Settlement Holds ERISA Lessons For Private Co. Directors

By **Carol Buckmann** (January 24, 2022)

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Litigation involving employee stock ownership plans, or ESOPs, has continued through the pandemic and, like 401(k) plan fee litigation, shows no signs of ending.

The majority of ESOPs are established and run without ever becoming involved in litigation, but the thing that many of the ESOPs sued by the U.S. Department of Labor have in common is that they are insider transactions in which the ESOP allegedly overpaid for employer securities because conflicts were ignored and decisions were not entrusted to responsible independent parties.

Often, selling shareholders had too much influence over the transaction.

The recent settlement presented for approval before the U.S. District Court for the District of Minnesota in litigation involving Kurt Manufacturing Co. Inc. is a case in point.

Although Reliance Trust Co.'s insurer funded its part of the settlement, the settlement also took aim at the directors for their role in the plan's purchase of 75% of Kurt's stock from an owner who was also chairman of the board. As a result of the purchase, the company became 100% ESOP-owned.

There are lessons to be learned by ESOP fiduciaries, and particularly by inside directors of private companies, from the missteps of the parties to that settlement.

The DOL's Lawsuit

As described in U.S. District Judge Susan Richard Nelson's opinion refusing to dismiss Acosta v. Reliance Trust in 2019,[1] Kurt initially looked for an outside purchaser, but became concerned that the company would not be kept whole in such a deal.

The insiders then turned to the alternative of buying out the majority owner, who was also chairman of the board, through a sale to an ESOP with an acquisition loan from the seller.

The ESOP ultimately purchased shares that had previously been valued by a financial adviser at up to $33.44 per share for $85 per share, which the DOL argued was an overinflated price. The DOL contended that the ESOP overpaid the seller by approximately $10 million.

The DOL contended that the directors knew that the price was inflated because they also granted stock appreciation rights under a plan that had a price support feature set at a per-share value of $55.29 per share, rather than $85.

The DOL claimed that as fiduciaries, the directors violated their duties of prudence and loyalty, and also caused the ESOP to engage in a prohibited transaction by paying more than adequate consideration, as defined in Section 3(38) of the Employee Retirement Income Security Act, for the stock.

Alternatively, even if they were not fiduciaries, the directors knowingly participated in a

prohibited transaction, which is also a violation of ERISA.

Indemnification Rights

As part of the sale transaction, the selling shareholder agreed to indemnify the ESOP if a court determined that the ESOP had overpaid for the stock.

Kurt separately agreed to indemnify Reliance as trustee unless a court determined that Reliance had committed gross negligence, breached its fiduciary duty or engaged in willful misconduct.

As part of the litigation, the defendants entered third-party complaints asking to be indemnified from the selling shareholder's estate.

The Judge's Decision

In August 2019, a Minnesota federal court refused to dismiss the DOL's case as requested by the directors and cleared it to move forward.

The court found plausible evidence of fiduciary breaches and agreed with the DOL that the directors could be held to be fiduciaries if they effectively controlled the transaction or failed in their duty to monitor Reliance after they appointed it as discretionary trustee.

The prohibited transaction claim could also stand. Even if the directors were not fiduciaries, nonfiduciaries may be liable for equitable relief if they knowingly participated in a prohibited transaction.

However, the indemnification claims against the estate were dismissed in the decision on the grounds that the defendants were not third-party beneficiaries of the indemnification agreements, and could not claim co-contribution from other fiduciaries or be indemnified for fiduciary breach.

A Big Picture of the Settlement

Per the settlement, the DOL will recover the excess paid by the ESOP from Reliance and the directors or their insurers. The agreement also directs that no portion of the recovery may be used to indemnify the parties for their legal fees under their various indemnification obligations, and it takes steps to limit any future influence of the defendant directors in company and ESOP operations.

An interesting aspect of the settlement is that it contains a provision barring the directors from receiving equity-based and other compensation, such as stock options and awards, and from participating in the supplemental executive retirement plan.

The DOL will also assess the 20% civil penalty imposed under Section 502(l) of ERISA on the amount involved when it reaches a settlement for fiduciary breach.

Of special interest here, though, were the specific steps mandated to set the ESOP, which owned 100% of Kurt, on a proper path to eliminate the influence and benefit perks of the directors who approved the challenged transaction and provide for the involvement of qualified independent parties going forward.

Specific Settlement Terms

According to the settlement, Reliance must restore $8.4 million to the ESOP and the directors will restore almost $1 million to the ESOP, representing the excess purchase price paid.

The refunded amounts may not be used to repay any ESOP loans or for indemnification. The ESOP will credit the refunds received to accounts pro rata, except that the directors may not participate in the corrective allocation.

The settlement requires allocating the proceeds to terminated participants, including those who had received complete distributions of their accounts, as well as to current participants.

DOL best practices were required to be followed to find missing participants, and if participants still could not be located after these best practices were followed, and they were owed at least $1,000, accounts in their name were to be maintained in the ESOP trust and, in the event of plan termination, transferred to an IRA established in the name of the missing participants.

If the ESOP was terminated, accounts worth less than $1,000 could be transferred to a bank account in the name of the missing participant or escheated.

Any legal fees advanced to the parties must be returned. In fact, in a 2020 settlement and process agreement with Farmers National Bank, the DOL took the position that legal fees may not be advanced in ESOP litigation unless an independent third party determines that there was no fiduciary breach.

Under the settlement of the Kurt litigation, the board will be expanded to seven members, and GreatBanc Trust Co., the current trustee, is to select an additional board member and a replacement for a current member who agreed to resign. Also, an independent valuation firm will be appointed.

Further, both Reliance and the directors are assessed penalties under Section 502(l) of ERISA, which authorizes the DOL to impose a penalty equal to 20% of the amount of any settlement involving fiduciary breach.

Reliance may challenge the penalty and request a waiver. The directors agreed to a reduced penalty imposed by the DOL and waived their right to challenge the assessment.

The defendant board members are permanently enjoined from being ERISA fiduciaries or providing services to the ESOP. They are specifically barred from voting on their own compensation, voting on ESOP shares or selecting the ESOP's valuation firm.

Finally, the directors lose their stock appreciation rights, may not receive future supplemental executive retirement plan contributions and may not receive severance compensation under their employment agreements when they terminate employment with Kurt.

While these terms appear extensive, as the ESOP owns 100% of Kurt, the DOL appears to have been concerned that excess compensation paid to these directors could adversely affect the value of the ESOP shares as well as allow them to profit from the ESOP transaction.

What the Directors and Reliance Should Have Done

Although there are no final regulations on the adequate consideration required under Section 3(38) of ERISA, in connection with settlements of ESOP litigation, the DOL has entered into a number of process agreements with ESOP trustees that cover valuation procedures, beginning with an agreement involving GreatBanc.

Other process agreements include agreements with Fiduciary Services Inc., Farmers National Bank and Wilmington Trust Co.

While not technically precedent or binding on other parties, the process agreements can be viewed as incorporating best practices, as well as a window into the DOL's thinking on ESOP issues and practices that the parties to this litigation should have followed.

ESOP transactions are required by law to be solely in the interest of ESOP participants. Where insiders are involved, personal considerations and outright conflicts of interest can impair the ability to make this determination.

The best protection in these ESOP transactions with insiders is therefore the employment of independent parties to participate in the transaction at the earliest possible time.

In this case, since there was no outside financing for the stock purchase, no independent financial institution had a role in the transaction. Initially, there were also no independent outside trustees to negotiate with the selling shareholder.

The company should have involved an outside trustee with its own counsel in the negotiations. Current board members should not have been negotiating with or influenced by the chairman in a situation where they may have reasonably feared their jobs were at stake.

If practices outlined in the process agreements had been followed, the firm that did the initial appraisals should not have been advising about the final share valuation. Reliance should have engaged its own counsel and retained its own financial adviser.

Reliance was alleged to have rubber-stamped the transaction without doing its own analysis. Reliance should not have relied on any valuation report without investigating the credentials of the parties who produced the report, the accuracy of the information provided by the company and the valuation methodology.

The process agreements provide more detail about the factors that should be reviewed. Fairness and valuation opinions could also have been obtained.

Who Will Pay

The parties did not admit liability in the settlement. The terms of the settlement contemplate payment of the recovery amounts by the parties' insurers.

It is likely that Reliance's insurer will bear its part of the settlement costs.

It is not clear whether the directors were covered by liability insurance. However, even if they had insurance, this settlement may not have been covered under it. Typically, any errors and omissions coverage the directors had would not cover liabilities related to serving as an ERISA fiduciary.

ERISA fiduciary liability insurance does not automatically cover ESOPs and, if it does, it may be limited to claims relating to ESOP administration.

While penalties and taxes are often excluded from such policies, it is possible to get coverage that includes the ERISA Section 502(l) penalty. However, all policies will exclude willful misconduct.

Even absent the court's ruling on indemnification, any claims by the settling parties to be indemnified by Kurt could be problematic in the case of a 100% ESOP-owned company.

Although there has been no admission of fiduciary breaches in the settlement, the DOL and the courts have sought to restrict indemnification of ESOP fiduciaries and trustees.

While it is not clear that the DOL would have insisted on the same terms if the ESOP owned a smaller percentage of the company, the Kurt settlement terms illustrate the potential consequences for inside directors who do not keep the participants' interests first when implementing private company ESOP transactions.

Carol I. Buckmann is a founding partner at Cohen & Buckmann PC.

[1] Acosta v. Reliance Tr. Co., No. 17-cv-4540 (SRN/ECW), 2019 BL 297149, 2019 EBC 297149, 2019 WL 3766379 (D. Minn. Aug. 09, 2019).