan suffered losses. Because trustees are worried that the DOL and plan participants are then going to bring a lawsuit against them, trustees rarely bring actions against appraisers or other advisors.

Second, the language in the engagement agreements with the appraiser routinely disclaims much of the state law obligations they would otherwise have.

So, it might be that state law requires appraisers to adhere to a standard of care, but the engagement agreement will have all kinds of language about how the appraisers are only liable if they are grossly negligent or if they do really bad things and so on. So while there might be state law claims that the trustee could otherwise pursue, the appraisers have set it up so that they have contractual defenses.

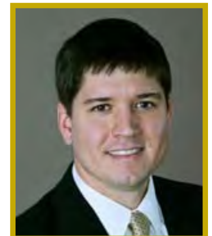
20. Can you share any insight into whether you expect ESOP related litigation to increase, decrease, or remain the same over the next couple of years?

Well, I'm hoping that there is a concerted effort in the industry to raise the bar so that these ESOP lawsuits are not necessary. At the moment, unfortunately, we have more ESOP cases than I would like to see.

Summary

The author—and the editors of *Insights*—would like to thank Tim Hauser and the Department of Labor for their cooperation and assistance with this interview.

The author would also like to thank Scott Rodrick and the National Center for Employee Ownership (NCEO) for the original publication of this interview, which appeared in the December 2014 *NCEO Issue Brief*. That *NCEO Issue Brief* was entitled "Current Perspectives on ESOP Valuation and Enforcement."



Chip Brown is a managing director in our Atlanta practice office. Chip can be reached at (404) 475-2306 or at cbrown@willamette.com.