

## A Lender's Primer on Leveraged ESOPs and Recent Litigation

Employee stock ownership plans (“ESOPs”) have become an increasingly popular vehicle for the sale of privately owned businesses and an attractive lending opportunity for banks and other third-party lenders. However, this popularity has been met with enhanced scrutiny from various plaintiffs’ law firms and the US Department of Labor (the “DOL”).

Mayer Brown’s ESOP lending, regulatory and litigation team has been closely monitoring this enhanced scrutiny and, in this Legal Update, provides an overview of leveraged ESOPs and some of the current issues facing ESOP trustees and their related fiduciary duties. Above all, this Legal Update will seek to address specific areas of concern for lenders that are contemplating making loans to ESOP-owned companies.

### Introduction

An ESOP is a qualified retirement plan designed to invest primarily in “qualifying employer securities” (generally, common stock) of its sponsoring employer or a member of its sponsor’s controlled group. As qualified retirement plans, ESOPs are accorded certain favorable tax benefits: (i) employer contributions to the ESOP are deductible for federal income tax purposes (up to certain specified limits) even if unvested, (ii) the ESOP’s income is generally exempt from federal (and often state) income tax and (iii) participants are not subject to federal income tax on amounts credited to their ESOP accounts until the accounts are distributed to them from the

ESOP’s trust. If the ESOP holds all of the common stock of an S corporation, the S corporation’s income is effectively exempt from federal income taxation. In addition, if certain requirements are met, Section 1042 of the Internal Revenue Code allows a shareholder of a corporation that establishes an ESOP to sell his or her stock to the ESOP and defer the taxable gain on the sale of the stock through the purchase of “qualifying replacement property.” All of these attributes make ESOPs an attractive structure for a lender or group of lenders looking to finance an acquisition.

Qualified retirement plans, including ESOPs, are regulated under the Employee Retirement Income Security Act (“ERISA”). ERISA includes provisions, which are derived from the common law of trusts, requiring a qualified retirement plan’s trustee (or other fiduciary responsible for the investment of the plan’s assets) to act prudently in investing the plan’s assets and in the sole interest of the plan participants. Additionally, ERISA’s fiduciary provisions prohibit certain specific transactions between a plan and “parties in interest” (such as the sponsoring employer of the plan) whose relationship to the plan is such that the transactions may not be in the plan’s interest or may even be to the plan’s disadvantage. Finally, ERISA’s fiduciary provisions prohibit plan fiduciaries from self-dealing, acting on behalf of another party, and receiving remuneration from another party in transactions involving plan assets. Plan fiduciaries who violate ERISA’s fiduciary requirements may be subject to suits

brought by a plan's participants or by the DOL and to certain civil and criminal penalties. Prohibited transactions are also subject to tax under the Internal Revenue Code.

ERISA and the Internal Revenue Code contain exemptions from the ERISA fiduciary requirements described above permit the formation of ESOPs. These include: (i) an exemption from ERISA's investment diversification requirement and its prudence requirement (to the extent prudence would require asset diversification) to allow ESOPs to be up to 100 percent invested in the qualifying employer securities of the sponsoring employer, (ii) an exemption from the prohibition on extensions of credit between an ESOP and its sponsoring employer, which allows an ESOP to borrow funds from its sponsoring employer to purchase employer securities and (iii) an exemption from the prohibited transaction rules that would otherwise prohibit ESOPs from purchasing qualifying employer securities from parties in interest, such as a shareholder of the sponsoring employer, provided certain requirements are met. Among these requirements is the requirement that in purchasing qualifying employer securities, an ESOP can pay no more than "adequate consideration" (i.e., the ESOP cannot pay in excess of the securities' fair market value). When lending to an existing ESOP or to a new leveraged ESOP, it is a crucial role of the lender and its counsel to understand the structure of the transaction and the work that has been undertaken by the seller, the trustee, the company and other related parties to satisfy these exemptions.

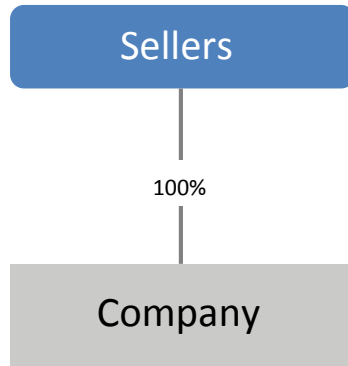
## Leveraged ESOPs

In a typical ESOP transaction, an ESOP is established by a sponsoring employer for the benefit of its employees (and/or the employees of its controlled group members). The ESOP's trustee, acting on behalf of the ESOP's trust, purchases qualifying employer securities, either from the corporation itself or from its shareholders. The acquisition is typically funded by a combination of third-party debt and seller debt, since prior to the stock purchase, the ESOP likely does not have any assets (it would typically have been formed immediately prior to the transaction for the purpose of consummating the initial purchase of employer securities). This debt is placed at the sponsoring employer level, but the sponsoring employer then lends the same funds to the ESOP (an "inside loan") for the ESOP to use to purchase the employer's stock.<sup>1</sup>

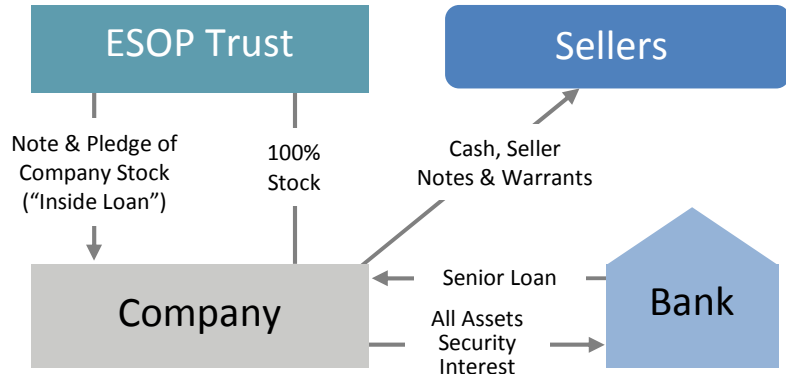
The third-party debt may come from bank or non-bank lenders, but will typically look like regular acquisition financing with certain modifications to account for the ESOP structure, including the ability of the sponsoring company (i.e., the borrower) to upstream cash to the ESOP and modifications to the financial covenants to account for these distributions as well as other adjustments typical for an ESOP. The selling shareholders receive a combination of cash, seller notes and, in many cases, warrants as consideration for the sale of their stock. The seller notes are typically direct obligations of the sponsoring employer rather than the ESOP; however, they can be structured as direct obligations of the ESOP that are guaranteed by the sponsoring employer.<sup>2</sup>

Customary pre- and post-acquisition structures for a 100 percent owned ESOP are also shown in graphical form below:

### Pre-Acquisition:



### Post-Acquisition:



After a leveraged ESOP stock acquisition closes, the employer sponsoring the ESOP then makes annual contributions to the ESOP's trust which, together with any dividends paid on the employer securities held by the ESOP, are sufficient to enable the ESOP's trust to meet its repayment obligations on the inside loan owing from the ESOP trust back to the sponsoring employer. When first purchased, the stock acquired by the ESOP is held in an unallocated "suspense account." As the inside loan is repaid over time, the employer stock acquired by the ESOP is released from the suspense account and allocated to the ESOP accounts of the ESOP's participants.

Regardless of the means by which an ESOP is financed, ERISA's fiduciary considerations loom large over the transaction. As noted, it is a fiduciary violation for an ESOP to pay greater than adequate consideration for the employer securities it purchases and the transaction must be fair to the ESOP. Although issues and resulting litigation are rare when taken in the context of the number of ESOP transactions, the stakes for the sponsoring employer and the ESOP's trustee for fiduciary violations are important to recognize:

- if the ESOP overpays for the securities, the exemptions from ERISA's and the Internal

Revenue Code's prohibited transactions provisions may not apply;

- the ESOP's trustee and other parties involved in the ESOP transaction may face lawsuits that may be brought by the ESOP's participants and by the DOL;
- there may be prohibited transactions excise taxes; and
- the sponsoring employer may have an obligation under the ESOP's trust agreement to indemnify the trustee.<sup>3</sup>

The result of any of the above is that the underlying company may come under stress that will distract it from its business operations and potentially make it more difficult for it to service its debt to the lender. While these risks are not unique to third-party lenders, it is important for lenders to be aware of the stakes involved and the steps that can be taken on the front end of an ESOP transaction to help mitigate any negative outcome.

### Current Regulatory and Litigation Atmosphere

Under President Obama, the DOL was active in investigating ESOP transactions and filing federal lawsuits against ESOP trustees when it believed the trustees had violated their fiduciary

duties by causing the ESOP to overpay for the sponsoring employer's stock. Although companies and ESOP trustees were cautiously optimistic that the DOL would be less aggressive under President Trump and his new labor secretary, Alexander Acosta, Mayer Brown's recent experience and observations of the current regulatory landscape have suggested that the DOL will continue to focus on ESOP transactions. In fact, in August of 2017, the DOL filed two lawsuits against ESOP trustees on consecutive days in different jurisdictions alleging, in each case, that the trustees breached their fiduciary duties and failed to act in the best interest of the plans by causing the respective ESOPs to overpay for the sponsoring corporation's stock.

Generally speaking, a plan participant's challenge to an ESOP transaction must complain of more than simply diminished stock value in a leveraged transaction to prevail. This is because the DOL has implicitly recognized that immediate "dollar-for-dollar" equity is not feasible in such circumstances because of the cash drain on leveraged stock (the so-called "Farnum rule"). This hurdle unfortunately has not deterred the plaintiffs' bar from targeting ESOP trustees with class action lawsuits. In addition, a number of courts have taken a pro-plaintiff approach and have held that a plan participant only needs to conclusorily allege that the ESOP trustee caused the ESOP to engage in a prohibited transaction, shifting the burden to the defendant ESOP trustee to prove that the stock purchase fell within one of the permitted exemptions.<sup>4</sup> These rulings have effectively forced ESOP trustees into a difficult litigation position and the prospect of expending significant time and resources defending against a potentially meritless claim.<sup>5</sup>

As an example of this, in two recent district court cases where the decisions were reached on the merits, the courts found the ESOP trustee liable for breaching its fiduciary duties by causing the ESOP to engage in a prohibited

transaction. These cases provide useful guidance to ESOP trustees moving forward:

- In the first of the two decisions, the court held that the ESOP trustee was liable for \$29.8 million for causing the ESOP to overpay for the sponsoring employer's stock. Among other things, the court emphasized that the ESOP trustee did not follow its own internal policies in approving the transaction and failed to adequately vet the valuation of the sponsoring employer's stock as part of the adequate consideration analysis. In addition, the court found that the ESOP trustee failed to adequately investigate the improper "exit strategy" motivations of the company's management and that it "rubber stamp[ed]" the company's proposals.
- In the second decision, the court held that the ESOP trustee breached its fiduciary duties of prudence and loyalty to the ESOP when it caused the ESOP to overpay for shares of the company's stock by \$9.4 million. Among other things, the court found that the trustee failed to independently and thoroughly investigate the true value of the company's stock and instead relied on unrealistically optimistic projections of the company's future earnings and an inflated value of the company's technology.

As these recent decisions and the discussion above reflect, federal courts and the DOL are closely reviewing the processes and procedures followed by ESOP trustees to ensure that an ESOP transaction reflects the fair market value of the sponsoring corporation's stock and that the trustees are acting in the best interests of the ESOP and its participants.<sup>6</sup> It is important to note from a lender's perspective that the sponsoring employer who is not also serving as trustee is not usually named in actions by the DOL or the plan's participants. As stated above, the company may be required to indemnify the ESOP trustee under the ESOP transaction documents and therefore it is important to understand the risks and responsibilities the company may face when underwriting these

transactions and for the lender to ensure that the transaction documents have been properly drafted so as to not overburden the company and thus potentially the lender group.<sup>7</sup>

## Conclusion

ESOPs remain an important part of the corporate landscape in the United States and an attractive opportunity for lenders; however, a disciplined approach to structuring the transaction will be necessary to maintain the vibrancy of this structuring vehicle and to protect lenders' interests in such transactions. Given today's regulatory and litigation environment, lenders to ESOPs need to place special care in the level of due diligence of the underlying corporate transaction, the relevant parties involved and the processes and procedures undertaken by the ESOP trustee in the structuring and negotiation thereof. A prudent lender should ensure that the ESOP trustee has independently performed due diligence on the target corporation; negotiated a robust and arm's-length transaction with the selling shareholder (including the inclusion of standard indemnities and other relevant provisions in the acquisition documents that sufficiently protect the ESOP, as purchaser, and the company as it continues operations post-acquisition); and otherwise fulfilled its fiduciary duties to the ESOP.

Mayer Brown's team of experienced lending, ERISA and regulatory lawyers, is well-positioned to handle all facets of ESOPs and ESOP loans, from straightforward acquisitions and financings all the way through to corporate and debt restructurings of mature ESOPs.

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## Endnotes

- <sup>1</sup> For simplicity, we have focused on this specific financing structure, which we see regularly in the market. Although there are several other variants of ESOP acquisition loans, the issues addressed in this Legal Update generally apply to the various alternative structures.
- <sup>2</sup> Even in this structure we see that the seller notes are often subsequently assumed by the sponsoring employer, either immediately after the closing or at some other point in the future.
- <sup>3</sup> We note that a plan sponsor may not be required to indemnify the ESOP trustee in instances where the ESOP trustee has not complied with its fiduciary obligations, since ERISA prohibits indemnification of an ESOP trustee for unlawful conduct. *See* ERISA 410(a), which provides that any instrument intended to relieve a fiduciary from any responsibility or liability is void as against public policy. In a lawsuit initiated by either the plan's participants or the DOL, we typically see the plan sponsor advance (or pay as they come due) the ESOP trustee's relevant defense fees and costs pursuant to its indemnification obligations. However, if there is a finding that the ESOP trustee did, in fact, allow the plan to engage in a prohibited transaction or otherwise breached its fiduciary duties, the ESOP trustee will be required to pay the judgment and reimburse the plan sponsor for any fees or costs that it received under the indemnification agreement. If the relevant lawsuit is settled out-of-court, however, it is not as clear as to whether or not the indemnification obligation will survive.
- <sup>4</sup> *See Allen v. GreatBanc Tr. Co.*, 835 F.3d 670 (7th Cir. 2016).
- <sup>5</sup> While ESOP trustees have limited options to defeat an ESOP prohibited transaction claim on a motion to dismiss for failure to state a claim, one Magistrate Judge in

Delaware recently recommended dismissal of such a claim for lack of subject matter jurisdiction (standing) because the plan participants failed to allege an adequate injury-in-fact. In this particular case, two plan participants alleged that the ESOP trustee engaged in a prohibited transaction by causing the ESOP to overpay for the sponsoring corporation's stock because an independent appraiser revalued the stock after the transaction at 60 percent less than the purchase price. In recommending dismissal of the lawsuit, the Magistrate Judge emphasized that, following the US Supreme Court's decision in *Spokeo, Inc. v. Robins*, 136 S. Ct. 1540 (2016), a plaintiff must allege a "particularized injury" that "affect[s] the plaintiff in a personal and individual way." Based on the allegations in the complaint, the court held that the plaintiffs lacked standing because they did not adequately allege an economic injury. The court explained that an inflated stock purchase price, on its own, does not constitute an economic loss. Rather the "stock must be purchased at an inflated price and sold at a loss for an economic injury to occur." Because the plaintiffs did not allege that they sold their shares in the ESOP, let alone that they sold their shares for a loss, they failed to show that they had in fact suffered economic harm.

- 6 Most recently, in settling an ESOP lawsuit brought by the DOL, the DOL required the ESOP trustee to, among other things, avoid using any valuation advisor that has a prior relationship with any party involved in the ESOP transaction, and to prepare written analyses of whether projections used in the analysis were reasonable. *See Acosta v. BAT Masonry Co., Inc.*, W.D.Va., No. 6:15-CV-00028, 9/29/17).
- 7 *See* the discussion above at footnote 3 relating to the potential unenforceability of such indemnification agreements.

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