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EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION

A New Reality for ESOP Fiduciaries

Company Stock Investments for Employee Participants in Retirement Plans of Public and Privately Held Companies Have Different Operating Requirements

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HIGHLIGHTS:

- » For the ESOP fiduciary of a publicly traded employer, the Supreme Court has made clear that non-public insider information is not required to be used in reaching a decision to buy, hold or sell employer securities.
- » The Court's decision is not particularly helpful for ESOP fiduciaries of privately held companies. In addition to no longer having the security of the presumption of prudence, these fiduciaries are now in ill-defined territory. However, there are measures to be taken to protect the fiduciary's decisions to buy and sell employer securities.

Much has already been written to summarize the recent U.S. Supreme Court decision in *Dudenhoeffer* where the presumption that an ESOP fiduciary acted prudently in acquiring and holding employer securities was discarded by the Court. As the dust settles, however, ESOP fiduciaries need to set a course of action for future dealings with respect to acquiring and holding employer securities given the decision.

Different Worlds for 401(k) Plans and ESOPs

The Court decision was rendered with respect to a 401(k) plan sponsored by a publicly traded company that offered employee participants multiple investment choices, including an employer stock fund. Typically under these plans, participants are able to transfer amounts between funds on a daily basis so that the plan fiduciaries are buying and selling shares frequently and the public markets offer nearly immediate liquidity. The employer's financial statements are publicly available, updated on a quarterly basis and financial analysts offer frequent reports on whether investors should buy, hold or sell shares.

However, most ESOPs are sponsored by employers whose stock is privately held and is not readily tradable on an established securities market. Purchases and sales of employer securities are far less frequent, normally when the founder(s) or the employer offer shares for sale to the ESOP or a third-party buyer purchases shares from the ESOP; otherwise the fiduciary has no liquidity or access to markets. Audited financials are issued once per year and are not normally

made available to the participant. An appraisal is conducted annually and issued after the audited financials are finalized, normally six months after the end of the previous fiscal year. Thus, the ESOP fiduciary does not have a constant flow of market pricing and corporate performance information. In conjunction with the appraisal process, the ESOP fiduciary will review the audited financials and interview board members and senior management about company operations and may have more frequent contact than on an annual basis. The ESOP fiduciary does not normally receive directions from participants as to the purchase and sale of employer securities.

Impact on ESOP Fiduciaries of Publicly Traded Employer Securities

The path for ESOP fiduciaries of publicly traded employers appears to be less murky than for ESOP fiduciaries of privately held employers. In large part this is because the Court's decision specifically relates to the plan of a publicly traded employer.

For the ESOP fiduciary of a publicly traded employer, the Court has made clear that non-public insider information is not required to be used in reaching a decision to buy, hold or sell employer securities. Further, it appears that if a plaintiff(s) merely alleges that a fiduciary should have recognized from publicly available information alone that the market was over or undervaluing the stock, the Court would grant a motion to dismiss, as a general rule, unless there are special circumstances articulated. Even where the plaintiffs may allege, for example, that an employer or fiduciary engaged in lending practices that were equivalent to lending in a subprime lending market and were aware of the risks of such investments, the Court did not appear to believe that this merited special circumstances.

While not relevant to the case before the Court, fiduciaries of public company ESOPs may be able to raise section 404(c) of ERISA as a defense. That section protects fiduciaries of plans providing participant-directed investments from liability for investment directions made by participants. There are a number of structural and disclosure requirements for section 404(c) plans, but this can be a viable defense for these fiduciaries. The fiduciary may still have liability exposure for making the employer securities fund available to participants, but even this risk can be mitigated with proper diligence.

Further, public company ESOPs are subject to the diversification requirements of Internal Revenue Code section 401(a)(35) which, in essence, give most participants to invest in employer securities and withdraw from employer securities on a daily basis. This ability alone will take most of the buy, hold and sell burden from the ESOP fiduciary, even where the plan does not meet the requirements of section 404(c) of ERISA. Again, however, the fiduciary may have liability exposure for making employer securities available as an investment option.

Some public companies take a further step by having an independent fiduciary monitor and review the performance and viability of an employer securities fund and vest in the independent fiduciary the power to shut down and even liquidate the fund. This provides a further layer of fiduciary protection.

Impact on ESOP Fiduciaries of Privately Held Companies

The decision is not particularly helpful for ESOP fiduciaries of privately held companies. There is little or no public information available, no market mechanism for liquidity and no federal securities laws applicable to insider trading prohibitions. These fiduciaries will no longer have the security of the presumption of prudence and are now in ill-defined territory.

Still, however, there are measures to be taken to protect the fiduciary's decisions to buy and sell employer securities. Appropriate due diligence and use of a qualified independent financial advisor in a careful, disciplined and documented approach can provide a great measure of protection against conclusory allegations from a plaintiff group or the U.S. Department of Labor. Plaintiff or Department of Labor claims will need to be very context specific and, where a fiduciary decision to purchase or sell employer securities is based on all information reasonably made available to and analyzed by the fiduciary in such a process, the fiduciary will be in a strong position to defend itself. For guidance, fiduciaries will need to carefully examine the [settlement reached in a case](#) involving the Sierra Aluminum transaction.

As far as holding employer securities in light of a drop in the appraised value of employer securities and evidence of diminished corporate performance from audited and interim financial statements, the ESOP fiduciary at a privately held employer has fewer reasonable choices. For example, after the ESOP fiduciary seeks a redemption of shares by the sponsoring employer or its non-ESOP shareholder(s) and explores with the employer's board of directors the feasibility of a third-party sale or reorganization of senior management and business strategy, the options are exhausted. It will be difficult for a particular group of participants to plausibly argue that a reasonable fiduciary would have acted differently.

The difficulty here is that it will likely be more difficult for an ESOP fiduciary in the private company rule to extricate itself from a prudence claim on a motion to dismiss and more likely that it will have to wait to develop its case for a motion for summary judgment. This will involve more time and expense in defending itself from spurious claims. Only time will tell how the federal district courts and appellate courts apply the vague principles from the decision to various fact patterns and claims before any clarity emerges. This may take awhile. In the meantime, these fiduciaries must take a careful, cautious, deliberate and pedantic approach to all transactions.

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