Memorandum

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To: Sirote Clients

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RE: ESOP Trustee Issues in a Potential Sale

Executive Summary

The fiduciary obligations under ERISA, as well as the qualification rules of the Code, serve to make the purchase of company stock from an ESOP much more complex than a normal acquisition. An ESOP trustee must act independently in all matters coming before the ESOP trustee, representing only the best interests of the plan participants and beneficiaries in all decisions. For this reason, it is never advisable to use an "inside" trustee (i.e., an individual who is a director, officer, employee, creditor or shareholder) for the ESOP in a sale transaction.

The use of an inside trustee for the ESOP in a sale transaction brings with it an unavoidable conflict of interest. As an officer or director of a company, one has the duty to protect and enhance the best interests of the company and to discharge his or her duties in the best interest of the company and its shareholders. Conversely, as an ESOP trustee one has the legal duty to advance the best interest of the plan participants and beneficiaries, even if contrary to the perceived wishes or plans of company management. One simply cannot wear both "hats." Inside trustees of ESOPs are the source of many of the law suits regarding ESOPs. Even if there is no wrong doing, there still exists the appearance of a conflict of interest.

Fiduciary Duties

Fiduciary duties under ERISA have been characterized as the highest known to law. An ESOP Trustee must observe the ERISA standard of care that requires the fiduciary to discharge his 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." ERISA §404(a)(1)(B). This standard is derived from the prudent person test as developed in the common law of trusts, but it has been modified so that the standard is required to be applied in light of the special nature and purpose of employee benefit plans. Courts and commentators have come to call the ERISA standard one of a "prudent expert." In lay terms, it is not enough that the trustee acted with a pure heart and an empty head. Therefore, an ERISA fiduciary's relative unfamiliarity with a certain transaction is no excuse for failure to meet its obligation to plan participants and beneficiaries, even if the fiduciary acted in good faith.

The traditional operation of the business judgment rule resembles the common law test of subjective good

faith, in that it presumes that directors' decisions are honest, well-intended, and informed. This presumption acts as an abstention doctrine which precludes the court from reviewing the substance of the director's decisions absent fraud, illegality or self-dealing. Attempting to reap the benefits of such a deferential standard of review, ESOP fiduciaries have argued that the business judgment rule is the correct standard to be applied when their conduct is subject to second-guessing. Courts, however, have consistently held that the business judgment rule is inappropriate when analyzing whether an ERISA fiduciary's conduct was proper in the context of ERISA Section 404.

Although it is true that that traditional abstentionist model of the business judgment rule may be too deferential for ERISA fiduciary litigation, the modern business judgment rule which operates more as a standard of substantive liability, which only frees directors from second guessing if they acted consistently with their fiduciary duties of good faith, loyalty, and due care resembles the approach taken by courts in deciding ERISA fiduciary breach cases. When deciding whether or not an ESOP trustee breached the trustee's fiduciary obligations, courts tend to focus on three issues: (1) whether the trustee was independent or free from a conflict of interest; (2) whether the trustee acted with the exclusive purpose of providing benefits (duty of loyalty), and (3) whether such a decision was reached using the appropriate investigatory methods (prudent expert). Where the court has answered in the affirmative to these three questions it has deferred to the trustee's judgment.

The remainder of this memorandum focuses on the first of these three issues.

Conflicts of Interest

To be entitled to deference for substantive decisions, the ESOP trustee must be independent and free from any conflicts of interest. The ESOP trustee must discharge his duties with respect to the plan solely in the interest of the plan participants and beneficiaries and for the exclusive purpose of providing benefits to plan participants and beneficiaries. This rule requires a fiduciary to make decisions with "an eye single to the interests of the participants and beneficiaries." *Donovan v. Bierwirth*, 680 F.2d 263 (2d Cir. 1982), cert denied, 459 US 1069 (1982). On the other hand, directors and management have a duty to act in the best interests of the corporation and its shareholders. When these competing duties collide, the inside trustee will be required to choose one over the other, which could result in a breach of his or her or its ERISA fiduciary duty with respect to the ESOP.

Courts are more suspicious of fiduciaries with dual loyalties and as a result have subjected them to a less deferential standard of review by considering their conduct under a heightened standard of care, which requires an intensive and scrupulous independent investigation of the fiduciaries options to insure that they act in the best interest of the plan participants and beneficiaries.

Outside vs Inside Trustee

The most common -- and, perhaps, effective -- way in which conflicted fiduciaries can protect themselves from personal liability associated with the conflicts of interest that are inherent in a sale transaction is to rely on an independent fiduciary to oversee the transaction. The best practice is for the independent fiduciary to become the responsible fiduciary for all purposes during the transaction period. In addition to overseeing the

transaction, the trustee will take over, hold all plan assets, and be involved in the day-to-day administration of the plan. This protects the conflicted fiduciaries from any possible claim by the plan participants and beneficiaries that they acted during the period in a manner contrary to the participants' and beneficiaries' best interests.

With an independent trustee in place, the conflicted fiduciaries are free to negotiate the transaction with the buyer, both in their role as corporate executives and for their own benefit as employees. The independent trustee will review the transaction in its entirety, including the purchase price and the other agreements made with the buyer, to ensure that it is in the best interests of the plan participants and beneficiaries and is reasonable overall.

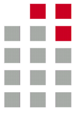
Serving as an ESOP trustee in a sale transaction involves significant litigation risk, heightened by the increased number of potential claimants (i.e., participants, beneficiaries, and the Department of Labor) that do not exist in a normal sale transaction. If conflicted fiduciaries choose not to resign they will bear a heavy burden to establish they were in compliance with ERISA's fiduciary rules, and as a result will be held to a higher level of conduct. This makes it very dangerous for inside trustees whose fiduciary duty to plan participants and beneficiaries may be compromised by their status as an employee, director, creditor, shareholder, or by another relationship with the corporation or another selling shareholder of the corporation.

If the conflicted fiduciaries retain responsibility for the transaction, their actions and decisions in relation to the transaction will be highly scrutinized by the other participants and beneficiaries, the Department of Labor, and possibly, the courts. In this case, it will be critical that they engage their own independent legal counsel and other professional advisors and that they keep careful records of the independent advice that they receive, their consideration of that advice, and their reasons for accepting or rejecting the professionals' recommendations in relation to the transaction. These records will constitute the basis of the conflicted fiduciaries' defense against challenges to their actions that may result when the transaction is completed.

Consequences of Breach

ERISA provides that a fiduciary that has breached any of its responsibilities, obligations or duties:

- Can be personally liable for restoring losses to the plan;
- Can be personally liable for restoring to the plan any profits made by the fiduciary through the use of plan assets;
- Can be subject to other equitable and remedial relief; and
- Can be subject to significant civil penalties, including a 20% penalty under ERISA and potential excise tax penalties if the transaction is a prohibited transaction (which can easily occur in a transaction if there is deemed to be any personal benefit to a fiduciary or party in interest).



Risk Mitigation

Although a fairness opinion is not required by ERISA, if the conflicted fiduciaries retain responsibility for the transaction, it is highly recommended as a defense to challenges to their actions. A fairness opinion will evaluate the price being paid by the buyer in comparison to the appraisal obtained, as well as any change-in-control payments being made to departing employees, stay bonuses that are paid to the employees who are being encouraged to remain with the company during the pendency of or after the transaction, and any other financial incentives, such as earn-out payments, being paid as a result of the transaction. A fairness opinion can instill confidence that the sale has been thoroughly vetted for its effects on the ESOP and the corporation. The best practice is to obtain the fairness opinion from a source independent of, and who has not performed work recently for the corporation.

That being said, even if adequate consideration is received, the recent 2016 case of *Perez v. Bruister*, 823 F.3d 250 (5th Cir. 2016), serves as a cautionary tale. In that case, the Fifth Circuit addressed the question of whether the trustees breached their duty of loyalty to an ESOP. The trustees argued that they did not breach their duty of loyalty because the valuations prepared by the ESOP appraiser were similar to the valuations set forth by defendants' trial experts. The Fifth Circuit rejected this "all's well that ends well" argument, holding that, for liability to arise under ERISA, the critical question is whether there was a conflict of interest, and, if so, whether the conflict was avoided because the trustees' decisions were "made with an eye single to the interests of the participants and beneficiaries."

Finally, if the conflicted fiduciaries retain responsibility for the transaction there are fiduciary liability insurance products that they may want to consider to limit their personal liability for breaches of their fiduciary obligations.