ESOP Fiduciary Committees

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Many ESOPs include an administrative committee, either to assist in the plan administration or, in some cases, to direct the trustee or otherwise serve in a fiduciary capacity. Particularly when serving as plan fiduciaries, ESOP committee members must be aware of the legal standards of conduct that govern them so that they can engage in their committee role fully aware of their responsibilities to the plan and plan participants. This article reviews the legal standards that govern ESOP committees.

Although not legally required, most employee stock ownership plans (ESOPs) provide for an ESOP committee, sometimes called the "ESOP Administrative Committee." The role of the ESOP committee may vary greatly from plan to plan. Duties range from purely administrative to the more complex role of plan trustee. Examples of administrative responsibilities include overseeing the distribution of mandatory reports and making sure allocations are made in a timely fashion. More complex responsibilities may include advising on certain aspects of plan design and amendments, directing the trustee on voting of certain matters, or ruling on the validity of qualified domestic relations orders. Although not as common, some plans establish the ESOP committee as the plan trustee. In these circumstances the ESOP committee performs all functions of the plan trustee and the ESOP committee is subject to all fiduciary obligations and liabilities attributed to trustees of a qualified plan.

The role the ESOP committee plays in the establishment and ongoing operations of a plan governs the level of fiduciary responsibility imposed upon its members. An ESOP committee that plays a purely advisory role to the company will not usually be deemed to have a fiduciary responsibility to the plan and its participants. An ESOP committee that makes binding decisions regarding operations of the plan or directs a trustee on voting

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matters serves as plan trustee, is acting as a plan fiduciary, and owes a legal duty to the participants in the plan.

ESOP committees that are a plan fiduciary are scrutinized more carefully and may be held accountable by the courts for the plan's failure to comply with its own plan requirements or for requirements imposed by law.

The remainder of this article will describe some of the major legal issues that arise for ESOP committees in their roles as plan fiduciaries. What follows is not intended to scare employees who read this away from serving on an ESOP fiduciary committee. On the contrary, such a role can be both personally and professionally rewarding. However, it is important to fully understand the attendant responsibilities so that they can be carried out in the most diligent fashion possible and with the least amount of risk to the individuals who serve in this important capacity.

What Is a Plan Fiduciary?

A plan fiduciary is a person or body that makes decisions affecting the design or operations of the plan. In a typical ESOP arrangement a trustee will be named as a plan fiduciary. However, this does not preclude others, including the ESOP committee, from also being designated plan fiduciaries. A plan fiduciary is defined by the Employee Retirement Income Security Act of 1974, as amended (ERISA), as a person, (i) who "exercises any discretionary authority or control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) renders investment advice for a fee or other compensation, direct or indirect with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) or has any discretionary authority or discretionary responsibility in the administration of such plan.[1]"

Plan fiduciaries must act in a prudent manner and for the exclusive benefit of plan participants and plan beneficiaries.[2] An ESOP fiduciary committee must evaluate matters and render decisions based on what is in the best interests of the plan participants and plan beneficiaries as participants and not as employees. Decisions should not be made based on the employment interests of the employees, or the financial viability or success of key management or shareholders, other than the interests of the ESOP trust. The failure of ESOP fiduciary committee members to carry out their duties in a prudent manner and for the exclusive purpose of the plan participants and beneficiaries are key failures that result in charges of liability against ESOP fiduciary committee members.

Examples of Breach in Fiduciary Duties by the ESOP Fiduciary Committee

Allegations of violations of fiduciary duties can be brought against an ESOP fiduciary committee by plan participants or beneficiaries, other trustees or fiduciaries of the plan, or the Secretary of the Department of Labor in his or her role as the federal agency that oversees compliance with ERISA. Cases that result in findings of violations of fiduciary duties generally include the following major categories:

Failure to Act in a Prudent Manner

In exercising their responsibilities, ESOP fiduciary committee members must act "with such care, skill, prudence and diligence under the circumstances then prevailing, that a prudent person 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."[3] This prudent person standard requires that ESOP fiduciary committee members evaluate information presented to them, question facts and reports presented by independent experts, and engage in meaningful discussion and evaluation of the information prior to actually making a determination on an issue that affects the participants in the plan. Failure to engage in such independent inquiry led to a finding of breach of fiduciary duty in such cases as the following:

Newman Howard et al. v. Edward A. Shay, et al.[4] In this case, plaintiffs were participants in a ESOP. In 1974 the ESOP purchased 40% of the company's stock from the founder Edward Shay for $10.67 per share. Shay was the CEO and chairman of the board of directors. Shay appointed two senior executives who worked for Shay to be the ESOP fiduciary committee. The company did exceedingly well, and its stock value rose considerably. In 1998, the ESOP fiduciary committee members authorized the ESOP to sell its shares of stock back to Shay for $14.40 per share, which, according to the court, was a meager increase compared to the overall growth of the company. In determining the sale price of the stock, the ESOP fiduciary committee members relied on a valuation report issued by an independent valuation firm.

The court ruled that the ESOP fiduciary committee members breached their fiduciary duties in the sale of the stock back to Shay because the independent valuation was flawed, and the ESOP fiduciary committee failed to make further inquiry into the analysis used in the valuation or otherwise conduct an independent investigation. The court was particularly angered

by the timing of the vote. The ESOP fiduciary committee members voted to sell the stock one day after they received the valuation.

In ruling against the ESOP fiduciary committee members and in favor of the ESOP participants, the court issued the following warning: "Fiduciaries must make an honest, objective effort to read the valuation, understand it, and question the methods and assumptions that do not make sense. An independent appraisal is not a magic wand that fiduciaries simply wave over a transaction to ensure that their responsibilities are fulfilled. It is a tool, and like all tools, is useful only if used properly."[5]

Gary L. Eyler v. Commissioner of Internal Revenue Service[6] The IRS charged excise taxes against Gary L. Eyler, the former CEO and majority shareholder of a large company that engaged in vocational training for truck drivers. Eyler, as CEO of the company, had a valuation conducted to determine if the company should go public. When there was not sufficient investor interest to go public, he established an ESOP with a loan from a bank for $10 million. The bank received opinion letters from counsel for the company, but did not require that the opinion state that the stock was purchased for "adequate consideration."

Eyler, as CEO, appointed himself and four other persons to the ESOP fiduciary committee. Between the time of the valuation and the time of the sale to the ESOP the company experienced a significant downturn in value. The IRS sued Eyler claiming that he was a disqualified person and received greater than adequate consideration for his stock in the company.

The court agreed with the IRS and ruled that excise taxes should be imposed against Eyler. The court ruling relied in part on the fact that the ESOP fiduciary committee failed to undertake a prudent and independent investigation into the fair market value of the company. The ESOP fiduciary committee approved the ESOP the same day it was introduced to them and relied on the reports given to them without comment and without engaging in any independent investigation.

Donovan v. Cunningham[7] This case involved the same issue as the *Eyler* case. Here, the Secretary of Labor brought an action against ESOP fiduciary committee members for a violation of their fiduciary duties. In this instance the company established an ESOP effective July 1, 1975. The plan allowed for the appointment of an ESOP fiduciary committee by the board of directors. In August of 1976, the board of directors appointed themselves as the members of the ESOP fiduciary committee.

In their capacity as board members, these same individuals voted to contribute $288,000 in cash to the ESOP for the purpose of acquiring stock from Cunningham, the chairman of the board. Then, in their capacity as

ESOP fiduciary committee members, these same persons voted to purchase 1,440 shares of stock from Cunningham at $200 per share. In 1977, this same process was undertaken whereby additional shares of stock were purchased by the ESOP from Cunningham.

The Secretary filed suit against the members of the ESOP fiduciary committee for breach of fiduciary duty, alleging that they failed to follow appropriate procedures necessary to determine the fair market value of the shares and causing the ESOP to pay Cunningham more than adequate consideration for his stock. The appeals court agreed with the Secretary and found the ESOP fiduciary committee members in breach of their fiduciary duties to the ESOP participants and beneficiaries. The court included in its reasoning that the ESOP fiduciary committee failed to conduct an independent investigation into the obviously flawed findings of the valuation expert, and the ESOP fiduciary committee relied on a stale valuation when undertaking the 1977 sale transaction.

Failure to Act in the Sole Interests of the ESOP Participants and Beneficiaries

In the above cases, the courts found the ESOP fiduciary committees failed to act in a prudent manner, in violation of the duties of a plan fiduciary established by Section 404 of ERISA. Like most (but not all) ESOP fiduciary litigation, they involved the ESOP fiduciaries not making a proper determination of share value. In *Robert B. Reich v. Hall Holding Company,*[8] the court found that the ESOP fiduciary committee failed to act solely on behalf of the interests of the ESOP participants and beneficiaries, also a violation of Section 404 of ERISA.

In *Reich,* an ESOP was established at the Hall Holding Company with the assistance of outside counsel. Before the formation of the ESOP an independent valuation was conducted for the company. Several months later, when the ESOP was formed this same valuation expert was hired, who arrived at the same value for the company.

When the ESOP was formed, Goldman, in his capacity as sole director of the company, appointed two individuals to be the ESOP fiduciary committee who, on behalf of the plan, acquired the stock of the company from Goldman and executed all loan documents necessary for this transaction. The Secretary of Labor alleged that the two members breached their fiduciary duties by paying more than adequate consideration for the shares of stock and for failure to act solely in the interests of the plan participants and beneficiaries.

After several hearings on the matter, the court ruled that the mere fact that the defendants, as the ESOP fiduciaries, did not conduct a prudent and

independent investigation to determinate fair market value of the Hall Holding stock purchased by the Hall ESOP, caused the ESOP so to engage in a prohibited transaction in violation of Section 406 of ERISA. At the final hearing, the court found the defendants jointly and severally liable and ordered them to pay the ESOP $1,049,549.00, the difference between the amount paid by the ESOP and the fair market value determined by the court.

Failure to Diversify the Investments of the Plan

Unlike other qualified ERISA plans, an ESOP is established with an express recognition that plan investments will not be diversified, but will instead be established and maintained primarily with employer stocks or securities. In limited circumstances however, the courts have found plan fiduciaries to be in violation of their fiduciary duties for failure to diversify investments so as to minimize the risk of large losses to the plan. Such was the conclusion of the court in *Charles Moench on His Own Right and on behalf of the Statewide Bancorp Employee Stock Ownership Plan v. Joseph W. Robertson, et al.*[9] In this case an ESOP was established on January 1,1986, by the Statewide Bancorp ("Statewide"), a holding company doing business through its two wholly owned subsidiary banks. In 1989 Statewide began having financial difficulties with stock prices falling more than 50%, from $18.25 to $9.50 per share, in a five month period. Stock prices continued to tumble and by May of 1991, the stock was valued at less than twenty-five cents per share. During this same period of time state regulators expressed concern directly to Statewide's board of directors, as to the financial condition and portfolio of Statewide.

The ESOP plan documents established an ESOP fiduciary committee, whose responsibilities included directing the trustee in its investments. Suit was brought against the ESOP fiduciary committee because throughout this period of rapidly declining value, the ESOP fiduciary committee continued to invest in Statewide common stock. The committee argued that it was without discretion to invest in other than Statewide stock since the plan was established to invest primarily in company stock.

The court concluded that (1) the committee did have discretion because "primarily" is not the same as "exclusively" and (2) a fiduciary's responsibility under the common principles of law of trusts mandates that fiduciaries in certain narrow instances must take actions at odds with how they are directed to act. The court concluding that the ESOP fiduciary committee had the authority to diversify the holdings of the trust, then remanded the case back to the trial court for a further investigation to examine whether, under the "prudent fiduciary standard," the ESOP fiduciary committee should have diversified the holdings of the trust.

This same issue was evaluated by the court in *Glenn Kuper and Cliff Jones v. Michael Iovenko and H. Weston Clarke, Jr, Quantum Chemical Corporation.*[10] Plaintiffs were former salaried employees of the Emery division of the Quantum Chemical Corporation ("Company"). The company established an ESOP in February, 1988, and the board of directors appointed an ESOP fiduciary committee. The ESOP allowed the plan fiduciaries to distribute the benefits in the employees' ESOP accounts, upon the sale by the company of substantially all of its assets or the assets of one of its subsidiaries.

In April 1989, the company completed its sale of the Emery subdivision to the Henkel Corporation. However, the trust-to-trust transfer of the plan assets was not completed until almost 18 months later. During this 18-month period the value of the stock of the Emery Division declined significantly. The ESOP fiduciary committee had actual knowledge of the decline in value and did not exercise the option of distributing the account balances to the participants and beneficiaries in the plan. Plaintiffs brought suit against the ESOP fiduciary committee (and plan trustees) alleging breach of fiduciary duty in not diversifying or liquidating the assets of the trust during this eighteen month period of stock value decline.

The court found no breach of fiduciary duty by any of the plan fiduciaries. The court found that the plaintiffs failed to provide sufficient evidence that any other reasonable and prudent fiduciary would have diversified or liquidated the assets of the Emery division of the company.

Hot Topics for ESOP Fiduciary Committees

The predominant standard of conduct for an ESOP fiduciary committee, to carry out its duties in a prudent manner for the exclusive benefit of plan participants, is outlined in the cases above. However, other "hot issues" may confront an ESOP fiduciary committee and certain other principles govern its actions as it carries out its duties.

Arbitrary and Capricious Decision Making

Many of the decisions made by an ESOP fiduciary committee are discretionary in nature. The law requires that an ESOP fiduciary committee make its decisions based on the exclusive interests of the participants and beneficiaries of the plan. The courts are loath to disrupt the discretionary decisions made by an ESOP fiduciary committee, unless the decision is one that is clearly so unfounded in its merit as to be deemed arbitrary and capricious or fraudulent in nature.

For instance, many ESOP fiduciary committees have the authority to

rule on whether certain classes of individuals meet the definition of participant, as this term is defined in the plan. Such was the authority granted to the ESOP fiduciary committee in the matter of *Anthony Trombetta, et al. v. Cragin Federal Bank for ESOP, et al.*[11] The plaintiffs were all independent contractors who performed as loan originators for the defendant, Cragin Bank. The plaintiffs sued Cragin Bank and its plan fiduciaries, including the ESOP fiduciary committee, claiming that they met the definition of "employee" and should therefore have the right to participate in the ESOP. The ESOP fiduciary committee ruled that they were not employees as defined by law or the plan and therefore were not eligible to participate in the plan.

The lower court and the Seventh Circuit Court of Appeals evaluated the decision of the ESOP fiduciary committee in order to determine whether the committee's action denying the independent contractors the right to participate in the ESOP was "arbitrary and capricious" or made in "bad faith." Both courts concluded that the ESOP fiduciary committee's determination that the plaintiffs were not employees under either the common law or plan definitions and the committee's decision to prohibit independent contractors from participating in the ESOP were based on careful and reasoned consideration of the facts before the committee and the applicable law; hence, the courts affirmed the decisions made by the committee.

The Principle of Adequate Consideration

For an ESOP fiduciary committee that has a role in determining whether to acquire or sell stock on behalf of the trust, it is important that this committee diligently examine the question of "adequate consideration" as it relates to this transaction. As the cases earlier in this article reveal, an ESOP fiduciary committee must take careful steps to ensure that the ESOP neither acquires stock for more than adequate consideration nor sells stock at a price that is less than adequate consideration.[12] All transactions should be conducted after an independent investigation and valuation of the company and its securities. The valuation report and the findings should be carefully examined for the accuracy of the information and underlying assumptions relied upon by the valuation firm.

This is the most serious issue any ESOP fiduciary committee will face; it accounts for most of the lawsuits. The law requires that the ESOP buy or sell shares based on an independent appraisal. However, the fiduciary committee cannot simply accept the appraisal at face value. It must carefully review the appraisal report to determine whether the report's assumptions, methods, and data were adequate. The fiduciary should also work, where possible, to negotiate a better deal than the appraisal indicates.

In most cases, if the committee is careful to hire a well-qualified appraiser, the share value given in the appraiser's report will be the one used to buy and sell shares, but committees need to recognize that their responsibility does not stop with careful hiring. People serving on committees often ask how they can prevent themselves from being sued when, after all, stock prices go up and down for unexpected reasons. An ESOP might pay $20 a share in year one, only to see business problems drive prices down to half that soon thereafter. Why can't employees then sue, saying the ESOP overpaid? The answer is that their suit will succeed only if they can show that the committee made a unreasonable decision based on facts available at that time, not later. When committees act carefully, detail the reasons for their decisions, work to promote the best interests of the plan, and use qualified advisors, successful suits are very rare.

Serving Two Masters: the Board of Directors and the ESOP Fiduciary Committee

In virtually all ESOPs, the board of directors appoints some, if not all of the members of the ESOP fiduciary committee. It is not uncommon for the board to appoint to the ESOP fiduciary committee some of its own directors or employees that are loyal to or who report directly to the board. This duality of roles may be perceived as a conflict of interest by ESOP plan participants who are not familiar with the laws that govern the formation and administration of ESOPs. However, this duality of service to both the company and the trust is expressly contemplated and authorized by ERISA[13] and will not in and of itself be viewed as a breach of fiduciary duty. Regardless of its allowance by law, to move beyond the suspicions and questions of loyalty to the trust, it is critical that ESOP fiduciary committee members take their roles seriously and engage in the levels of scrutiny required by law of plan fiduciaries.

While courts will initially give the benefit of the doubt to the discretionary actions and decisions of plan fiduciaries, this presumption in favor of the ESOP fiduciary committee may be overcome if the actions of the committee fail to reveal a clear understanding of their responsibilities to the trust. One court has cautioned that "Courts should be cognizant that as the financial state of the company deteriorates, ESOP fiduciaries who double as directors of the corporation .. serve two masters. And the more uncertain the loyalties of the fiduciaries, the less discretion it has to act. Indeed, when a fiduciary has dual loyalties, the prudent person standard requires that the fiduciaries make careful and impartial investigations of all . . . decisions."[14]

Actions Outside the Scope of the Plan

The ESOP plan document establishes the terms for the operation and administration of the ESOP. In most instances, ESOP fiduciary committee members who have discretionary authority must make their determinations within the four squares of the terms of the plan. However, as plan fiduciaries, the first duty and obligation of the ESOP fiduciary committee is to the participants and beneficiaries of the plan. Therefore, in some very limited circumstances, plan fiduciaries may exercise their discretionary authority and make decisions that are inconsistent with or that contravene the express terms of the plan. One instance may be if certain plan provisions are in violation of established law, in which case the ESOP fiduciary committee may be obligated to ignore the plan provisions as stated in favor of a decision that is consistent with the law. The ESOP fiduciary committee may also make a decision in contrast to stated plan provisions if in so doing, the committee is acting exclusively in the interests of the plan participants and beneficiaries. Such a decision might be, for example, to diversify plan assets where the plan expressly states that plan assets should be invested in employer securities, if the committee believes that the financial viability of the company is questionable and the diversification of plan assets will protect the accounts of the plan participants and beneficiaries. As one court has noted, in some instances "following the terms of the plan is at odds with a fiduciary's responsibility under the common law of trusts, which mandates that the fiduciaries, in certain narrow instances must take actions at odds with how it is directed generally to act."[15]

Conclusion

The role of an ESOP fiduciary committee member is not to be taken lightly. Committee members must engage in serious due diligence in order to meet the standards of a prudent fiduciary, prior to actually making a decision on matters that affect the interests of the plan participants. However, the committee members should also not lose sight of common sense. If the issue at hand is relatively minor, or the financial risk to the ESOP is nominal, the committee members should undertake the level of diligence that is appropriate for the circumstances. They should use their judgment, question information that seems unreasonable or unclear, and use their best efforts to investigate what needs investigating. They will enjoy the role they play in the oversight of their ESOP and find satisfaction in knowing they are a vital party to its future success.

Notes

1. 29 U.S.C. § 1002(21)(A).
2. In carrying out their duties, plan fiduciaries may also consider defraying reasonable expenses of administering the plan and diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so.
3. ERISA § 404(a)(1)(B).
4. *Howard v. Shay,* 100 F.3d 1484 (9th Cir. 1996), *cert. denied*, 520 U.S. 1237; 117 S. Ct. 1838 (1977).
5. Citing *Donavan v. Cunningham,* 716 F.2d 1455, 1474 (5th Cir. 1983).
6. *Eyler v. Commissioner of Internal Revenue Service,* 88 F.3d 445 (7th Cir. 1996).
7. *Donovan v. Cunningham,* 716 F.2d 1455 (5th Cir. 1983), *cert. denied,* 467 U.S. 1251, 104 S. Ct. 3533 (1984).
8. *Reich v. Holding Co.,* 990 F. Supp. 955 (N.D. Ohio 1998), *reconsideration granted,* 1998 U.S. Dist Lexis 2957, (N.D. Ohio Mar. 10, 1998); 60 F. Supp. 2d 755 (N.D. Ohio 1998).
9. *Moench v. Robertson*, 62 F.3d 553 (3rd Cir. 1995), *rehearing denied*, 1995 U.S. App. LEXIS 26141, *cert. denied,* 516 U.S. 1115, 116 S. Ct. 917 (1996).
10. *Kuper v. Iovenko,* 66 F.3d 1447 (6th Cir. 1995).
11. *Trombetta v. Cragin Fed. Bank,* 102 F.3d 1435 (7th Cir. 1996), *rehearing denied,* 1997 U.S. App. LEXIS 2195.
12. Adequate consideration is defined in ERISA as: “a price not less favorable to the plan than the offering price for the security as established by the current bid and asked prices quoted by persons independent of the issuer and of any party in interest.” ERISA, § 3(18)(B).
13. Section 408(c)(3) of ERISA expressly exempts from the definition of a “prohibited transaction” “serving as a fiduciary in addition to being an officer, employee, agent or other representative of a party in interest.”
14. *Moench v. Robertson,* 62 F.3d 553 at 572.
15. Ibid. at 567.