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Interdisciplinary Advisory Committee on Fiduciary Issues

The Role of the ESOP Fiduciary in Corporate Redemptions

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The "traditional" ESOP transaction involves a purchase of stock by an ESOP from an employer-sponsor or a shareholder of the plan sponsor and a loan to the ESOP. Most ESOP-related case law focuses on the "prohibited transaction" rules – which apply to a *sale, exchange, loan or acquisition* between a plan (the ESOP) and a "disqualified person" or "party in interest" (the employer-sponsor or shareholder). What rules apply when the corporate transaction which impacts the ESOP's relative ownership of a company does not directly involve the ESOP? This article discusses the key issues for an ESOP fiduciary when the plan sponsor redeems the stock of some or all of the non-ESOP shareholders and takes on debt to do so.

Unlike in the "prohibited transaction" context, where interpretations of the Internal Revenue Code and ERISA predominate, the ESOP fiduciary's obligations in a corporate redemption involve a subtle blend of federal pension law and state corporate law – and the outcome can vary widely from state to state. While state corporate law generally imposes a duty of loyalty and care on boards of directors which requires them to act in the best interests of shareholders and to not "oppress" minority shareholders, directors are customarily given wide latitude in determining the course of corporate events under the "business judgment rule." In pricing the redemption transaction, the company generally will not be limited to the narrow conception of "fair market value" embedded in the "adequate consideration" definition of ERISA §3(18)(B) ("the fair market value … as determined in good faith by a trustee … in accordance with regulations promulgated by the Secretary [of Labor]") and the related regulations and judicial interpretations. As a result, the plan sponsor may be able to pay more for stock in a redemption than the ESOP could pay in an ESOP stock purchase, taking into account factors (such as tax savings and potential synergies) that an ESOP appraiser could not. As one court noted in a recent case, "buying one shareholder's shares at a premium could reasonably be founded on a valid business judgment…" *Powell v. MVE Holdings, Inc.*, 626 N.W.2d 451, 464 (Minn.App. 2001).

If the board of directors – after careful consideration – has determined that it is in the best interests of the company to redeem all of the non-ESOP shareholders' stock – even at a premium – and to borrow heavily to do so in order for the company to become a 100% ESOP-owned S Corporation, does the ESOP fiduciary even have, as they say, a "dog in the hunt?" Depending upon state law and the company's articles of incorporation and by-laws, a board of directors' decision to redeem stock and borrow large sums of money may not require a shareholder vote, especially if the members of the board of directors are not operating under a conflict of interest. State law may also not require that the ESOP be given the opportunity to sell its stock to the company. If that is the case, an ESOP fiduciary may have no right to approve the transaction.

While state corporate law issues may be critical to the outcome, the starting point for the ESOP fiduciary's analysis remains ERISA's bedrock requirement of all fiduciaries – the "prudent man standard of care." ERISA §404(a)(1) provides that:

"… a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and – (A) for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries; and … (B) with the care, skill, prudence, and diligence

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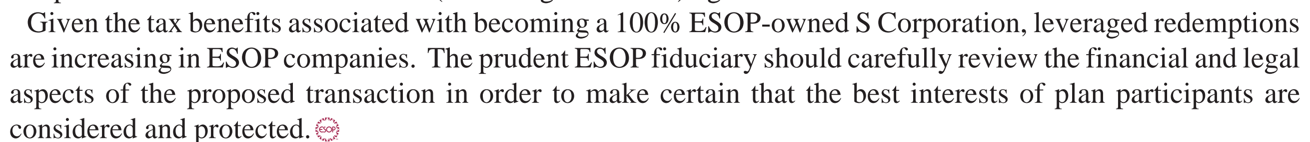
under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims…." in the interest of the participants and beneficiaries and – (A) for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries; and … (B) 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…."

What, then, is in the best interest of plan participants and what is the prudent thing to do when a plan sponsor embarks on a leveraged redemption? As a 100% S Corporation, the company may have significant tax savings which will, in the long run, greatly enhance the value of the company and, in turn, the ESOP. At the same time, a large increase in debt may overburden the company and limit its ability to use capital resources for other needs. Regardless of whether the ESOP owns a majority or a small minority of the company's stock before the transaction, a leveraged redemption will have a significant impact on the company and on the short and long term value of the ESOP. As a shareholder, the ESOP has the right to expect that the board of directors has acted appropriately. And an ESOP fiduciary has a duty under ERISA to become informed as to how – and why – the board of directors has acted. As a shareholder, the ESOP (acting through the ESOP fiduciary) can also pursue legal remedies if there is evidence that the board has acted improperly and in a manner which causes harm to the ESOP.

At a minimum, then, upon learning of a proposed redemption, it is incumbent upon the ESOP fiduciary to gather all of the relevant facts. How did the board of directors determine that the redemption would be beneficial to the shareholders – including the ESOP? Is the price to be paid in excess of the most recent ESOP valuation (considering minority and other appropriate discounts)? What are the terms of the company's borrowings from banks and/or the selling shareholders? Is the company issuing synthetic equity to management and/or the selling shareholders as part of the redemption transaction and, if so, was a compensation study or other financial analysis conducted? Were alternative structures considered? Did the board of directors seek outside expert advice? Are members of the board of directors also sellers in the redemption transaction or the proposed recipients of synthetic equity? Does the corporate law of the company's state of incorporation require a shareholder vote? If so, does the ESOP itself require a pass-through to participants under these circumstances?

Armed with the facts, the ESOP fiduciary can then determine whether there is an opportunity or need for negotiation and/or further investigation or, if necessary, more dramatic action. Clearly, an appropriate analysis will likely require expertise that the ESOP fiduciary may not possess. In those circumstances, the ESOP fiduciary should turn to its financial and legal advisors for assistance. The ESOP's financial advisor should be able to provide important and sophisticated analyses to the ESOP fiduciary even though a formal "adequate consideration" valuation opinion is not necessary. Counsel can advise the ESOP fiduciary regarding any potential shareholder claims. Even if the board of directors may have the legal right to complete the redemption without the approval of the ESOP, it is unlikely that a significant transaction that the ESOP fiduciary believes is fundamentally flawed will be completed, especially since the company cannot elect to begin being taxed as an S Corporation unless all shareholders (including the ESOP) agree.

Given the tax benefits associated with becoming a 100% ESOP-owned S Corporation, leveraged redemptions are increasing in ESOP companies. The prudent ESOP fiduciary should carefully review the financial and legal aspects of the proposed transaction in order to make certain that the best interests of plan participants are considered and protected.



The author of this article is a member of The ESOP Association's new Interdisciplinary Advisory Committee on Fiduciary Issues. While the author consulted with the Committee Chair, Judith L. Kornfeld of ESOP Economics, Inc., Philadelphia, PA, and committee members David Ackerman, Esquire, of Morgan Lewis & Bockius LLP, Chicago, IL and Marilyn H. Marchetti of GreatBanc Trust Company, Oak Brook, IL, and wishes to acknowledge their contributions to this article, the opinions expressed here do not represent the position of the Committee or The ESOP Association.

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