September 22, 2022

Via Federal Express

Mr. Ali Khawar
Acting Assistant Secretary
Employee Benefits Security Administration
U.S. Department of Labor
200 Constitution Ave., NW
Suite N-5677
Washington, D.C. 20210

Re: Petition for Notice-and-Comment Rulemaking Regarding the Definition of "Adequate Consideration" Under Section 408(e) of the Employee Retirement Income Security Act of 1974

Dear Acting Secretary Khawar:

Enclosed with this letter is a Petition for Notice-and-Comment Rulemaking Regarding the Definition of "Adequate Consideration" Under Section 408(e) of the Employee Retirement Income Security Act of 1974 ("ERISA"), which we are submitting pursuant to section 553(e) of the Administrative Procedure Act ("APA") on behalf of The ESOP Association.

Congress created ERISA section 408(e)'s adequate consideration exemption nearly 50 years ago to encourage the spread of employee stock ownership plans, or ESOPs—a type of plan Congress viewed as crucial to building wealth among American workers. Congress enlisted the U.S. Department of Labor ("Department") to help further its policy aims: baked into ERISA section 408(e) is a directive to the Department to issue prospective regulations fleshing out the otherwise vague adequate consideration standard. Unfortunately, the Department has chosen not to do so for nearly 50 years, electing instead to regulate informally—and in violation of the APA's notice-and-comment rulemaking requirements—via an ever-evolving series of litigation positions. This regulatory approach has, for a number of reasons, stymied the spread of ESOPs, frustrated Congress's intent to expand employee ownership, and—most importantly—robbed American workers of an important opportunity to generate real wealth.

After nearly 50 years, it is time for the Department to end its procedurally improper, retroactive approach to policymaking and engage with stakeholders in a notice-and-comment rulemaking process as Congress originally intended. It is not only The ESOP Association and its members that recognize this fact; both the House and Senate recently passed bipartisan legislation that would require the Department to provide formal guidance on the adequate consideration exemption.

The ESOP Association, its members, and our country's employee-owners—both current and future—look forward to your prompt attention to this important matter.

Sincerely,

Lars C. Golumbic
Andrew D. Salek-Raham
Nathaniel W. Ingraham

Enclosure

Cc: Joe Canary, Director
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BEFORE THE UNITED STATES DEPARTMENT OF LABOR, EMPLOYEE BENEFITS SECURITY ADMINISTRATION

PETITION FOR NOTICE-AND-COMMENT RULEMAKING REGARDING THE DEFINITION OF "ADEQUATE CONSIDERATION" UNDER SECTION 408(e) OF THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974

Submitted September 22, 2022

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EXECUTIVE SUMMARY

Employee stock ownership plans ("ESOP") are a type of benefit plan that Congress designed to invest in the stock of a sponsoring employer company. By establishing ESOPs and incentivizing their creation, Congress hoped to expand American workers' equity ownership stake in American companies, which would allow workers to build wealth as their employers grow.

As with all qualified employee benefit plans, ESOPs are governed by the Employee Retirement Income Security Act of 1974 ("ERISA"). Congress designed ERISA to allow ESOPs to buy employer stock using funds borrowed from the ESOP's sponsoring company itself so long as the ESOP pays no more than "adequate consideration." Virtually all ESOPs are established via this legal standard, known as the "Adequate Consideration Exemption."

When ERISA was passed in 1974, Congress directed the Department of Labor ("Department") to issue regulations outlining more specifically how companies and ESOP trustees could satisfy the Adequate Consideration Exemption. As the Department itself has long recognized, such a regulation is crucial to eliminate confusion surrounding the vaguely written standard and to protect ESOPs and their participants from potential abuse. To issue a regulation, the Department would need to engage with interested stakeholders in a notice-and-comment rulemaking process under the Administrative Procedure Act ("APA"). Unfortunately, the Department has ignored Congress's directive and circumvented the APA's requirements using a procedurally improper tactic of "regulation by litigation."

Under this now all-too-common approach, the Department investigates a professional ESOP trustee and forces it, under threat of debilitating litigation, to sign a settlement agreement outlining a process the trustee must adhere to going forward. The Department then publicizes the agreement and the process it contains as its new interpretation of the Adequate Consideration Exemption. The Department has done this, on average, roughly every 18 months since 2014.

The Department's unchecked, *ex post facto* approach to regulation has been devastating: it has sown confusion, emboldened and expanded an opportunistic class action plaintiffs' bar, driven up insurance costs, and pushed insurers out of the market. At bottom, the Department's policies have discouraged companies from establishing new ESOPs and prevented innumerable American workers from building wealth through equity as Congress intended. Employers, ESOP fiduciaries, and, most importantly, current and future ESOP participants, need the Department to regulate as Congress directed 50 years ago—transparently, prospectively, and with stakeholder input—so that American workers can reap the rewards that ESOPs provide.

The ESOP Association[1] is therefore petitioning the Department under the APA to undertake a notice-and-comment rulemaking process and issue a final regulation interpreting the Adequate Consideration Exemption.

[1] The ESOP Association is a national nonprofit organization with a professional commitment to the expansion and protection of employee ownership through ESOPs. For more information, visit https://esopassociation.org/about.

I. Introduction.

In 1974, Congress enacted ERISA[2] and its rules prohibiting employee benefit plans from entering into certain types of transactions. Fearing that these statutory bars would stifle the creation of ESOPs—a type of employee benefit plan that Congress specifically designed for the important purpose of expanding American workers' equity stake in American companies—Congress included the Adequate Consideration Exemption, a carve out for transactions in which ESOPs acquire or sell privately held employer securities for "adequate consideration,"[3] which ERISA defines as "the fair market value of the asset as determined in good faith by [a] fiduciary… ***and in accordance with regulations promulgated by the Secretary***."[4]

In the nearly half century since that Congressional directive, the Department has not issued any regulations interpreting the Adequate Consideration Exemption. The Department's decades-long delay is not the result of an inadvertent omission, the unhurried machinations of a large federal agency, or indifference, but instead a seemingly deliberate regulatory choice to supplant Congress's vision with its own.

Rather than issue regulations, the Department has chosen to pursue a policy of "regulation by litigation." The pattern is familiar: the Department (i) conducts a years-long, expansive, and expensive investigation of an ESOP transaction, leading it to investigate an ESOP trustee; (ii) concludes that, for reasons supported neither by ERISA's text nor existing case law, the trustee failed to satisfy the Adequate Consideration Exemption in connection with one or more ESOP transactions; and (iii) threatens to file multiple lawsuits against the targeted trustee unless it signs a settlement agreement in which it agrees to act within the gray lines of the Department's current interpretation of the Adequate Consideration Exemption. The Department then publicizes the settlement agreement—often referred to as a "process agreement" because it sets forth the process the trustee agrees to follow in the future—to notify other ESOP trustees and their advisors of the Department's latest interpretation. The Department has announced six different process agreements in the last eight years—in other words, a new agency interpretation roughly every eighteen months.

It is not difficult to understand why the Department would prefer this unchecked process to the Congressionally directed alternative: the notice-and-comment rulemaking process described by the APA.[5] The APA would require the Department to draft a proposed rule, issue a notice of proposed rulemaking in the Federal Register, receive written comments and/or testimony from interested stakeholders critiquing the Department's position, and incorporate stakeholder feedback or explain why it is not doing so. Acting unilaterally through lawsuits and process agreements allows the Department to assume an ever-evolving (and often contradictory) series of enforcement positions without publicly confronting—on the record and in detail—input from members of the affected community.

[2] 29 U.S.C. §§ 1001 *et seq*.

[3] *Id.* § 1108(e)(1).

[4] *Id.* § 1002(18) (emphasis added).

[5] 5 U.S.C. §§ 551 *et seq*.

The Department's process agreements are not guidance. Like all settlement agreements, their contents are dictated under the threat of, or after the institution of, formal legal action; they are not binding on courts; they are relevant only to the signatories thereto; and it is unclear whether each becomes moot the moment the Department announces the next one, or whether their overlapping and often conflicting terms are somehow supposed to be simultaneously authoritative. Opportunistic members of the plaintiffs' bar have taken advantage of the regulatory vacuum created by the Department's inaction, filing factually thin, cookie-cutter lawsuits in federal courts across the country challenging ESOP purchase and sale transactions and often pointing to particular process agreements, vague though they may be, as evidence of an employer's and trustee's culpability. With the increased litigation risk comes adverse consequences: costlier fiduciary insurance premiums for companies sponsoring ESOPs and their trustees or the ***complete inability*** to obtain coverage; higher trustee and advisor fees that burden ESOP sponsors; and concerns about financial and reputational harm that cause business owners to shy away from establishing new ESOPs—the exact opposite of Congress's intent when it created ESOPs and the Adequate Consideration Exemption.

Simply put, the Department's decision to circumvent the APA and Congress's directive has been devastating to interested stakeholders and—most importantly—to employee-participants who stand to benefit most from the continued formation and success of ESOPs. The Department must therefore change course and issue a regulation clearly defining the contours of the Adequate Consideration Exemption as Congress directed. The Department itself acknowledged in a draft regulation it proposed—but never finalized—in 1988 ("1988 Proposed Regulation") that doing so is crucial to eliminate confusion and protect ESOPs from potential abuse:

> Public utilization of [ERISA's] statutory exemptions requires a determination of "adequate consideration." . . . Guidance is especially important in this area because many of the transactions covered by these statutory exemptions involve plan dealings with the plan sponsor. A fiduciary's determination of the adequacy of consideration paid under such circumstances ***represents a major safeguard for plans against the potential for abuse***. . . . ***[T]he Department recognizes that plan fiduciaries have a need for guidance in valuing assets***, and that standards to guide fiduciaries in this area may be particularly elusive with respect to assets other than securities for which there is a generally recognized market. See, for example, *Donovan v. Cunningham*, 716 F.2d 1455 (5th Cir. 1983) (court encourages the Department to adopt regulations under section 3(18)(B)).[6]

For these reasons and those explained more fully below, The ESOP Association—whose members include ESOP company sponsors and professionals committed to expanding employee ownership—hereby petitions the Department to engage with interested parties in a notice-and-comment rulemaking process culminating in a final regulation interpreting the Adequate Consideration Exemption in the context of privately-held ESOP stock purchase and sale transactions.

[6] Proposed Regulation Relating to the Definition of Adequate Consideration, 53 Fed. Reg. 17,632, 17,633 (May 17, 1988).

II. Background.

A. Congress designed ESOPs to allow American workers to participate in the equity growth of American companies.

In the early 1970s, Congress foresaw that technological improvements would lead American businesses to grow ever more efficient and profitable. But it was concerned that the average American worker—largely a wage-earner whose only "stock in trade" was the labor likely to be made obsolete by new technology—would not profit directly from this growth.[7, 8] Congress knew that, to share in this prosperity, American workers would need an equity stake in American companies—but they would first need the capital with which to acquire it.[9]

Congress's solution was the ESOP. Congress first established the legal framework for creating and administering ESOPs when it enacted ERISA in 1974. In doing so, Congress sought not only to codify a new type of employee benefit but also to create tax incentives to encourage companies to create ESOPs to allow American workers to participate in the equity growth of their employers:

> The ESOP is designed to accomplish corporate financing through an employee benefit plan. . . . The ESOP's primary purpose, however, is not to serve as a retirement vehicle but, rather, to serve as an incentive for corporations to structure their financing in such a way that employees can gain an ownership stake in the company for which they work.[10]

More specifically, the type of "corporate financing" that Congress envisioned was the "'leveraged' ESOP,"

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[7] 129 Cong. Rec. S16629, S16633-34 (daily ed. Nov. 7, 1983) (Statement of Sen. Long) ("Thus, each round of new investment [in technology] further threatens [laborers'] power to earn a living. Instead of being part owners of the system, they find themselves pitted against it. If this new technology is to have a welcome context for its use, we must begin to strike a new balance between social and economic objectives.").

[8] Congress also saw ESOPs as a democratic, capitalistic counter to communism. 129 Cong. Rec. at S16635 ("The path that expanded ownership takes faces in exactly the opposite direction from that taken by those who favor ownership by the State. Expanding ownership financing seeks to steadily increase the number of capital owners instead of preventing anyone from owning capital by making the State the only owner. Employee ownership has far-reaching implications for those who share the democratic vision.").

[9] 129 Cong. Rec. at S16634 ("Concentrated wealth holdings contribute to the cumulative and self-reinforcing nature of the concentration of wealth and income. The concentration of stock ownership leads to a situation where those who currently own stock are those best able to save significant amounts and, thus, best able to make additional investments, thereby increasing their stock ownership.").

[10] 129 Cong. Rec. at S16637. *See also id.* at S16630 ("[T]he goal is to provide incentives for financing to be structured in such a way that, in the future, more Americans will have a chance to accumulate a capital estate.").

> an ESOP that uses borrowed funds to acquire employer stock, with the employer, or a related party, guaranteeing repayment of the loan. It is this guarantee, plus the underlying security provided for the loan, that puts the logic of corporate finance to work for a company's employees.[11]

In other words, in a leveraged ESOP (and the vast majority of ESOPs generally), employees do not invest their own money, but rather harness their employer's capital and future earnings to acquire their ownership interest. An employee's "investment is the time and effort he puts into his job to make his employer profitable" over time—a profit that accrues to the ESOP's employee-owners."[12]

Congress took several steps to encourage the proliferation of leveraged ESOPs.[13] *First*, it created tax incentives unique to ESOPs. For example, Congress allowed those who sell shares of a Subchapter C corporation to an ESOP to defer paying capital gains tax if they roll over their proceeds to other qualified investments, much like those who sell to another company for that entity's stock;[14] made employer contributions to ESOPs tax deductible, like other contributions to employee benefit plans;[15] made ESOPs exempt from unrelated business income tax, essentially allowing ESOPs to benefit from not paying federal income tax on their Subchapter S earnings;[16] and made C corporation dividends tax deductible when passed through to ESOP participants or used to repay the debt the ESOP incurred to buy shares.[17]

Second, Congress realized that ERISA's provision requiring fiduciaries to diversify trust assets and the statute's broad proscriptions against certain uses of plan assets would prevent the

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[11] 129 Cong. Rec. at S16637.

[12] Staff of S. Comm. on Fin., 95th Cong., *ESOPs: An Explanation for Employees* 1 (Comm. Print 1978), https://www.finance.senate.gov/imo/media/doc/sprt95-23.pdf.

[13] *See, e.g.*, *Fifth Third Bancorp v. Dudenhoeffer*, 573 U.S. 409, 416 (2014) (describing congressional interest in encouraging ESOPs); *Grindstaff v. Green*, 133 F.3d 416, 422 (6th Cir. 1998) ("Congress has repeatedly expressed its intent to encourage the formation of ESOPs by passing legislation granting such plans favorable treatment, and has warned against judicial and administrative action that would thwart that goal.") (quoting *Donovan v. Cunningham*, 716 F.2d 1455, 1466 (5th Cir. 1983)).

[14] 26 U.S.C. § 1042.

[15] *Id.* § 404(a)(9).

[16] *Id.* §§ 512(e)(3), 1361(c)(6).

[17] *Id.* § 404(k).

very existence of ESOPs.[18] Congress therefore carved ESOPs out of ERISA's requirement to diversify trust assets;[19] empowered ESOPs to borrow funds from various third parties;[20] and created the Adequate Consideration Exemption, an ESOP-specific exemption from ERISA's prohibited transaction rules.[21] Congress's efforts to encourage ESOPs have borne fruit: As of 2019, about 14 million American workers held about $1.6 trillion in assets through approximately 6,500 ESOPs.[22] Employers sponsoring ESOPs enjoy tangible benefits from having a workforce with skin in the game:

- Layoff rates at employee-owned companies in the U.S. are four to eight times less than layoff rates for conventionally owned companies.[23]

- Survival rates for ESOP companies are higher than the survival rates for their non-ESOP counterparts.[24]

- Both before and after the Great Recession, ESOP-owned companies outperformed other private employers.[25]

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[18] H.R. Rep. No. 93-1280, at 58 (1974) (Conf. Report), 1974 U.S.C.C.A.N. 5038, 5097 ("Any diversification principle that may develop in the application of the prudent man rule is not to restrict investments by [ESOPs] in qualifying employer securities.").

[19] 29 U.S.C. § 1104(a)(2).

[20] *Id.* § 1108(b)(3).

[21] *Id.* § 1108(e).

[22] Nat'l Ctr. for Emp. Ownership ("NCEO"), *Employee Ownership by the Numbers* (Dec. 2021), https://www.nceo.org/articles/employee-ownership-by-the-numbers.

[23] Fidan Ana Kurtulus & Douglas L. Kruse, *How Did Employee Ownership Firms Weather the Last Two Recessions? Employee Ownership, Employment Stability, and Firm Survival: 1999-2011* 12-14 (2017).

[24] Joseph Blasi, Douglas Kruse & Dan Weltmann, *Firm Survival and Performance in Privately Held ESOP Companies*, *in Sharing Ownership, Profits, and Decision-Making in the 2st Century (Advances in the Economic Analysis of Participatory & Labor-Managed Firms, Volume 14)* 109-24 (Dec. 2013), https://www.emerald.com/insight/content/doi/10.1108/S0885-3339(2013)0000014006/full/html ("The higher survival may . . . be tied to complementary policies adopted along with ESOPs to create a more committed and engaged workforce that contributes ideas to enhance survival and is more flexible when economic difficulties arise.").

[25] NCEO, *Largest Study Yet Shows ESOPs Improve Performance and Employee Benefits* (Nov. 6, 2017), https://www.nceo.org/articles/esops-improve-performance-employee-benefits#:~:text=In%20the%20largest%20and%20most,over%20what%20would%20have%20been; Alex Brill, *An Analysis of the Benefits S ESOPs Provide the U.S. Economy and Workforce*, Matrix Global Advisors (July 26, 2012), http://employeeownership.com.au/eoa/wp-content/uploads/2012/08/Brill_S_ESOP_Study_2012.pdf ("S ESOPs showed more employment growth in the prerecession period of the previous decade than private U.S. firms generally"; "[I] n 2007, when the recession hit, private U.S. employment took a dramatic downward turn while active participants among this subset of S ESOPs actually increased.").

- Recent research following the COVID-19 pandemic shows that ESOP-owned companies again outperformed other firms in key areas, including securing employees' jobs, maintaining work hours and salary, and providing workplace health and safety.[26]

At the same time, ESOPs directly benefit employees by creating and growing wealth through equity investments. In nearly all ESOPs, none of the cash used to purchase employer stock comes from the participants themselves but from the company sponsoring the plan. In contrast, most cash invested in a 401(k) plan comes from the employee.[27] And ESOP participants regularly profit handsomely from their investment. Specific examples abound,[28] and a recent study by Ernst & Young of the financial benefits to participants in S corporation ESOPs demonstrates that ESOP success stories are not aberrations, but the norm. The study found that

- the total cumulative return per participant on average for S-corporation ESOPs from 2002 through 2019 was over $300,000, which is a compound annual growth rate of 12.1% and approximately a third higher than returns from the S&P 500 over this same period;

- net assets grew from $12 billion in 2002 to $94 billion in 2019—a 678% increase—approximately 30% of which is attributable to employer contributions and the remainder from returns generated by ESOP account balances;

- ESOPs distributed 25% more on a per participant basis than 401(k) plans: from 2002 through 2019, S-corporation ESOP participants received an annual average distribution of $5,900, while 401(k) plans distributed an annual average to participants of $4,700;

- ESOP distributions to employee-owners totaled more than $77 billion from 2002 through 2019; and

[26] The Emp. Ownership Found., *Employee-Owned Firms in the COVID-19 Pandemic* (Oct. 2020), https://employeeownershipfoundation.org/sites/eof-master/files/2020-10/EOF_CovidResearch_Oct23b.pdf.

[27] Blasi et al., *supra* n.24.

[28] *E.g.*, NCEO, *What Does the Sale of New Belgium Brewing Mean for Employee Ownership?* (Nov. 21, 2019), https://www.nceo.org/employee-ownership-blog/article/what-does-sale-new-belgium-brewing-mean-employee-ownership (noting that 300 ESOP participants received at least $100,000 in company's 2019 sale); NCEO, *Employee Ownership & Economic Well-Being* (May 15, 2017), https://www.ownershipeconomy.org/wp-content/uploads/2017/05/employee_ownership_and_economic_wellbeing_2017.pdf (study finding that employee owners in the ages 28-34 demographic have higher levels of income, wealth and benefits relative to non-employee owners of the same age group).

- the financial benefits provided by ESOPs accrue largely to regular American workers: the manufacturing, construction, wholesale, and retail sectors combined to account for roughly 60% of net S corporation ESOP assets in 2019 and roughly 62% of distributions from 2002 through 2019.[29]

Unfortunately, the Department's regulatory approach is threatening to undo this American success story.

B. The Department's failure to finalize regulations regarding the Adequate Consideration Exemption.

An ESOP's purchase of stock from company officers, directors, or certain stockholders is technically a "prohibited transaction" under ERISA section 406(a), which broadly prohibits a fiduciary from "caus[ing] the plan to engage in" the "sale or exchange . . . of any property between the plan and a party in interest[,]" including the "acquisition, on behalf of the plan, of any employer security."[30]

Congress created the Adequate Consideration Exemption in recognition that section 406 would otherwise "significantly hamper the implementation of ESOPs, particularly by small companies[.]"[31] In the context of closely-held corporations, ERISA defines "adequate consideration" as "the fair market value of the asset as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan ***and in accordance with regulations promulgated by the Secretary [of Labor]***."[32] In charging the Department to issue regulations, "Congress intended for the Secretary [of Labor] to flesh out the standards for fiduciaries to follow in establishing [the adequate consideration] figure."[33]

The closest the Department has come in the last 50 years to following this clear Congressional rulemaking instruction is the 1988 Proposed Regulation.[34] With no other extant guidance, ESOP fiduciaries, trustees, service providers, and courts have often looked to the 1988 Proposed

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[29] EY, *Contribution of S ESOPs to Participants' Retirement Security and Employee-Owner Benefits* (Apr. 2022), https://esca.us/wp-content/uploads/2022/04/EY-ESCA-S-ESOP-Analysis-2022.04.2257.pdf.

[30] 29 U.S.C. § 1106(a). Under 29 U.S.C. § 1002(14)(C), (H), a "party in interest" is an "employee, officer, director . . . or a 10 percent or more shareholder directly or indirectly" of "an employer any of whose employees are covered by such plan[.]"

[31] *Henry v. Champlain Enters., Inc.*, 445 F.3d 610, 618 (2d Cir. 2006).

[32] 29 U.S.C. § 1002(18)(B) (emphasis added).

[33] *Donovan*, 716 F.2d at 1466. In *Donovan*, the Fifth Circuit rejected the Department's request to apply "a set of highly specific estate and gift tax regulations promulgated by the Internal Service" on the "valuation of closely-held stock," given that Congress intended for the Department to issue its own regulation interpreting adequate consideration, not to advance novel interpretations flouting basic principles of finance via litigation positions. *Id.*

[34] *See* 1988 Proposed Regulation, 53 Fed. Reg. 17,632.

Regulation as a guidepost to interpret the Adequate Consideration Exemption. However, courts and the Department have repeatedly observed that the regulations are not binding,[35] and judicial adoption has therefore been piecemeal, adding to the hopeless confusion surrounding the standard.[36] Frustrated courts have admonished the Department for failing to issue final regulations as Congress intended:

> [ERISA] itself makes clear that Congress intended for the Secretary to flesh out the standards for fiduciaries to follow in establishing [the Adequate Consideration Exemption]. . . . It should not be necessary to point out that the appropriate means of implementing that legislative intent is by way of an orderly regulatory proceeding, 29 U.S.C. § 1135 (1976), not by attempting to convince a court to short-circuit the process. . . .
>
> Judicial adoption of [the Department's preferred standard] is no substitute for the regulations the Secretary has never promulgated; we are unwilling to hold that ERISA fiduciaries who fail to follow it jot and tittle have breached their duties. . . . The standard they must follow remains one of prudence. If more specific rules are needed, the better—and fairer—approach is to inform fiduciaries of them beforehand by regulation.[37]

Yet today, ESOP trustees, fiduciaries, service providers, and the courts continue to operate without formal guidance from the Department.[38]

C. The Department's regulatory approach: regulation by litigation.

The Department's failure to regulate has long been legally indefensible but, until the past two decades, had been mostly innocuous. That changed beginning in 2005, when the Department

[35] *See, e.g.*, *Brundle v. Wilmington Tr., N.A.*, 919 F.3d 763, 780 (4th Cir. 2019) ("[B]ecause the DOL never enacted the proposed regulations, they are not binding."); *DeFazio v. Hollister, Inc.*, 854 F. Supp. 2d 770, 789 n.19 (E.D. Cal. 2012) (stating that the court would not rely on "the Department of Labor's proposed regulation that has not, for some reason or no reason at all, been adopted since its proposal over twenty years ago"), *aff'd*, 612 F. App'x 439 (9th Cir. 2015).

[36] The DOL could not, of course, seek to enforce the 1988 Proposed Regulation against ESOP trustees and fiduciaries given that the DOL did not follow notice-and-comment procedures. *See, e.g.*, *Mann Constr., Inc. v. United States*, 27 F.4th 1138 (6th Cir. 2022) (setting aside IRS guidance because the agency failed to follow the APA's notice-and-comment procedures).

[37] *Donovan*, 716 F.2d at 1466 & n.22, 1473.

[38] *See Perez v. Bruister*, 54 F. Supp. 3d 629, 652-59, 661 (S.D. Miss. 2014) (observing that "there are few bright-line rules [concerning the regulation of ESOPs] due to the DOL's longstanding failure to fulfill the statutory directive to promulgate regulations"), *aff'd as modified*, 832 F.3d 250 (5th Cir. 2016).

announced an "ESOP National Enforcement Project" designed to "identif[y] and correct[] violations of ERISA in connection with ESOPs."[39] Between 2007 and 2017, the Department conducted ***over 2,000 investigations*** related to ESOPs—roughly ***one-quarter of all ESOPs*** in existence during that time period.[40, 41]

Under its national enforcement initiative, the Department has opted not to regulate ***prospectively*** as Congress intended, but ***retroactively*** via mercurial litigation positions that morph the Department's official interpretation of the Adequate Consideration Exemption with each new dispute. Under this approach, the Department opens an investigation of a trustee that specializes in representing ESOPs in stock purchase and sale transactions; issues findings, typically based on the Department's idiosyncratic view of very technical valuation issues (and oftentimes critical of a trustee's policies and procedures that are nowhere prescribed in ERISA), stating that the trustee violated the Adequate Consideration Exemption in several ESOP transactions; and either sues or threatens to sue unless the trustee agrees to (i) enter into a process agreement, largely on the Department's terms, governing how the trustee will perform future engagements, and (ii) pay millions of dollars to buy peace via settlement. Since 2014, at least six trustees have entered into such process agreements with the Department.[42]

Like all settlement agreements, each of the Department's process agreements are binding only on the party that has agreed to it, not the industry as a whole. Yet the Department has repeatedly emphasized its view that these agreements, with their ever-changing terms, have broader application as the Department's interpretation of the Adequate Consideration Exemption.[43] Take, for example, comments from the Deputy Assistant Secretary for Program Operations of the Employee Benefits Security Administration ("EBSA"), the arm of the Department responsible for enforcing

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[39] https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/enforcement#esop (last visited Aug. 2, 2022).

[40] *See* Nathan Nicholson, *New NCEO Publication Analyzes DOL ESOP Investigations*, NCEO, Employee Ownership Blog (Oct. 14, 2019), https://www.nceo.org/employee-ownership-blog/article/new-nceo-publication-analyzes-dol-esop-investigations (reporting that between 2007 and 2017, the Department closed 2,069 civil ESOP investigations, and estimating that nearly a quarter of all ESOPs were the subject of a Department investigation during this period).

[41] It goes without saying that the lion's share of the Department's investigatory costs and efforts could have been avoided had the Department enacted clear, formal regulations. Likewise, a clear rule would have allowed ESOP-owned companies to avoid the massive resource drain associated with responding to Department investigations—resources that those companies could have reinvested to improve or expand operations, boost the value of their stock, and grow wealth for their employee-owners.

[42] Consent Order and Judgment, *Scalia v. The Farmers Nat'l Bank of Danville*, No. 1:20-cv-674 (S.D. Ind. Apr. 3, 2020), ECF No. 5; Consent Order and Judgment*, Acosta v. First Bankers Tr. Servs., Inc.*, No. 1:12-cv-8648 (S.D.N.Y. Sept. 21, 2017), ECF No. 317; Consent Order, *Acosta v. BAT Masonry Co.*, No. 6:15-cv-28 (W.D. Va. Oct. 11, 2017), ECF No. 187; Consent Order*, Acosta v. Mueller*, No. 2:13-cv-1302 (E.D. Wis. Dec. 22, 2017), ECF No. 229; Settlement Agreement, *Acosta v. Cactus Feeders, Inc.*, No. 2:16-cv-49-J (N.D. Tex. May 4, 2018), ECF No. 92-1; Consent Order and Judgment*, Perez v. GreatBanc Tr. Co.*, No. 5:12-cv-1648 (C.D. Cal June 2, 2014), ECF No. 167.

[43] *E.g.*, U.S. Dep't of Labor, EBSA News Release, *US Labor Department Reaches $5.25M Settlement with GreatBanc Trust* (June 30, 2014), https://www.dol.gov/newsroom/releases/ebsa/ebsa20141043, (statement by then-Assistant Secretary of Labor for Employee Benefits that "[o]thers in the industry would do well to take notice of the protections put in place by this [2014 process] agreement"); *see also* U.S. Dep't of Labor, EBSA, *National Enforcement Projects* tab, https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/enforcement (publicizing process agreements) (last visited Aug. 2, 2022).

ERISA, repeatedly pointing ESOP fiduciaries to the Department's most recent process agreement for guidance regarding the Department's interpretation of "adequate consideration":

> Q: What could ESOP practitioners . . . do to help improve these issues that you are seeing?
>
> A: We recently entered into a settlement agreement in the Sierra Aluminum case. . . . I think the transactions would be much better if people really took the provisions in this agreement to heart and followed them. . . . [T]here is a lot in the agreement that is broadly applicable to everybody. . . .
>
> Q: In general, what due diligence should be performed in regards to the reasonableness of management projections used in the valuations?
>
> A: I would point to the portions of the Sierra Aluminum settlement agreement that cover the topics of projections. . . . [W]e took some care in spelling out how plan fiduciaries should look at projections. Basically, we think you should consider the source of the projections. . . .
>
> Q: It is my understanding that . . . ERISA contemplates that the DOL would promulgate regulations to guide valuations of closely held stock of ESOP sponsor companies. Given that there are no such regulations (at least not finalized), what guidance would you encourage or suggest that plan fiduciaries consider . . . ?
>
> A: The Sierra Aluminum settlement agreement lays out a lot of factors or guidance. . . .
>
> Q: Can you discuss in general what you consider to be an independent appraiser?
>
> A: The Sierra Aluminum settlement agreement goes into this in some detail. . . .
>
> Q: [W]hat should be done to assess the work of an appraiser?
>
> A: The Sierra Aluminum settlement agreement discusses this. . . .[44]

[44] Frank Brown, *Q&A with Tim Hauser of the U.S. Department of Labor*, Willamette Mgmt. Assocs., INSIGHTS 77-78 (Spring 2015), http://www.willamette.com/insights_journal/15/spring_2015_8.pdf.

The Department's aim is thus plain: to use a series of ever-evolving (though often contradictory) process agreements to circumvent the Congressionally-mandated notice-and-comment rulemaking process.[45]

D. Problems with the Department's regulatory approach.

The APA's requirement that agencies engage in notice-and-comment rulemaking with interested members of the public is one of the most important checks on the regulatory power of federal agencies. By failing to promulgate regulations on the Adequate Consideration Exemption—despite Congress's direction to do so—the Department has thwarted public participation in the regulatory process, thereby liberating the Department from the checks and balances that public input provides. The Department's tactics have had a profoundly negative impact on interested stakeholders—American workers chief among them. Each of these problems would be remedied by engaging with interested parties in a notice-and-comment rulemaking process.

1. Undermining public trust.

Congress passed the APA to ensure that agencies are subject to constraints as they exercise their regulatory powers. "[F]ramed against a background of rapid expansion of the administrative process," the APA serves as "a check upon administrators whose zeal might otherwise . . . carr[y] them to excesses not contemplated in legislation creating their offices."[46] The APA describes the procedure agencies must typically follow when making rules. The procedure begins with an agency publishing a "[g]eneral notice of proposed rulemaking," typically in the Federal Register.[47] After publishing a proposed rule, the agency must "give interested persons an opportunity" to comment—that is, "to participate in the rule making through submission of written data, views, or arguments."[48]

A "central purpose of notice-and-comment rulemaking is to subject agency decisionmaking to public input and to obligate the agency to consider and respond to the material comments and concerns that are voiced."[49] Doing so "assure[s] fairness and ***mature consideration*** of rules

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[45] The Department appears to be developing a regular practice of supplanting the APA's procedural requirements with unilateral, unofficial "guidance." For example, the Department most recently issued Compliance Assistance Release No. 2022-01 outlining fiduciary standards governing whether to include cryptocurrency investment options in 401(k) plans. At least one lawsuit has been filed seeking to vacate and set aside the "guidance" on the grounds that it is an "arbitrary and capricious attempt to restrict the use of cryptocurrency in defined contribution retirement plans, in excess of [the Department's] authority [ERISA], and without following the notice and comment process required under the APA." *ForUsAll, Inc. v. U.S. Dep't of Labor*, No. 1:22-cv-01551 (D.D.C. June 2, 2022), ECF No. 1 at 1-2.

[46] *United States v. Morton Salt Co.*, 338 U.S. 632, 644 (1950).

[47] 5 U.S.C. § 553(b).

[48] *Id.* § 553(c).

[49] *Make The Rd. N.Y. v. Wolf*, 962 F.3d 612, 634 (D.C. Cir. 2020) (citing *Perez v. Mortg. Bankers Ass'n*, 575 U.S. 92, 96, (2015) ("An agency must consider and respond to significant comments received during the period for public

having a substantial impact on those regulated" by ensuring that the agency "***educate[s] itself*** before adopting a final order . . . [and] disclose[s] its thinking on matters that will affect regulated parties."[50] "Equally important, by mandating 'openness, explanation, and participatory democracy' in the rulemaking process, these procedures assure the legitimacy of administrative norms."[51]

The Department's policy of "regulation by litigation" has enabled it to evade the requirements of the APA's notice-and-comment process, depriving the public of its APA-given right to participate meaningfully in agency rulemaking. This has eroded the public's trust in the Department in at least two critical ways.

First, by shunning public input, the Department has failed to fully "educate itself" on the merits of its interpretation of the Adequate Consideration Exemption, yielding regulatory positions based not on the "mature consideration" that would result from fulsome discourse with interested parties, but on echo chamber deliberations backed by uncredentialed, self-styled experts who espouse aberrant positions. The subpar policies born of this cloistered decision-making risk causing the Department to lose credibility with interested members of the public, who may come to doubt the Department's purported expertise and ability to regulate effectively, and who may come to believe that the Department has intentionally avoided public input precisely because it does not want to work with interested parties.

Second, the Department's secluded approach creates the impression among members of the public that it harbors a confidential interpretation of the Adequate Consideration Exemption that it could reveal at any time. Indeed, the Department's representatives have said as much. For example, EBSA's Deputy Assistant Secretary for Program Operations has admitted that he "keep[s] a running list" of what he views as "issues with ESOP appraisals"—none of which are publicly known.[52] This creates an *ex post facto* problem for well-intentioned ESOP fiduciaries: they become worried that actions that are permitted today will be verboten tomorrow when the next process agreement is suddenly announced. Consequently, ESOP fiduciaries increasingly distrust the Department, viewing it not as a guide to help avoid pitfalls, but as a threat to ensnare them.

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comment.")); *Lilliputian Sys., Inc. v. Pipeline & Hazardous Materials Safety Admin.*, 741 F.3d 1309, 1312 (D.C. Cir. 2014) ("An agency's failure to respond to relevant and significant public comments generally 'demonstrates that the agency's decision was not "based on a consideration of the relevant factors."'") (quoting *Thompson v. Clark*, 741 F.2d 401, 409 (D.C. Cir. 1984)).

[50] *United States v. Johnson*, 632 F.3d 912, 931 (5th Cir. 2011) (emphasis added).

[51] *Air Transp. Ass'n of Am. v. Dep't of Transp.*, 900 F.2d 369, 375 (D.C. Cir. 1990), *vacated on other grounds*, 932 F.2d 1043 (D.C. Cir. 1991).

[52] Brown, *supra* n.44, at 77-78.

Not surprisingly, this fear of entrapment has created a chilling effect on the development of new ESOPs. Many of our members have had conversations with companies that want to establish an ESOP but are driven away by the specter of a future Department of Labor investigation and public lawsuit unfairly vilifying the company and its shareholders, directors, and officers. In fact, this chilling effect was born out by the 2021 Private Capital Markets Report done by Pepperdine University Graziadio Business School, which showed that "[f]ear of [the] Department of Labor as primary regulator/downstream financial [and] reputational exposure" was directly cited as the reason for not establishing an ESOP by 11% of respondents of all revenue sizes and up to 13% of respondents with revenues between $5-100 million.[53] This is precisely the result that Congress sought to avoid when it created ESOPs: a regulatory approach that would discourage their proliferation.[54]

At bottom, by obfuscating the agency's decision-making process and evading stakeholder input, the Department risks tarnishing its legitimacy in the eyes of the American public.

2. Confusion in the courts.

The Department's failure to issue clear, detailed, static rules interpreting the Adequate Consideration Exemption has led courts to articulate a confusing and, at times, contradictory standard. Issuing a formal rule following a notice-and-comment period would eliminate this confusion and the unwarranted litigation risk attendant to it.

One way in which this confusion has manifested is the collapsing of separate legal standards into one. For example, some courts have held that the "fair market value" and "in good faith" prongs "are closely intertwined" and "overlap[] considerably," such that both are "expressly focused upon the *conduct* of the fiduciaries."[55] In the same vein, some courts have merged the "adequate consideration" standard with ERISA's fiduciary duties of prudence and loyalty, holding that:

> ERISA's requirement that ESOP fiduciaries purchase employer stock for "adequate consideration" must be interpreted so as to give effect to the Section 404 duties to

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[53] Everett, Craig R., *2021 Private Capital Markets Report*, Pepperdine Graziadio Business School 119 fig. 176, (Aug. 18, 2021), https://digitalcommons.pepperdine.edu/cgi/viewcontent.cgi?article=1013&context=gsbm_pcm_pcmr.

[54] Tax Reform Act of 1976, Pub. L. No. 94-455, § 803(h), 90 Stat. 1520 (1976) ("The Congress is deeply concerned that the objectives sought by this series of laws will be made unattainable by regulations and rulings which treat employee stock ownership plans as conventional retirement plans, which reduce the freedom of the employee trusts and employers to take the necessary steps to implement the plans, and which otherwise block the establishment and success of these plans.") (emphasis added); *see Fifth Third Bancorp*, 573 U.S. at 416 (describing Congressional interest in encouraging the use of ESOPs and quoting the Tax Reform Act of 1976); *Grindstaff*, 133 F.3d at 422 ("Congress has repeatedly expressed its intent to encourage the formation of ESOPs by passing legislation granting such plans favorable treatment, and has warned against judicial and administrative action that would thwart that goal.") (quoting *Donovan*, 716 F.2d at 1466).

[55] *Henry*, 445 F.3d at 619 (citing *Donovan,* 716 F.2d at 1467 (emphasis in original)).

> which those persons remain subject. . . . The statutory reference to good faith in Section 3(18) must be read in light of the overriding duties of Section 404. Doing so, we hold that the ESOP fiduciaries will carry their burden to prove that adequate consideration was paid by showing that they arrived at their determination of fair market value by way of a prudent investigation in the circumstances then prevailing.[56]

These courts tend to focus on the trustee's fiduciary process when conducting due diligence and negotiating a challenged transaction's terms, and not on technical valuation issues that are the purview of appraisal experts.[57] For example, these courts hold that "ERISA fiduciaries need not become experts in the valuation of closely-held stock—they are entitled to rely on the expertise of others" so long as they ensure that the "information upon which the experts' opinions are based . . . is complete and up-to-date."[58]

Other courts have deemphasized conduct and process; restricted a trustee's ability to rely on its expert advisors; and, at the Department's and the class action plaintiffs' bar's behest, held ESOP trustees liable for extremely technical valuation issues that are the province of appraisal experts.[59]

These differing interpretations of the Adequate Consideration Exemption breed confusion. To what extent are ESOP trustees permitted to rely on the opinions of their retained expert consultants? Can a process that meets ERISA's fiduciary duties of prudence and loyalty fall short of the Adequate Consideration Exemption, or are they one and the same? In a lawsuit challenging an ESOP's purchase of employer stock under both ERISA sections 404 and 406, do plaintiffs or defendants have the burden of proof?

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[56] *Donovan*, 716 F.2d at 1467-68 (footnote omitted).

[57] *E.g.*, *Henry*, 445 F.3d at 619 ("As this definition indicates, 'fair market value' is an imprecise term."); *see Rhodes v. Amoco Oil Co.*, 143 F.3d 1369, 1372 (10th Cir. 1998) ("There is no universally infallible index of fair market value. There may be a range of prices with reasonable claims to being fair market value.") (cleaned up); *Alvary v. United States,* 302 F.2d 790, 795 (2d Cir. 1962) (noting the "inherent inexactness of the concept of fair market value"); *Donovan*, 716 F.2d at 1467-68 ("A court reviewing the adequacy of consideration under Section 3(18) is to ask if the price paid is 'the fair market value of the asset *as determined in good faith by the . . . fiduciary;*' it is not to redetermine the appropriate amount for itself *de novo.*").

[58] *Donovan*, 716 F.2d at 1474; *accord Howard v. Shay*, 100 F.3d 1484, 1489 (9th Cir. 1996).

[59] *E.g.*, *Brundle v. Wilmington Tr., N.A.*, 241 F. Supp. 3d 610, 639-40 (E.D. Va. 2017) (holding that trustee breached its fiduciary obligation to plan participants because its appraiser's report rounded numbers), *aff'd*, 919 F.3d 763 (4th Cir. 2019); *Pizzella v. Vinoskey*, 409 F. Supp. 3d 473, 496-502 (W.D. Va. 2019) (holding that trustee is liable for not questioning its appraiser's decision to use a three- rather than five-year lookback period to compute historical cash flows, for using a working capital assumption of 10% of total assets, and for using inconsistent capitalization rates), *aff'd in part & rev'd in part*, 19 F.4th 672 (4th Cir. 2021).

The Department's inaction has allowed fundamental inconsistencies and open questions like these to fester. Opportunistic members of the class action plaintiffs' bar have emerged from the chaos to launch their own wave of frivolous civil litigation against ESOP sponsors, ESOP trustees, and shareholders who have sold to ESOPs, often citing the Department's process agreements in support.[60] And the Department has only encouraged them by, among other things, filing amicus briefs at the appellate level and filing subsequent lawsuits against trustees already facing private lawsuits.[61]

3. Contradictory "guidance."

Much of the Department's process agreement "guidance" conflicts with ERISA, widely-accepted valuation standards, and even the Department's own prior positions. Had the Department engaged with interested stakeholders, it is likely these conflicts would have been brought to the Department's attention and avoided. To take just one example, the most recent process agreement—an agreement between the Department and Farmers National Bank of Danville ("FNB Process Agreement")[62]—is brimming with problematic provisions, two of which we highlight below.

<u>Control</u>. The FNB Process Agreement obligates FNB, when acting as trustee in an ESOP transaction, to approve a transaction in which the ESOP pays for control only if FNB ensures the ESOP acquires a host of specific rights that, in the DOL's view, reflect "control" over the company.[63] The FNB Process Agreement states that control is evidenced by "all of the unencumbered rights that a shareholder would have that acquired the shares to be purchased by the ESOP, ***and the right to control the company's direction***."[64]

As an initial matter, the emphasized language is inconsistent with general principles of corporate governance, as shareholders do not typically have the right to "control a company's direction" (*i.e.*, assume operational control of a company). Typical shareholder rights include the right to elect the board of directors and to vote on certain corporate actions. However, the FNB Process Agreement lists over a dozen specific aspects of control, several of which go far beyond rights typically exercised by a shareholder.

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[60] *See, e.g.*, Compl., *Burnett v. Prudent Fiduciary Servs. LLC*, No. 1:22-cv-00270 (D. Del. Feb. 28, 2022), ECF No. 1 ¶ 110 & n.14 (summarizing process agreement provisions concerning treatment of corporate debt).

[61] *See, e.g.*, Brief for the Sec'y of Labor as Amicus Curiae, *Brundle v. Wilmington Tr., N.A.*, No. 17-1873 (4th Cir. July 23, 2018), ECF No. 51-1 (amicus brief submitted in favor of upholding judgment against trustee); Brief for the Sec'y of Labor as Amicus Curiae, *Vigeant v. Meek*, No. 18-3616 (8th Cir. Feb. 26, 2019) (amicus brief submitted in favor of reversal of judgment against plaintiff); Compl., *Acosta v. Reliance Tr. Co.*, No. 1:19-cv-2725 (N.D. Ill. Apr. 22, 2019), ECF. No. 1 (DOL complaint against trustee facing separate suit brought by class of ESOP participants).

[62] Consent Order and Judgment, *Scalia v. The Farmers Nat'l Bank of Danville*, No. 1:20-cv-674 (S.D. Ind. Apr. 3, 2020), ECF No. 5.

[63] *Id.*, Exhibit B, at 14.

[64] *Id.* (emphasis added).

Equally important, the FNB Process Agreement's control provision is inconsistent with longstanding principles of ERISA fiduciary governance. The Department's position is that a shareholder must sell to an ESOP at a discounted price where the ESOP acquires a controlling position but not the post-transaction discretion to vote the acquired shares, which instead rests with a committee of company-appointed individuals. In other words, the Department believes that an ESOP does not acquire a controlling interest unless ***the ESOP's trustee*** obtains and exercises voting discretion. Presumably, the Department believes that company appointees have a conflict of interest preventing them from voting shares in the ESOP's best interest.

The problem with the Department's position is that it assumes a false equivalency between ***the ESOP's*** control and the ESOP ***trustee's*** control. To state the obvious, ESOPs do not vote; individuals acting on behalf of ESOPs do. Whoever possesses that voting discretion must exercise it subject to ERISA's fiduciary duties of prudence and loyalty,[65] meaning they must make voting decisions with "an eye single" to the ESOP's best interests.[66] This fact—that the person voting the ESOP's shares must do so in the ESOP's interest or risk facing liability[67]—is what it means for the ESOP to have voting control, not whether one person or another is voting on the ESOP's behalf.

Indeed, a bedrock principle of ERISA—one of its most important and significant departures from the common law of trusts—is that a fiduciary is permitted to wear "two hats" so long as the fiduciary wears only one at a time.[68] The Department's position that company directors and officers are incapable of exercising voting discretion in an ESOP's best interests flies in the face of this longstanding, black letter ERISA law.

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[65] *See, e.g.*, *Spires v. Schools*, 271 F. Supp. 3d 795, 804 (D.S.C. 2017) ("[T]he voting of shares held by an ESOP is the use or management of a Plan asset.") (citing *Neil v. Zell*, 677 F. Supp. 2d 1010, 1028-29 (N.D. Ill. 2009)).

[66] *Donovan v. Bierwirth*, 680 F.2d 263, 271 (2d Cir. 1982).

[67] The risk of liability is not academic—fiduciaries "wearing two hats" have faced lawsuits premised on exactly this theory. *See, e.g.*, *Spires*, 271 F. Supp. 3d 795 (recognizing as a viable cause of action claim that defendant ESOP trustees breached their fiduciary duties to the plan by failing to replace themselves as company's board).

[68] *Pegram v. Herdrich*, 530 U.S. 211, 225 (2000); 29 U.S.C. § 1108(c) (stating that ERISA's prohibited transaction rules shall not "be construed to prohibit any fiduciary from . . . serving as a fiduciary in addition to being an officer, employee, agent, or other representative of a party in interest"). The Seventh Circuit recently explained the centrality of "dual-hat" fiduciaries to ERISA:

> By "expressly contemplat[ing] fiduciaries with dual loyalties," § 408(c)(3) takes "an unorthodox departure from the common law" that is in obvious tension with ERISA's exclusive benefit rule. *Donovan v. Bierwirth*, 538 F. Supp. 463, 468 (E.D.N.Y. 1981), *aff'd as modified*, 680 F.2d 263 (2d Cir. 1982). As noted, scholars have defended this "fundamental contradiction" as necessary to encourage employers to establish benefit plans. Without dual-hat fiduciaries, employers that establish ERISA plans would be "assuming financial liabilities without effective controls." Langbein & Fischel, 55 U. Chi. L. Rev. at 1127. The effect of adhering strictly to the common-law rule would likely be a lower rate of plan formation. *Id.*

Halperin v. Richards, 7 F.4th 534, 547 (7th Cir. 2021).

Indemnification. It is common in ESOP acquisition transactions for the company sponsoring the ESOP to indemnify the ESOP's trustee against any losses the trustee incurred that were not the result of its breach of fiduciary duty. Indemnification agreements typically include the advancement of defense costs. These commonplace arrangements allow ESOP trustees and their advisors to offer much lower fees—a savings passed on to the ESOP and its participants. Without such arrangements, most would not agree to provide services at all.

The legality of these arrangements rests on over 40 years of Department guidance interpreting ERISA. Section 410 of ERISA explicitly permits fiduciaries to obtain insurance.[69] In 1975, the Department issued an Interpretive Bulletin Relating to Indemnification of Fiduciaries, stating that section 410 permits indemnification of fiduciaries so long as the plan sponsor—not the plan itself—acts as indemnitor.[70] Following the Department's guidance, courts over the years have generally upheld indemnification agreements, so long as the agreement did not relieve a fiduciary of its ultimate liability for a breach.[71]

Despite this longstanding guidance, the FNB Process Agreement bars FNB from seeking indemnification from an ESOP sponsor, regardless of the ESOP's percentage ownership interest.[72] This position is in direct conflict with over 40 years of guidance. What's more, the FNB Process Agreement prohibits FNB from receiving advanced defense fees unless an independent third party determines that there has been no breach of fiduciary duty. This process creates a cumbersome, expensive, and impractical standard. Requiring a third party to determine whether a fiduciary breach occurred would necessitate a "mini-trial" on the issue of ultimate liability, a costly exercise (and one of potentially dubious value given that a court could overturn such a determination).[73]

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[69] 29 U.S.C. § 1110(b) (clarifying that ERISA does not preclude, *inter alia*, "an employer or an employee organization from purchasing insurance to cover potential liability of one or more persons who serve in a fiduciary capacity with regard to an employee benefit plan.").

[70] DOL Interpretive Bulletin 75-4, 29 C.F.R. § 2509.75-4.

[71] *See, e.g.*, *Packer Eng'g, Inc. v. Kratville*, 965 F.2d 174, 175 (7th Cir. 1992) (upholding award of defense costs to plan fiduciary who was found not to have breached his duty because fiduciaries "should be praised, not told to write a check for [legal expenses], when they carry out their responsibilities properly"); *Pfahler v. Nat'l Latex Prods. Co.*, 517 F.3d 816, 837 (6th Cir. 2007) ("Given that ERISA explicitly permits parties to insure against possible liability, it would be illogical to interpret the statute as prohibiting indemnification agreements, which accomplish the same thing.").

[72] Consent Order and Judgment, *Scalia v. The Farmers Nat'l Bank of Danville*, No. 1:20-cv-674 (S.D. Ind. Apr. 3, 2020), ECF No. 5, Section N, p. 28 of 29.

[73] The Department has objected to indemnification of trustees and advisors in other circumstances, too, such as its recent proposed amendments to its regulations governing the procedures for the filing of prohibited transaction exemption applications. *See* Procedures Governing the Filing and Processing of Prohibited Transaction Exemption Applications, 87 Fed. Reg. 14,722 (Mar. 15, 2022) (proposing standards for a plan's contract with an independent fiduciary or appraiser and providing that such contracts could not include indemnification for breach of contract or violations of applicable law). The Department seems to believe that because they are indemnified, trustees and advisors act differently than they would were they not indemnified. This flawed argument ignores that trustees are not indemnified

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As discussed above, the Deputy Assistant Secretary for Program Operations at EBSA previously put the ESOP industry on notice that the Department's position on the definition of "adequate consideration" was contained in its 2014 process agreement in the Sierra Aluminum matter.[74] He specifically claimed that ESOPs would be best served if fiduciaries "really took the provisions in [the Sierra Aluminum] agreement to heart and followed them."[75] That agreement and the next four contained little commentary regarding control and did not address indemnification, though both issues are relevant to virtually every ESOP transaction. The FNB Process Agreement is the first to contain detailed control and indemnification provisions.

This is where confusion sets in.[76] ESOP trustees and their advisors are left to wonder whether the Department's "official" positions are outlined in the Sierra Aluminum agreement (the terms of which they were told to "[take] . . . to heart and follow[]"), FNB Process Agreement, or the four in-between. Does each new process agreement moot the preceding agreements? Which agreement governs when their terms are discordant? Without a regulation promulgated after the notice-and-comment rulemaking process, ESOP fiduciaries and service providers are left without answers.

E. Consequences of increased litigation risk.

The state of affairs created by the Department's regulatory approach—uncertain, contradictory, and non-binding guidance regarding the Adequate Consideration Exemption, the threat that indemnification arrangements are *void ab initio*, and a hyperactive class action plaintiffs' bar—has caused insurance rates to rise drastically and, in many instances, have made it nearly impossible for professional trustees to purchase fiduciary insurance, no matter the premium amount or policy terms. Increased, uninsurable litigation risk totaling in the hundreds of millions of dollars can only result in higher costs to ESOP plan sponsors; either professional ESOP trustees

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for breaches of fiduciary duty. Thus, eliminating fiduciary indemnification does not change trustee actions but instead only considerably increases defense costs and litigation risk. Long-standing principles of corporate law allow indemnification of corporate directors and their advisors under the understanding that individuals would not accept such responsibilities without the protection provided by indemnification. Why does the Department feel otherwise when it involves fiduciaries and advisors?

[74] *See supra* Part II.C.

[75] *See supra id.*, n.44.

[76] And it is just one example of how contradictory terms in the Department's process agreements sow confusion. Other examples include: (i) some agreements require a trustee to document why their valuation advisor did not conduct a discounted cash flow analysis, but some do not; (ii) some agreements require the trustee to explain and document material differences between the company valuation in question and the most recent prior valuation, but some do not; (iii) some agreements require the trustee to obtain and retain signed certifications from key employees that they fully reviewed the valuation report in question, but some do not. The list goes on. *See* Holland & Knight, *Summary Chart* https://www.hklaw.com/-/media/files/insights/publications/2020/03/esopcomparisonchart.pdf?la=en (last visited Aug. 2, 2022) (summarizing differences across process agreements).

will significantly raise their fees to account for the greater risk they must now shoulder—a direct cost to plan sponsors—or exit the business in droves, reducing the number of competitors offering trustee services and increasing the cost of engaging those few that remain.

The possibility that professional trustees will exit the business because of increased risk is not conjectural—it has been happening since the Department announced its national enforcement initiative in the mid-2000s and began using investigations and lawsuits that take advantage of the regulatory uncertainty the Department created. We are aware of ***at least 20*** prominent professional trustees that have shuttered or sold their ESOP trustee businesses in that time.

The only alternative to appointing a professional trustee to represent an ESOP in a transaction is to appoint a corporate insider—a member of the plan sponsor's management or board of directors. While ERISA expressly permits such "dual hat" fiduciaries,[77] hiring an independent, professional trustee that specializes in ESOP stock purchase and sale transactions is considered to be a best practice for obvious reasons. For one, a corporate insider deals with only its own company's transactions, but a professional trustee is an expert and can compare transactions against one another to better understand market terms and best practices. But no professional trustee will be left standing if the Department continues its current regulatory course of action, and informed corporate insiders will be reluctant to serve in any ESOP capacity in the absence of guidance from the Department.

III. The Rulemaking Petition.

The Department's failure to regulate as Congress intended has thus added risks and costs to the process of establishing ESOPs, all of which discourage their creation and frustrates Congress's goal of expanding employee ownership among American workers.

What is needed is regulatory clarity—in short, for the Department to do as Congress instructed nearly 50 years ago and engage with interested stakeholders in a formal notice-and-comment rulemaking process culminating with a final regulation interpreting the Adequate Consideration Exemption. The purpose of this rulemaking petition is to request formally, via the Administrative Procedure Act, that the Department do so—a request that, to our knowledge, no one has made previously.[78]

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[77] *See supra* n.68.

[78] However, this is not the first time interested stakeholders have attempted to engage with the Department about the problems caused by its unique regulatory approach. For example, in October 2018, 27 prominent members of Congress submitted a letter to the President of the United States, with a copy to the DOL Secretary, addressing ESOP enforcement issues. *Congress of the United States letter to President Donald Trump* (Oct. 1, 2018), https://www.erisalitigation.com/wp-content/uploads/sites/846/2019/07/Congress-Letter-to-Minimize-Unfair-ESOP-Enforcement.pdf. The letter stated in part that the "Department [of Labor] has released very little guidance on substantive issues including, for example, valuation. . . . [W]e believe the Department [of Labor] could immediately eliminate some of the regulatory uncertainty by collaborating with the ESOP community to develop clear guidance with respect to valuation and

A. Standard for rulemaking petitions.

The APA mandates that each agency "give an interested person the right to petition for the issuance, amendment, or repeal of a rule,"[79] and requires an agency that denies such a petition to give "[p]rompt notice . . . of the denial . . . accompanied by a brief statement of the grounds for denial."[80] "The agency's statement must be one of 'reasoning'; it must not be just a 'conclusion'; it must 'articulate a satisfactory explanation' for its action."[81] In addition, an agency's "reasons for action or inaction must conform to the authorizing statute."[82] An agency must resolve a petition "within a reasonable time,"[83] which is "typically counted in weeks or months, not years,"[84] Any denial of a petition is subject to judicial review.[85]

B. An inexhaustive list of topics the Department could address in regulations interpreting the Adequate Consideration Exemption.

Below are some preliminary thoughts on key issues related to each element that a proposed regulation should address. The following list is not meant to be exhaustive. The ESOP Association and its members would welcome the opportunity to address these and other issues during the notice-and-comment rulemaking process.

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other important issues." *Id.* Most recently, in June 2022, the Senate passed bipartisan legislation that would require the Department to provide formal guidance on the Adequate Consideration Exemption. *Retirement Improvement and Savings Enhancement to Supplement Healthy Investments for the Nest Egg (RISE and SHINE Act)*, S. 4353, 117th Cong. § 702 (2022). Specifically, the bill would reiterate that ERISA requires the Department to develop "acceptable standards and procedures to establish good faith fair market value for shares of a business to be acquired by an employee stock ownership plan." *Id.*

[79] 5 U.S.C. § 553(e). The term "interested person" is not defined in the APA. However, the term "person" is defined broadly in the APA to include any "individual, partnership, corporation, association, or public or private organization other than an agency[.]" 5 U.S.C. § 551(2). The Congressional Research Service guide on rulemaking petitions suggests that the requirement of "interest" is a low bar. *See* CRS, *Petitions for Rulemaking: An Overview* 4 (Jan. 23, 2020) https://sgp.fas.org/crs/misc/R46190.pdf (explaining that the term "interested person" enables anyone to file a petition "whose interest are or will be affected by the issuance, amendment or repeal of a rule.") (citing Attorney General's Manual on the Administrative Procedure Act). Courts have held that a party may be an "interested person" under the APA without Article III standing. *See, e.g.*, *Animal Legal Def. Fund, Inc. v. Vilsack*, 237 F. Supp. 3d 15, 21-22 (D.D.C. 2017) (explaining that a "lower threshold for participation" under the APA "comports with the important role played by citizens groups in ensuring compliance with the statutory mandate that agency proceedings serve the public interest.") (alteration omitted) (internal quotation marks omitted).

[80] 5 U.S.C. § 555(e).

[81] *Butte Cnty. v. Hogen*, 613 F.3d 190, 194 (D.C. Cir. 2010).

[82] *Massachusetts v. EPA*, 549 U.S. 497, 533 (2007).

[83] 5 U.S.C. § 555(b).

[84] *In re Am. Rivers & Idaho Rivers United*, 372 F.3d 413, 419 (D.C. Cir. 2004).

[85] 5 U.S.C. § 706(2) (stating that courts can review and set aside final agency actions that are "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law").

1. Process.

General admonitions to act prudently are too vague to be of any value. Consequently, a final regulation should address in specific detail the following issues related to the process a fiduciary must undertake in evaluating an ESOP stock purchase or sale transaction:

- Reasonable requirements to qualify as a fiduciary, such as prior experience and capital requirements.
- Reasonable requirements for engaging advisors, including standards for determining what types of advisors ESOP fiduciaries should engage, evaluating their qualifications, and assessing their independence.
- The extent to which an ESOP fiduciary may rely on its advisors' work, particularly with respect to specific valuation issues.
- Requirements for documenting the fiduciary's process for accepting, evaluating, and negotiating the terms of an ESOP transaction.
- The circumstances in which a company may indemnify an ESOP fiduciary and its advisors.
- The differences, if any, between the process required to meet the Adequate Consideration Exemption and ERISA's fiduciary duties of prudence and loyalty.
- The degree to which the ESOP trustee must be involved in the business affairs of the company and its governance.

2. Valuation issues.

A final regulation could address the following issues related to the valuation of company stock to be acquired or sold by an ESOP:

- The definition of "fair market value," including the extent to which it is a range of values, and the impact of the "hypothetical" buyer and seller concept on specific transaction- and valuation-related issues (e.g., warrants, S corporation tax benefits, and others).
- The definition of control and minority interest and the circumstances in which an appraiser should perform his or her analysis on a controlling or minority ownership interest basis, keeping in mind Congress's intent related to the control characteristics conveyed in an ESOP transaction.
- The precise manner by which debt and other financing terms, including interest rates, scheduled debt payments, debt maturity, warrants, and other customary features of debt should be analyzed in a purchase transaction in evaluating the overall fairness to the ESOP of the transaction.

- The effect of management incentive plans, including certain forms of synthetic equity such as phantom stock, restricted stock, and stock appreciation rights, on fair market value and the effect of such plans on the fairness of the transaction as a whole to the ESOP.

- The evaluation and reliance on management projections, including appropriate techniques for managing risk associated with projections and other company-specific risk factors (e.g., adjustment of discount rates in certain analyses), and for establishing long-term growth rates.

- The effect, if any, of prior valuations of a company's stock, and the effects of indications of interest, letters of intent, or other offers to purchase some or part of a subject company or a subject company's stock on the appraiser's and trustee's conclusion of fair market value and criteria for when such indications or offers would be deemed relevant.

- The use of contingent consideration such as earnouts and clawbacks in a transaction, their permissibility, and their effect on the determination of fair market value.

- Whether fair market value in a sale of an ESOP company can be determined absent an auction process.

IV. Conclusion.

When ERISA was enacted in 1974, Congress directed the Department to promulgate regulations interpreting the Adequate Consideration Exemption. Yet for nearly 50 years, the Department has refused to issue formal guidance. The Department has instead preferred to follow its policy of "regulation through litigation," which has enabled it to avoid working with and learning from industry participants as required by the APA, and to circumvent the necessary costs and difficulties of a formal notice-and-comment rulemaking process. The Department's tactics have created an environment of profound regulatory uncertainty, which has frustrated Congress's intent to expand employee ownership, ultimately harming American workers.

The benefits of engaging in a rulemaking process are clear. A static, reasonable, well-defined regulation would be a stabilizing force in the industry, providing prospective guidance that would allow well-intentioned ESOP trustees, ESOP service providers, and selling shareholders to feel comfortable that they are not at risk of being sued for reasons they could not have anticipated. This would, in turn, reduce currently skyrocketing insurance premiums (where insurance is even available)—a cost that is passed on to ESOP sponsors and their employee-participants in the form of higher trustee and service provider fees. Each of these ripple effects—predictable rules, mitigated litigation risk, lower premiums—would encourage the formation of new ESOPs, increase the number of employee-owners, and bring new wealth to American workers.

The ESOP Association, its members, and our country's employee-owners—both current and future—look forward to your prompt attention to this important matter.