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Employee Stock Ownership Plans

A POPULAR RETIREMENT PLAN WITH **UNIQUE CHALLENGES**

WHITE PAPER

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Employee Stock Ownership Plans Present **Unique Challenges**

Employee stock ownership plans, or ESOPs as they are often called, are becoming a more and more popular way for companies to offer retirement plans to their employees. They allow for certain tax benefits for the sponsoring company, the selling shareholder and the participants in the plan. ESOPs are also an attractive way to align the interests of the company with its employees.

Due to their unique nature, suits by shareholder employees of the company alleging breach of fiduciary duty are more likely and more severe due to employees' intimate knowledge of a company's operations, customers, financial well-being, and competition.

Since Employee Retirement Income Security Act (ERISA) makes the plan trustees and fiduciaries personally responsible for any damages incurred by plan participants, there has been greater focus on placing insurance to protect them and their personal assets in the event of a suit.

How ESOPs Work

An ESOP is a kind of employee benefit plan. In an ESOP, a company creates a trust fund where it can make contributons of new shares of stock or cash in order to buy existing shares.

Some ESOPs borrow money to buy new shares (referred to as a leveraged ESOP) or stock from existing shareholders. The sponsoring company can then make contributions to the plan to help repay the loan. These contributions are highly attractive as they are a tax-deductible option.

Shares are allocated to employees typically based off pay or seniority with the company. Over time, the employee gains an increasing right to their allocated shares. When an employee leaves they can then cash out their stock which the company must buy from them at fair market value.

The Importance of Fiduciary Liability

Breaches of fiduciary duties or errors in administration of ESOPs can lead to personal liability for the plan's sponsors and fiduciaries which puts personal assets on the line in the event of a lawsuit.

Section 410 of ERISA prohibits a plan from paying for or indemnifying a fiduciary for a breach of fiduciary duty. This means that the only barrier between the fiduciary and their personal assets is the sponsoring company.

In one particular instance, litigation arose after a dispute over the management of a manufacturing company's ESOP. Employee plan participants alleged the fiduciaries of the plan breached their fiduciary duty by allowing certain incentive agreements that benefited the former company president. Litigation was exhaustive and the policy limit of $5,000,000 was eventually paid out.[1]

When it comes to ESOPs, some courts have ruled that plan sponsors cannot indemnify fiduciaries because doing so would be harmful to the plan itself. The share value in an ESOP is directly tied to the financial well-being of the sponsoring company. Had the fiduciaries in the example above been indemnified by the sponsoring company, then that could potentially be detrimental to the ESOP plan. A large indemnification payment to a fiduciary could harm the sponsoring company financially.

Fiduciary liability is often the only protection fiduciaries have in the event of a claim.

Sources of Fiduciary Claims

Valuation of the ESOP

The biggest source of litigation when it comes to ESOPs is simply the valuation of the company. It is notoriously difficult to evaluate a company that does not publicly disclose financial information.

ESOPs are typically valued by a valuation firm. But that firm must rely on the information provided by the executives from the company being valued.

It is not uncommon to see valuations of private companies vary drastically. The first three years of an ESOP can pose an even higher risk as former owners could be alleged to have driven an inflated valuation and saddled the company with debt at just the right time. As a result, sellers of shares may be more inclined to seek litigation should they feel their stock was overvalued at the time they purchased it.

Department of Labor

The Department of Labor has drastically increased the oversight of ESOPs over the last few years. As of 2014, the DOL was a plaintiff in 15 suits directly related to the valuation of ESOPs. According to a recent *Wall Street Journal* article, the DOL has recovered nearly $241 million through suits or investigations that did not see the inside of a courtroom.[2]

The DOL recently completed an investigation accusing the former president of a company of undervaluing the stock when he sold his shares to the ESOP. The result was a $2,500,000 loss to the plan.

The DOL was particularly aggressive after they discovered the president was the only person on both sides of the transaction, and using the same attorney for the purchase and the sale. The DOL eventually settled the matter for $2,000,000.[3]

D&O

The vast majority of claims as it relates to ESOPs are claims from shareholders. Shareholder claims often fall under D&O coverage.

Given that most claims arising from an ESOP exposure allege a violation of fiduciary duty—as well as negligence on the part of the directors and officers—it can be difficult to distinguish which line of coverage is triggered. Purchasing the D&O and the fiduciary liability for an ESOP from the same carrier is highly important.

Since both coverages could possibly respond to a claim, you do not want two carriers fighting over who should cover it once a suit is filed. By purchasing both lines with one carrier, the fiduciaries of the plan can rest assured that figuring out who will cover the claim will not be an issue.

Conclusion

It is important to consider the potential pitfalls of establishing an ESOP and how to protect the plan's fiduciaries. Fiduciary liability insurance should always be considered in any company's risk management portfolio, but this especially rings true for companies that sponsor ESOPs.

Notes

[1] Great American Insurance (2015). "Claims Examples for Fiduciary Liability." Retrieved from *www.gaig.com.*

[2] Needleman, R.S. (2014). "U.S. Increases Scrutiny of Employee-Stock-Ownership Plan." *Wall Street Journal.*

[3] Great American Insurance (2015). "Claims Examples for Fiduciary Liability." Retrieved from *www.gaig.com.*

About Worldwide Facilities, LLC

Worldwide Facilities, LLC is a national wholesale broker and managing general agent providing services to insurance agents and brokers. In business since 1970, our seasoned team of brokers and underwriters offers specialized knowledge of ESOPs, broad access to specialty markets, and extensive expertise in placing challenging insurance risks.

We offer unmatched tools, resources, and strategies to help insurance agents and brokers expand their corporate accounts to include ESOPs—including training materials and marketing support.

Take advantage of our expertise in ESOPs today—contact Connor Dippel in our Dallas office at cdippel@wwfi.com or (972) 850-5653 to schedule a conversation.

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