TEA Testifies Before Congress

Member Daniel Goldstein Tells Committee that Adequate Consideration Regulations, ESOP Loans, Must Be Addressed Now

America is facing a potential employment and business crisis, and ESOPs can be an ideal solution—but that can happen only if unfair barriers to ESOP formation are addressed. That was the message Daniel Goldstein delivered to Congress, and it appears to have struck home.
Goldstein, President and CEO of Folience, a Cedar-Rapids-based company, testified before the House Small Business Committee in February, representing The ESOP Association and the 10.6 million employee owners who work for ESOP companies.

**An Ideal Solution to a Perfect Storm**

Goldstein launched his testimony by informing House Committee members that ESOP employees outnumber the workforce of the entire U.S. auto industry by more than half a million and exceed the combined workforce of the federal and state governments by three million.

The message to the committee was clear and unmistakable: Employee owners are numerous and are not to be ignored.

He then discussed the retirement in the coming decade of baby boomers who own nearly 2.5 million small businesses. This looming wave of retirements—known as the Silver Tsunami—means businesses that have no succession plan or qualified buyer face the possibility of being forced to shutter operations or sell to competitors, who most often break the business apart.

Goldstein’s testimony showed that ESOPs can present a qualified, willing buyer when others might not exist—while providing tremendous benefits to employees and the community. But first, federal agencies must be required to follow Congress’ instructions and make it easier to form and operate ESOP companies.

To that end, Goldstein specifically asked the Small Business Committee and others in Congress to:

- Task the Department of Labor with issuing regulations on adequate consideration and other issues vital to forming and growing ESOPs. The ESOP community has waited 45 years for the agency to issue such regulations.
- Task the Small Business Administration with carrying out the mandates of the Main Street Employee Ownership Act—such as streamlining the ESOP loan process and working to promote employee ownership. One quick fix: The SBA should be required to add ESOP loans to the agency’s Preferred Lending Program. This decentralized program speeds up lending decisions, which clearly was the intent of the authorizing legislation, the Main Street Employee Ownership Act.

Goldstein’s testimony reached a supremely interested audience: Committee Chairwoman Nydia Velazquez (D-NY) introduced the Main Street Employee Ownership Act two years ago.

**Adequate Consideration**

After Goldstein’s testimony, Ranking Member Steve Chabot (R-OH) asked him to describe how the lack of guidelines regarding adequate consideration has affected the ESOP community.

Goldstein pointed out that the DOL has not only refused to issue guidelines, it also has spent the past decade practicing regulation by litigation—pursuing ESOP companies in a series of one-off cases that sometimes drag on for years and often fail to reach a formal resolution.

The result: ESOP companies have been left to interpret a patchwork of settlement agreements or decisions that sometimes were predicated on such unique circumstances they provided little or no guidance at all.

*‘The employees of the companies that don’t become employee owned are the ones that lose.’*

Through the combination of both practices, the agency is adding undue risk to forming and running an ESOP, discouraging companies from becoming employee owned. This does not benefit employees, and it denies our economy potential buyers of businesses at a time when we will need them most.

“The employees of the companies that don’t become employee owned are the ones that lose,” Goldstein told the Committee.
Rep. Pete Stauber (R-MN) showed great interest in the lack of adequate consideration regulations; he asked Goldstein for his help in getting greater clarity of the adequate consideration issue and offered to connect with him at a later time to do so.

**SBA Loans**

When Chairwoman Velazquez asked Goldstein about his experiences with SBA loans, he said Folience would be unlikely to use them due to the slow approval process.

“There are two principles I’ve learned from my experience,” he told the Chairwoman. “The first is that time is the enemy of all deals. The second is that accessing capital is the greatest bottleneck in timing.”

He explained how a delay of only 12 days in purchasing a company required additional work to ensure that changes in inventory, work in progress, and other factors did not alter the adequate consideration Folience had offered.

**Wealth Inequality**

Goldstein also was asked about Folience's health plan offerings and in responding broadened his answer to touch on the importance of the pay and retirement benefits that are offered by ESOP companies. “Income inequality gets the employee through the next pay period; wealth inequality, if you address that, gets the employee and their family through a funded retirement,” he told the committee.

**Going Forward**

During the hearing, Chairwoman Velazquez said she would have the Administrator of the SBA before the committee by month’s end; the Chairwoman made it clear she planned...
Debate Sparks Dialogue on Government Mandated Employee Ownership

Democratic Presidential Candidates Support Growing Employee Ownership, But Sanders’ Approach Draws Criticism

The topic of employee ownership arose during the Democratic Presidential Debate held in Nevada on Feb. 20. Debate moderator Hallie Jackson asked about a proposal from Sen. Bernie Sanders that would mandate employee ownership and electing board seats in very large companies. The exchange sparked an agreement of the important role that employee ownership can play in our economy, but a sharp disagreement about making employee ownership a government mandate.

In the animated and rushed confines of that forum, the conversation was neither as clear nor as informative as the ESOP community might have hoped. Former South Bend, Indiana Mayor Pete Buttigieg stated his support for employee ownership, but expressed a difference with Sanders in making it compulsory. Former New York Mayor Michael Bloomberg flatly opposed such a mandate, labeling it “communism” and that it would not work.

The ESOP Association issued a statement to the media to clarify what employee ownership is and how it benefits our nation. We are also following up with all Presidential candidates to solicit their views on a range of public policies of interest to our membership.

During the Debate

The issue arose when Jackson posed a question to Buttigieg regarding Sen. Sanders’ proposed policy that would require certain companies to give 20 percent of their stock to employees and to ensure that employees elect 45 percent of the members on a company’s Board of Directors.

“I think that employee ownership of companies is a great idea,” said Buttigieg. “I’m not sure it makes sense to command those companies to do it.”

Sen. Sanders spoke next, stating, “I’m very proud of that policy.” He added that to address “this grotesque level of income- and wealth-inequality... it is important that those workers are able to share the benefits.”

Too many people, he said, are working jobs where they feel like cogs in a machine. “I want workers to be able to sit on corporate boards as well so they can have some say over what happens to their lives,” said Sen. Sanders.

Mayor Bloomberg was then asked if he would support this kind of plan for his business. “Absolutely not,” he replied. “This is ridiculous. We’re not going to throw out capitalism. We tried that, other countries tried that, it was called communism and it just didn’t work.”

Both Sen. Sanders and Sen. Elizabeth Warren took issue with Bloomberg’s characterization of Sanders’ plan as communism, but it wasn’t until a few minutes had passed that Sanders was able to respond directly. When asked to respond to a poll that showed many Americans would be uncomfortable with a socialist candidate for president, Sanders said, “Let’s talk about democratic socialism—not communism, Mr. Bloomberg, that’s a cheap shot.”

Bloomberg did not appear to be referencing employee ownership, but rather the specific part of the Sanders proposal to mandate employee ownership and electing seats on corporate boards. This part of Sanders’ proposal is highly suspect, with most scholars believing such a mandate would be unconstitutional.

(Video of this exchange is available on YouTube.)

After the Debate

The ESOP Association does not support compulsory employee ownership. To ensure that ESOPs and employee ownership are accurately characterized, The Association issued a statement to the media. That statement is included below, in its entirety.

TEA’s Statement

The ESOP Association is pleased that employee ownership arose in the Democratic party Presidential debate last...
night and that multiple candidates were able to vocalize their support. We believe more Americans need to know about and participate in employee ownership—especially ESOPs, which are the largest and most common form of employee ownership—and would encourage greater discussion about this important form of business ownership in America.

In fact, through ESOPs, 10.6 million Americans already own a stake in the businesses where they work. That represents a larger number of employees than the entire U.S. auto industry. Participating in ESOPs helps address wealth and income inequality and can help our nation’s local economies as well.

While reasonable people can disagree on the best tactics used to grow employee ownership, it is entirely refreshing to observe that those in the Presidential field—Democrat, Republican, and Independent—seem to be in agreement that growing employee ownership is important for our economy.

**Wealth and Income Inequality**

ESOPs excel at addressing wealth and income inequality because they share the rewards of capitalism broadly with employees. ESOPs typically offer:

- Higher wages than conventionally businesses.
- Greater job security. ESOP companies are more likely to withstand tough economic conditions—like recessions—and are 6.2 times less likely to lay off employees.
- ESOPs typically offer two forms of retirement—the ESOP, which has no out-of-pocket cost to employees, and a 401(k). Many non-ESOP companies offer no employer sponsored retirement option.
- Greater opportunities for training, which spurs employee development and can result in employees earning higher salaries. Compared to conventionally owned companies, ESOPs are 40 percent more likely to offer employee training.

**Benefitting Local Communities**

As outlined in The ESOP Association’s testimony before Congress last week, we believe ESOPs are an ideal way to keep businesses in business and employees employed in the face of the looming retirement of 2.5 million business owners. Without viable buyers, many of these 2.5 million businesses will be shuttered. Others will be bought by competitors or private equity firms and carved up for their financial and physical assets—often leaving behind the human beings who work in these companies.

Too many business owners do not have successors positioned to take over the business; others have no succession plan at all. And some communities lack the capital required to purchase a business from a retiring owner.

ESOPs can overcome all these problems. In an ESOP:
- The successors are the employees—the same people who have helped build the business and know its customers, programs, and products better than anyone.
- The capital comes from the business itself, which takes out a loan to buy shares on behalf of employees. The loan is payed out using future company earnings, and all participating employees receive shares.

**More Conversations**

We thank the many participants in our nation’s political process—past and present; Republican, Democrat, and Independent—for their ongoing support of ESOPs. We look forward to additional conversations about ESOPs and employee ownership, and to the day when all Americans will be able to reap the rewards of owning a stake in the companies where they work.

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**Current Trends in ESOP Insurance**

Litigation, Other Factors Are Affecting the Availability and Pricing of Products Available to Protect ESOP Companies and Executives

By Jeff Gelburd and Patrick Dixon of Murray Insurance

Over the last 30+ years, corporate members have benefited from the affinity insurance program endorsed by The ESOP Association. More than 300 ESOP companies are served by this program, which provides Director’s and Officer’s, Fiduciary Liability, Employment Practices Liability, Crime, and Cyber insurance.

Murray Insurance—a 25-year old ESOP insurance broker headquartered in Lancaster, PA—administers this insurance program. Within the past five years, we have seen tremendous change in the insurance available to those working in or serving ESOP companies.

Here are some of the key insurance trends that we have noticed.
Cyber Insurance

Businesses large and small are becoming increasingly interested in cyber insurance. As more work gets done digitally every day, organizations face increasing risks for issues such as cyber attacks and viruses. Fortunately, coverage for these policies is growing ever broader, and premiums are remaining stable.

A cyber policy covers business costs associated with:
- A security breach, including expenses related to remediation and notification.
- Computer virus and/or malware.
- Computer fraud.
- Crisis management following a breach.
- Lawsuits following a breach by a government agency or third party that suffers loss from a breach.
- Regulatory defense expenses.
- E-commerce extortion.
- Business interruption.
- Social engineering.
- Funds transfer fraud.

Outside Trustee Liability

ESOP litigation has unfortunately made it difficult to purchase competitive coverage for service providers who are individual trustees. These policies cover the trustee for their ongoing trusteeships and for the transactions they facilitate.

Institutional trustees have an even harder time procuring insurance. The number of insurers offering coverage to outside trustees has decreased. Insurers deciding to provide the necessary coverage extensions often exit the market 18-24 months later.

Policy forms often present problems as there is no standard trustee policy form and coverage needs to be highly negotiated.

Within the past couple years, trustees are purchasing an individual policy to protect themselves on a single ESOP transaction. These policies insure only the outside trustee, provide several millions in policy limit, and cost several hundreds of thousands of dollars.

Trustees often require ESOP companies to reimburse them for the policy premium, even though the companies are not protected by the policy.

Plan Sponsor Fiduciary Liability Insurance

While the number of companies offering Fiduciary Liability Insurance to ESOP companies has remained relatively steady, they have significantly increased the amount of underwriting information they request about the ESOP—including reviewing the most recent share valuation.

When this kind of information is requested, it is likely that both the insurer requesting the information and the outside trustee or valuation firm will be required to sign a non-disclosure agreement.

Also, virtually every insurer offering this coverage requires completion of their own questionnaire about the ESOP.

The underwriting guidelines are particularly stringent when a company has recently performed an initial ESOP transaction; in these situations, a Fairness Opinion may be required, along with the valuation.

Limits are typically between $3 million and $5 million for a company with transactional exposure (an account with an ESOP transaction within the last six years). As an ESOP matures, underwriters are more willing to offer increased capacity.

We are seeing a trend towards fiduciary limits being requested at a minimum of $5 million for both mature and transactional exposures; an excess insurer is often engaged to provide capacity to the requested limit.

Coverage has expanded and now includes Settlor's coverage—although it is best to check with your agent because some carriers add this via endorsement but do not include it in the base policy form.

We are also seeing an increasing trend for certain insurers to add a tie-in of limits endorsement on the Directors & Officers and Fiduciary coverages for an ESOP claim that triggers both policies. It is preferable to have this endorsement removed and enable these limits to stack.

Directors and Officers Insurance

Pricing for Directors and Officers insurance is increasing at a rate of around 5-10 percent. This is not specific to ESOP companies and is part of a broader market trend due to litigation. Rate increases and retentions may be higher in California.

It is recommended that Directors and Officers Liability be purchased alongside of the fiduciary coverage to help protect ESOP company executives from non-ERISA claims.

Reps and Warranties

Company stock or asset transactions—such as in a sale of an ESOP company—often involve Reps and Warranties Insurance. This type of policy has become more prevalent today as a result of more insurers entering the marketplace and underwriting smaller transactions.

This kind of policy protects against seller’s or buyer’s breaches of contractual representations and warranties in a definitive agreement. This policy is used to stand in the place of a portion of the seller’s indemnification obligations.
The policy usually is in place for three-to-six years, has a deductible ranging from 1-2 percent, and has a premium range of 2-4 percent of the coverage limit purchased.

Professional Liability for Business Valuation Appraisers

Capacity for this type of E&O insurance remains plentiful with a host of insurance companies offering coverage. Policy limits normally start at $1 million and can go as high as $10-$15 million. Policy premiums are stable at around the $2,000-$3,000 mark for $1 million of coverage.

Editor’s Note: The authors administer this affinity insurance program, which is primarily underwritten by Great American Insurance Company. For more information, contact Jeff at jgelburd@murrayins.com or Patrick at pdixon@murrayins.com.

Advisory Committee on Administration

Recycling vs. Redeeming

by Ashleigh Newlin, Chartwell Financial Advisory
Reviewed by Barbara M. Clough, QPA, QKA, Director, Newport Group

Should you recycle or redeem ESOP shares that need to be repurchased? There is no quick answer, no one-size-fits-all solution. There are pros and cons associated with each method, depending on the goals for the ESOP; outcomes will differ based on the circumstances.

Nevertheless, this article defines the two basic methods for repurchasing ESOP shares and explains how variations of each approach impact employee benefits, shareholder returns, and the company’s repurchase obligations.

First, some basic definitions:

- Recycling is when the ESOP uses cash to repurchase shares, which are immediately reallocated to remaining participants.
- Redeeming is when shares are distributed from the ESOP and repurchased by the company.

Recycling maintains the ESOP’s ownership stake and ensures that all shares remain outstanding. Shares can be recycled with contributions or dividends. (For purposes of this article, “dividends” means traditional shareholder dividends, as in a C corporation—or S distributions, the S corporation equivalent.) Recycling is often the default repurchase strategy.

Here are some key aspects related to variations of recycling and redeeming.

Recycling with Contributions reallocates shares to those participants who are eligible to share in company contributions.

A potential disadvantage of this “pay-as-you-go” strategy is that the benefit level is driven by the repurchase obligation and may be inconsistent from year to year.

Alternatively, the company may make ongoing cash contributions based on a percentage of compensation, so that reserves accumulate in years of low repurchase obligations to be used in later years. This strategy provides a consistent annual benefit but can be “leaky,” meaning any cash balance in a participant’s account is distributed to the participant upon termination and therefore cannot be used for future repurchase obligations.

ESOP contributions are constrained by the IRC section 404(a) limit for deductible contributions. A company’s contributions to qualified plans may not exceed a total of 25 percent of eligible compensation (although there are different deduction rules when the ESOP is leveraged and sponsored by a C corporation).

If repurchase obligations exceed a company’s target contribution level or the 25 percent limit, some repurchased shares can be recycled with dividends or redeemed.

A specific concern exists for plan sponsors who maximize their employer contributions and sponsor a 401(k) plan with a matching or safe harbor non-elective contribution; that concern is the Annual Additions limits under §415. For 2020, Code Section 415 limits the additions to each individual participant’s account to the lesser of $57,000 or 100 percent of compensation. For participants age 50 or older, the $57,000 limit may be exceeded by age 50 catch-up deferrals.

Plan sponsors who maximize employer deductible contributions may cause excesses to individuals’ additions.
These excesses could be corrected in the 401(k) plan through one of two methods:

- Refunding the salary deferral contributions and possibly forfeiting the match on refunded deferrals.
- Reducing the participant’s ESOP allocation.

### Recycling with Dividends

Recycling with Dividends on allocated shares results in the reallocation of shares to all ESOP participants (active and terminated), pro rata to share balance. If any of the ESOP shares are unallocated as of the beginning of the plan year, dividends on these shares typically go to participants in the same manner as a contribution.

As compared to contributions, dividends have the advantage of not counting towards the 404(a) limit. However, they can be more expensive because dividends must be paid equally on all outstanding shares, including any non-ESOP shares.

A company can control the ESOP benefit level by supplementing its desired contributions with dividends. (Since dividends are allocated based on existing balance, they generally are not considered a “benefit” to employees, with the exception of dividends on unallocated shares since they typically are allocated in the same manner as contributions.)

However, dividends often increase repurchase obligations by providing additional earnings allocations to the longest-tenured employees, who are closest to retirement, thereby concentrating value in accounts that will soon be eligible for distribution. In extreme cases, if the ESOP is funded heavily with dividends, a have/have-not situation can develop—or worsen—and threaten the ownership culture.

### Redeeming

When redeeming, repurchased shares leave the ESOP. Similar to recycling with dividends, redeeming can be used to manage the benefit level when repurchase obligations exceed the desired contribution level or as a method of providing additional return to shareholders.

After shares are redeemed, they can be retired to treasury, recontributed to the ESOP, or sold back to the ESOP.

### Redeeming and Retiring

Redeeming and Retiring results in a reduced number of shares outstanding. Over time, a declining number of shares outstanding results in per-share value growing faster than equity value. This accelerated increase in per-share value rewards shareholders pro rata to existing balance, which has a concentrating effect similar to Recycling with Dividends.

It is a common misconception that Redeeming and Retiring shares reduces future repurchase obligations, as compared to Recycling with Contributions. In reality, fewer shares will need to be repurchased, but at a higher value per share. The total cost is often higher when redeeming due to the concentration of value.

The higher value per share also affects the value of stock appreciation rights or similar synthetic equity arrangements the company may have. The company’s total repurchase obligations and potential payouts tied to synthetic equity should be considered when deciding whether to redeem or retire shares.

A final consideration relates to communicating performance. A discrepancy between equity value growth and share value growth can create a challenge, as employees often equate share value growth with performance.

### Redeeming and Recontributing

Redeeming and Recontributing has a similar effect on repurchase obligations and participants’ account balances as Recycling with Contributions. Stock contributions are allocated to active participants in the same manner as cash contributions and also are subject to the Internal Revenue Code 404(a) limit.

Many companies combine the previous two redeeming strategies by redeeming all repurchased shares, and then recontributing shares equal to a target contribution level and retiring the remainder. This strategy allows the company to control the benefit level and provide additional return to shareholders; however, to the extent shares are retired, the concentrating effect may increase repurchase obligations.

### Redeeming and Releveraging

Redeeming and Releveraging involves selling redeemed shares back to the ESOP with an internal loan. Future repurchase obligations are reduced because the releveraged shares are reallocated to participants’ accounts over many years as the loan is repaid. Since relatively fewer shares are held by participants, fewer shares need to be repurchased.

Furthermore, because unallocated shares are considered outstanding shares, share value growth remains in line with equity growth, versus the faster growth caused by Redeeming and Retiring shares.

Releveraging can be used on a one-time or periodic basis to handle high repurchase obligations. It is most effective at reducing future repurchase obligations if a large number of shares is releveraged, and if the term of the resulting loan is sufficiently long, typically at least 20 to 30 years. Some ESOP companies releverage as frequently as every year in conjunction with a strategy for evergreen sustainability.

However, releveraging is a transaction with a party in interest; accordingly, the plan sponsor should integrate the ESOP team into the transaction to ensure that all legal and administrative documentation is complete and executed. In addition, the plan sponsor must obtain a contemporaneous valuation of the shares being transacted.
Plan sponsors should be aware that there are negative consequences associated with overusing releveraging. The combined loan payments can grow large relative to desired contributions and/or IRS limits, which locks in a future benefit level and limits the company’s ability to recycle with contributions. Furthermore, it is important to review any transaction with your ESOP Trustee to ensure he or she feels it is in the best interest of the plan participants.

Conclusion

There are many factors to consider when determining whether to redeem or recycle; nuances within each method can greatly impact the results. It might be necessary to use a combination of methods and the best approach may evolve over time as the ESOP matures or business conditions change. Determining an optimal strategy requires a company-specific analysis, with careful consideration of the goals for the ESOP and the implications for all stakeholders.

Ownership Advantage

Help Your Teams Thrive with the Right Charter

By Matt Hancock, Principal, Praxis Consulting Group, Inc.

Skilled managers in ESOP owned companies know that problems are opportunities for engaging and developing others. Knowing that “the best ideas come from those closest to the work,” these leaders assemble a team and create the opportunity for employees to own the problem and the solution.

Effective teams have shared goals, a mission, and vision that inspires; roles that are clearly defined; and strong executive sponsorship. They also negotiate boundaries up front. With these ingredients, team members feel motivated and supported and can sustain their efforts for the long-haul.

If these ingredients are lacking, or are not clearly defined, team members can experience frustration and isolation as initiatives stall.

By following a formal chartering process, leaders can ensure that their teams have what it takes to thrive and perform.

Who Needs to Be Involved?

It is unlikely you will have the desired team assembled for the chartering process itself. This is okay, since one of the purposes of the charter is to identify who should be on the team. Still, ensure you have the right people in the room for the process.

For an Employee Owner Committee (EOC), for example, the right group typically includes members of the senior leadership team, with the active participation of the President/CEO. Chartering other types of committees—for example, a steering committee for a new training program or a continuous improvement initiative—requires that the executive sponsor consider key stakeholders and relevant subject matter experts.

During the chartering process, less is more: Consider limiting participation to between three and five people. If it makes sense to engage more voices, be clear up front who the “core” group is that will guide the work and who has the authority to authorize the charter.

Can’t I Just Write the Charter Myself?

Leaders need to balance expediency with the benefits of engaging the right voices. Engagement takes time but can yield dividends down the road as teams spend less time “storming and norming” and more time “performing.” The results of an effective chartering process are clarity around goals, enthusiasm for the initiative, strong executive support, and alignment of resources.

Consider these steps to getting to an effective team charter:

- **Context Setting.** Once you have recruited members to the chartering group, ask them to do some pre-work to help set the context. This might take the form of a visit to another company, reading articles, viewing webinars, or attending a conference presentation. The point is not to duplicate what someone else has done, but to help give people a frame of reference for what is to be done in your organization.

- **Workshop.** When possible, it is always best to get everyone in the room together. Otherwise, video conferencing solutions can work well.

Get the meeting started with a catalyzing question. Here is a good one: What resonated for you about the [reading,
The main goal is to get every voice engaged, right from the start. Discuss the elements of a strong charter (see below). Use flipcharts to capture ideas. Allow participants to think out loud and see if the group arrives at consensus on their own. If you get stuck, the leader or facilitator can offer to draft something for the group to react to later.

Close the meeting on a strong note. Try an activity like “Plus + / Delta ∆” where you invite participants to share one aspect of the meeting they felt went well (plus), and one area for improvement (delta).

**Draft and Revise.** One person has to get the ball rolling. This could be the executive sponsor, facilitator, or a participant. Using the ideas captured on the flipcharts, this person should draft a team charter (it can be helpful to follow a template).

### What Is in a Charter?

A charter should clearly explain the team’s purpose, goals, and scope; determine the desired team composition; identify key roles, including executive sponsor; outline decision making authority, resource needs, and measurable results; and outline communication and reporting expectations.

At the end of the day, the success of a particular initiative will come down to the people on the team, the quality of leadership, and the relationship between the executive sponsor and the team leader(s). By following a formal chartering process, you can set teams up to perform by gaining clarity over the purpose of the initiative and fostering a shared commitment to doing what it takes to succeed.

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### Legal Update

**Liability Insurer Must Pay Defense Costs in ERISA Case**

By Joseph C. Faucher and Dylan D. Rudolph, Trucker Huss, APC

For companies that provide services involving ESOPs, risk management and liability avoidance are critical—but they aren't enough. Because no matter how carefully and professionally service providers—such as valuation companies, third party administrators, and auditors—go about their work, lawsuits are an unfortunate cost of doing business. Appropriate insurance is therefore a must.

There are other realities that service providers need to face when it comes to insurance, including:

- Not all insurance policies cover all types of claims that might be brought against them.
- Even if a policy appears on its face to cover claims made in a litigation matter, the insurance carrier might see it differently.

And these can be expensive lessons to learn after the fact. Traditionally, when limited to performing their typical role, valuation professionals are not considered ESOP fiduciaries. Trustees may rely upon an appraiser’s conclusions—for example, by ultimately agreeing with the appraiser’s conclusions when deciding to approve an ESOP transaction—but the decision belongs to the trustee, and not the appraiser.

Because the trustee (and not the appraiser) is the party exercising its discretion to proceed, it is most often the trustee that faces scrutiny and litigation, and not the appraiser. But that is not always the case. Valuation professionals may still find themselves pulled into litigation alleging, among other things, breaches of ERISA’s fiduciary duties, and violations of federal and state securities and state common laws.

And that is where insurance coverage comes in. ESOP professionals can't be criticized for expecting that, when they are sued in connection with the services they provide, their insurance coverage will provide them with a defense to those claims. But in reality, insurers routinely push back, and argue that the terms of their policy do not require them to defend, or indemnify, their insureds when lawsuits strike.

A recent decision in a federal district court in Michigan illustrates how these concerns converge in the real world. The case itself makes for dense reading regarding rather complex insurance coverage concepts, but we discuss the main points here to illustrate how important it is for ESOP-industry professionals to carefully review their insurance needs.

**Great American Fidelity Insurance Company v. Stout Risius Ross, Inc.** (No. 19-cv-11294, 2020 WL 601784 (E.D. Mich., Feb. 7, 2020)), arose in the wake of two ESOP-related lawsuits brought against Stout Risius Ross, Inc. Stout’s involvement in the underlying lawsuits stemmed from
financial advice it provided to the trustees of the Appvion ESOP. Specifically, the ESOP’s trustees retained Stout to value the stock of Appvion’s parent company, Paperweight Development Corp.

Appvion, however, later filed for bankruptcy and the Appvion ESOP suffered losses. Following Appvion’s bankruptcy, Stout was sued in two federal lawsuits by the Appvion ESOP’s participants and bankruptcy trustees along with multiple other entities.

These lawsuits alleged, among other claims, that Stout breached ERISA’s fiduciary duties and securities laws because there were problems with Stout’s valuation of Paperweight’s stock.

But critical to the outcome of the case, the lawsuits also alleged claims based on state law fraud and negligent misrepresentation theories.

Stout was insured under a Great American professional liability insurance policy, commonly referred to as an Errors and Omissions (E&O) policy. The court noted that Stout bought this policy “to provide defense and indemnification protections for claims arising from Stout’s valuation services.” But as is typical in standard E&O policies, the policy contained an exclusion for claims “based on or arising out of actual or alleged violations of [ERISA and federal and state securities laws].”

Despite this exclusion, Great American initially defended Stout in these two lawsuits under a full reservation of rights. But Great American later filed a “declaratory relief” action, seeking a judicial declaration that its policy provided no coverage for any of the claims set forth in the underlying cases (including the claims based on state law), and that the company had no obligation to defend or indemnify Stout and certain individual defendants affiliated with it.

Great American moved for summary judgment on grounds that it did not have a duty to defend or indemnify Stout because the two ESOP lawsuits involved ERISA and federal securities claims. It argued for a broad interpretation of the policy’s exclusionary language “based on or arising out of” ERISA and securities law violations.

Ultimately, the court focused on the policy language requiring that, in order for a claim to be excluded, it must be based on or arise out of a violation of ERISA or securities law.

The court reasoned that for a claim to be excluded, “a violation of ERISA must have caused Stout to commit...” a violation of state negligence or fraud laws. Great American argued that the alleged violations of those state laws arose out of an ERISA violation. But the court’s opinion noted a distinction between any alleged ERISA violation, and the purported violations of state law by Stout:

Great America explains the connection between [the state law claims] and an ERISA violation as follows: ERISA imposed a fiduciary obligation on the ESOP trustees to value Paperweight stock and so the ESOP trustees hired Stout to conduct this valuation.

Although this could arguably explain how the fraud and negligent misrepresentation arise out of ERISA, it does nothing to explain how the counts arise out of an ERISA violation.

In other words, the court concluded that even if Stout committed some negligent act in the course of its valuation work, that would not mean that in doing so it engaged in a violation of ERISA. On that basis, the court ruled in favor of Stout, and dismissed the insurer’s request for declaratory judgment on the question of whether Great American had a duty to defend Stout.

There are a number of potential takeaways from this decision, but here are some of the main ones.

Service providers can control the quality of their work, but no matter how well they do it, they can’t control whether someone sues them for it, or the claims that someone asserts against them. While those in the know generally understand that valuation professionals—who are engaged in providing their standard services—are not typically ERISA fiduciaries, it is not unheard of for plaintiffs to bring claims against them alleging ERISA violations in connection with their services.

It also should be noted that if the language of the policy had been slightly different in this case, the outcome may have been different; an insurer might be able to avoid coverage in another situation involving different policy language or a different judge.

Insurance companies offer different insurance products to protect against different risks. Standard E&O policies generally are designed to avoid providing coverage for alleged violations of ERISA, by expressly excluding coverage of those claims. And when plaintiffs allege violations of ERISA, insurers are likely to rely on those exclusions to deny an obligation either to indemnify their insured or defend them against litigation.

Consequently, sound risk management practice suggests that ESOP service providers should carefully evaluate their insurance coverage and assess whether it may be worthwhile to consider additional insurance coverage.

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