Employee Owned 2019

Legal and Regulatory Update: To be Repeated

The Conference & Trade Show for ESOPs
JOIN THE CONVERSATION!

Use #EO2019 to talk with others before, during, and after the conference.
TODAY’S AGENDA

Legal Update Topics

• Indemnification
• Trustee Fees as Prohibited Transaction
• Moving to Dismiss, Release of Claims and Arbitration Clauses
• Claims when an ESOP-owned Company is insolvent
• Control, Valuation, and Trustee Diligence
• Seller Liability and Damages

Administrative and Regulatory Update Topics

• Expansion of VCP
• Expansion of Determination Letter program
• The Uncashed Distribution Check
• Secure Act of 2019
LEGAL UPDATE
INDEMNIFICATION

• ISSUE: Is it a violation of ERISA for an ESOP trustee to enter into an indemnification agreement? Or, can a company indemnify an ESOP trustee without violating ERISA?

• ERISA Section 410: ...[A]ny provision in an agreement or instrument which purports to relieve a fiduciary from responsibility or liability for any responsibility, obligation or duty under this part shall be void as against public policy.
INDEMNIFICATION

- ERISA Section 410(b) permits:
  - A plan to purchase insurance for its fiduciaries or for itself ... if insurance permits recourse against the fiduciary in the case of a breach of a fiduciary obligation;
  - A fiduciary may purchase its own insurance; or
  - An employer may purchase insurance for fiduciaries
INDEMNIFICATION

• 29 CFR 2509.75-4 – DOL regs find employer indemnification OK because it is akin to insurance, but no Plan indemnification.

• Permits indemnification agreements so long as it does not relieve fiduciary of responsibility.

• Indemnification provisions which leave the fiduciary fully responsible and liable, but merely permit another party to satisfy any liability incurred by the fiduciary in the same manner as insurance purchased.
INDEMNIFICATION

• But can an employer indemnify a fiduciary of an ESOP that holds 100% of the issued and outstanding stock of the employer?
• *McMaken v. Greatbanc*, Case No. 17-cv-04983 (N.D. Ill Apr 3, 2019)
• *Acosta v. Reliance Trust Co.*, Case No. 17-cv-04540 (D.C. Minn. Aug 9, 2019)
INDEMNIFICATION

• How did we get here?
• Johnson v. Couturier, 572 F.3d 1067 (9th Cir. 2009)
• But see Pfeifer v. Wawa, Inc., 214 F. supp. 3d 366, 373 (E.D. Pa 2016)
TRUSTEE FEES A PT?

• ISSUE: Can a trustee receive an annual fee based on the FMV of Plan’s assets?

• ERISA Section 406(b)(1) – plan fiduciary may not “deal with assets of the plan in his own interest or for his own account”

• McMaken v. Greatbanc, Case No. 17-cv-04983 (N.D. Ill Apr 3, 2019)
STATING A PT CLAIM AND MOVING TO DISMISS

• ISSUE: What must a Plaintiff show to state a plausible claim against a fiduciary for PT?

• *Allen v. GreatBanc*, 835 F.3d 670 (7th Cir. 2016)

• Holding for PT: A plaintiff alleging an ERISA claim out of a prohibited transaction involving an exchange of stock between a plan and a party in interest need not plead the absence of adequate consideration.
STATING A PT CLAIM AND MOVING TO DISMISS

• ISSUE: What must a Plaintiff show to state a plausible claim against a fiduciary for a fiduciary breach?

• *Allen v. GreatBanc*, 835 F.3d 670 (7th Cir. 2016)

• Holding for Fiduciary Breach: An ERISA plaintiff alleging breach of fiduciary duty does not need to plead details to which she has no access, as long as the facts alleged tell a plausible story.
STATING A PT CLAIM AND MOVING TO DISMISS

• Following Allen?
• 41 cases with positive treatment including *Hurtado v. Rainbow Disposal Co. Inc.*, 2018 WL 3372752 (CD Cal. July 9, 2018)
• But see – *Lee v. Argent Trust Company*, Case No. 5:19-CV-156 (ED N.C. Aug. 6, 2019)
RELEASE OF CLAIMS

• ISSUE: When an individual signs a release of claims under a severance agreement, is that individual barred from bringing claims on behalf of the ESOP?
  • No - McMaken v. GreatBanc Trust Company, 1:2017cv04983 (N.D. Illinois, August 21, 2019)
RELEASE OF CLAIMS

• ISSUE: When an individual signs a release of claims under a severance agreement, is that individual barred from bringing claims on behalf of the ESOP?


• No - McMaken v. GreatBanc Trust Company, 1:2017cv04983 (N.D. Illinois, August 21, 2019)
ARBITRATION CLAUSES

• ISSUE: Is an arbitration clause enforceable under ERISA?
• Is it in the Plan?
• *If not, then no.* See Munro v. USC, 896 F.3d 1088 (9th Cir. 2019)
• *If it is in the Plan, then yes.* See Dorman v. Charles Schwab & Co., Case No. 18-15281 (9th Cir. August 20, 2019), overruling prior law in Amaro v. Continental Can Co., 724 F.2d 747 (9th Cir. 1984)
CLAIMS WHEN AN ESOP-OWNED COMPANY IS INSOLVENT

• *In re Indian Jewelers Supply Co.* US Bankruptcy Court for the District of New Mexico June 6, 2019

• Terminated employees awaiting delayed ESOP distributions are creditors, not equityholders, in bankruptcy

• *First American Bank v. SJP Group, Inc.* USDC New Jersey, Oct. 31, 2018

• Settlement and litigation funds for Fiduciary breach are not “proceeds” of the shares.
CONTROL

• ISSUE: When does an EOSP have control such that a control premium may be considered in establishing FMV?
• *Brundle v. Wilmington Trust*, 919 F.3d 763 (4th Cir. 2019)
CONTROL

• ISSUE: What level of control is necessary for a valuation to be performed on a controlling-interest basis?

• Pizzella v. Vinoskey, Case No. 6:16-cv-00062 (WD Va. August 2, 2019) (Sentry Equipment Erectors ESOP)
VALUATION AND TRUSTEE DILIGENCE

• Very fact specific, the heart of most cases.
• Issue most frequently identified: “Aggressive and unrealistic projections”

Other Issues Include:
• Customer concentration
• Projections inconsistent with industry, history, or economy
• Lofty revenue growth rates
• Increasing margins
• Ignoring cyclicality
• Unrealistic long-term growth rate
• You didn’t use projections (Sentry Case appears to imply that CCF should not be used at all)
VALUATION AND TRUSTEE DILIGENCE


• Key Valuation Issues
• Only relied on Capitalized Cash Flow Income Approach
• Look back period was too short
• Improper projection adjustments (assumptions)
• Company Specific Risk Premium too low
VALUATION AND TRUSTEE DILIGENCE


- **Key Diligence Issues**
  - Trustee raised concern about use of only Capitalized Cash Flow
  - Trustee notes post-transaction adjustments but did not ensure valuation excluded them
  - Less than 60 days from beginning to end
CONFLICTS OF INTEREST

• Appearance of Impropriety
• Who does the lawyer represent?
• Who made the initial phone call?
• Does an initial estimate of value taint the process?
SELLER LIABILITY

• ISSUE: Can a seller be liable for the fiduciary breach of the trustee?
• Yes. And potentially joint and several liability with trustee.
• Two Forms –
  • Knowing Participant Liability
  • Co-Fiduciary Liability
Non-fiduciary seller may be held liable as a knowing participant in a prohibited transaction if

- (a) seller had actual or constructive knowledge that the price per share he received exceeded fair market value; OR

- (b) that the Trustee did not arrive at this price through a good faith determination (i.e., a prudent process)

*Pizzella v. Vinoskey, Case No. 6:16-cv-00062 (WD Va. August 2, 2019)*

(Sentry Equipment Erectors ESOP)
CO-FIDUCIARY LIABILITY

Co-fiduciary may be held liable for a breach of fiduciary responsibility of another fiduciary if

- (a) he knowingly participates in an act or omission of such other fiduciary, knowing such act or omission is a breach; OR
- (b) he has knowledge of a breach, unless he makes reasonable efforts under the circumstances to remedy the breach

*Pizzella v. Vinoskey, Case No. 6:16-cv-00062 (WD Va. August 2, 2019)*
(Sentry Equipment Erectors ESOP)
ISSUE: Will damages be reduced by any reduction in the seller note previously applied?

REGULATORY UPDATE
Expansion of VCP

• Rev. Proc. 2019-19
• Self-correction available to correct a plan document failure
• Self-correction available to correct more operational failures by adoption of a plan amendment
Expansion of D-Letter Program

- Rev. Proc. 2019-20
- Merged individually designed plan may request determination letter
- Timing requirements for merger and d-letter request
- Sanctions for any document failure identified by the IRS other than provision to effectuate the merger
Uncashed Distribution Check

- Rev. Rul. 2019-19
- Even if check not cashed,
  - Amount actually distributed is taxable to distributee
  - Withheld tax satisfies withholding obligation
  - Distribution must be reported on Form 1099-R
SECURE Act of 2019

- Passed House 417–3 May 23, 2019
- The age 70½ trigger for taking required minimum distributions would be raised to age 72
- Plan adopted by the employer’s filing due date for the year may be treated as in effect as of the last day of the year
Pete Jones

Peter E. Jones is a Vice President and ESOP Trust Officer for Horizon Trust & Investment Management in Columbus, Ohio. Peter has worked extensively with ESOPs and ESOP-owned companies.

pjones@horizonbank.com
Larry Goldberg is a Partner at ESOP Law Group, LLP. He focuses his practice on the design, implementation, and operation of ESOPs, and he is nationally recognized for his extensive experience in structuring a wide variety of ESOP transactions. He regularly serves as legal counsel to ESOP trustees, and advises investors and lenders with respect to ESOP transactions. ESOP Law Group, LLP is a boutique law firm serving clients throughout the United States.

lgoldberg@esoplawgroup.com