

ESOP FIDUCIARY LIABILITY:
AN OVERVIEW OF THE OBLIGATIONS AND EXPOSURES OF ESOP FIDUCIARIES

Prepared by Stephen D. Rosenberg,
The Wagner Law Group¹

Table of Contents

Important Note	1
Executive Summary	2
ESOP Fiduciary Duties	2
Accidental Fiduciaries	4
Personal Liability of ESOP Fiduciaries	4
Violations of Fiduciary Obligations	5
Continuing Duties to Monitor and Evaluate	5
Reliance on Experts Will Not Avoid Fiduciary Liability	6
Avoiding Fiduciary Liability	6
Insurance	7

Important Note

The Wagner Law Group has prepared this white paper on behalf of StockShield, LLC for general informational purposes only. It does not constitute legal, tax or investment advice on the part of The Wagner Law Group or StockShield, LLC. Plan sponsors and other fiduciaries should consult with their own legal counsel to understand the nature and scope of their responsibilities under the Employee Retirement Income Security Act of 1974 (ERISA) and other applicable law.

¹ Stephen Rosenberg is Of Counsel to the Wagner Law Group, where he heads the firm’s ERISA litigation practice. Stephen has substantial expertise in ERISA litigation, including disputes over ERISA governed benefit plans, fiduciary obligations, plan regulation, ESOPs and top-hat plans. He has extensive experience litigating class action disputes involving 401(k) plans, pension plans, wage act claims, ESOP valuations and fiduciary actions. After having overseen his work on one class action involving ESOP issues, his lawyering was described by a senior federal court judge as “a very good job in all aspects.” Stephen has extensive trial experience, having represented clients at trial in federal and state courts as well as in commercial arbitrations. His practice has included litigation in numerous jurisdictions across the country. He also has substantial experience representing company benefit plans, plan sponsors and employers before the Massachusetts Commission Against Discrimination.

Executive Summary

- An Employee Stock Ownership Plan, commonly referred to as an ESOP, allows employees to hold stock or ownership shares in the employer. The ESOP is governed by ERISA, and those managing the ESOP, directly or indirectly, can be liable for any violations of ERISA with regard to the ESOP.
- The ESOP can be, and is in fact expected to be, disproportionately invested in the employer's stock. An ESOP is not subject to ERISA's requirement that participant investments be properly diversified.
- However, ESOPs and those who run them are subject to other fiduciary and operational obligations imposed on ERISA governed plans, including the duty to prudently manage their affairs and the employee investments.
- Company officers and employees who are actively involved in managing the operations of the ESOP face potential liability for any fiduciary breaches involving the ESOP. This is not limited to those who are named in the ESOP's governing plan documents as fiduciaries of the ESOP, but will also include others who actively participate in the ESOP's operations and decision making. Under ERISA, all can be considered fiduciaries of the ESOP, whether or not expressly named in the plan documents.
- Although numerous types of errors in the operation of an ESOP can give rise to lawsuits by participants against the fiduciaries of an ESOP, the most common and potentially expensive are so-called stock drop suits or similar claims alleging that the value of the participants' stock holdings contained in the ESOP have declined, and that the fiduciaries should have avoided that decline.
- Any company officers, executives or employees who are named in the ESOP's governing documents as fiduciaries of the ESOP, as well as those who, even if not so identified in the plan documents, operate the plan, can be held personally liable for any losses suffered by employees who are participants in the ESOP as a result of fiduciary breaches, including any that cause the value of the employee stock holdings to decline.
- Insurance will typically not fully protect the company and any fiduciaries of the ESOP against these types of liabilities.
- ESOP fiduciaries and other company executives with responsibility for the operation of the ESOP must act prudently to avoid being liable for losses suffered by plan participants.
- The adoption of an ESOP Protection Trust constitutes powerful evidence that fiduciaries and company executives acted prudently in operating and managing an ESOP.

ESOP Fiduciary Duties

ERISA imposes certain obligations on those who run retirement, pension or other employee benefit plans. ERISA treats them as fiduciaries for purposes of the plans, and requires them to act prudently. Many people refer to this obligation as the duty to act as a prudent expert would under the

circumstances, regardless of whether or not the company executive in charge of the plan is, in fact, an expert.

More specifically, ERISA declares that: “a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and

- (A) for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan;
- (B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;
- (C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and
- (D) in accordance with the documents and instruments governing the plan.”

A fiduciary who breaches any of these obligations is personally liable for any losses that occur as a result.

The fiduciaries of an ESOP, however, are not required to comply with one part of this standard, which is part C, the requirement that they diversify the plan’s investments “so as to minimize the risk of large losses.” ESOP fiduciaries also cannot be found liable for having violated part B, which requires acting with the care, skill, prudence and diligence of a reasonable expert, by failing to diversify the ESOP’s holdings. Although hotly disputed in the courts for many years, it is now established that an ESOP fiduciary is not obliged to diversify the investments of the plan so as to minimize the risk of large losses or to act “with the care, skill, prudence, and diligence” of a “prudent man” to the extent doing so would require diversification.²

However, the fiduciaries of an ESOP remain obligated to comply with these duties, in particular the duty to act with the care, skill, prudence and diligence of someone knowledgeable about the topic, with regard to all other risks posed to the employee holdings in the ESOP. This means, in essence, that while the fiduciaries have no obligation to protect against a lack of diversity in the investment holdings of the ESOP, and the ESOP may primarily or exclusively hold ownership in the employer of the ESOP participants, ESOP fiduciaries are otherwise obligated to act as a fiduciary, and to act in that role to protect the value of the participants’ interests held in the ESOP. In the words of the United States Supreme Court, this means that “ESOP fiduciaries, unlike ERISA fiduciaries generally, are not liable for losses that result from a failure to diversify. But aside from that distinction . . . ESOP fiduciaries are subject to the duty of prudence just as other ERISA fiduciaries are.”³

This standard clearly applies to the fiduciaries of all ESOPs, including private company ESOPs. Although the Supreme Court’s recent, and well-publicized, decision in *Dudenhoeffer* clarifying the duties of ESOP fiduciaries did not involve a private company ESOP, there is no question that the obligations of prudence dictated by that decision apply to the fiduciaries of all ESOPs, including private company ESOPs. As the Supreme Court emphasized in *Dudenhoeffer*, ERISA’s fiduciary obligations apply in full force to the fiduciaries of ESOPs, with the exception of the

² *Fifth Third Bancorp v. Dudenhoeffer*, 134 S.Ct. 2459 (U.S. Jun 25, 2014).

³ *Id.*

obligation to diversify, and there is no basis in the case law or in ERISA itself for assigning a lesser duty of care to the fiduciaries of private company ESOPs than apply to those of other ESOPs.

The Supreme Court in *Dudenhoeffer* specifically rejected the idea that a presumption of prudence can attach to ESOP holdings that would prevent the fiduciaries of an ESOP from being liable for losses to the plan except in the most extraordinary of circumstances. As a result, ESOP fiduciaries, after *Dudenhoeffer*, again face the risk of liability in all types of circumstances where the value of the stock holdings have fallen, so long as it can be shown that the fiduciaries acted in a manner that increased the risk of such a loss or failed to take action that could have decreased the risk of such a loss. With the removal, by the Supreme Court in *Dudenhoeffer*, of a judicially created presumption limiting the potential exposure of ESOP fiduciaries, private company ESOP fiduciaries face potential liability whenever company stock values collapse, even if the cause is systemic and market-based, and not directly caused by an operational decision of a plan fiduciary. While the loss in value from such an event would not in and of itself be sufficient to trigger fiduciary liability, a showing that the fiduciaries could and should have acted to either avoid or even just reduce the loss can be enough to impose fiduciary liability. To the extent the ESOP Protection Trust protects against market-based losses to the value of an ESOP's holdings, it can provide protection against exposure to those types of claims.

Accidental Fiduciaries

An ESOP, just like any other ERISA governed plan, is required to have a named fiduciary who is responsible for the plan's prudent management and operation, including prudence with regard to the investments held in the plan. However, just like any other ERISA plan, the fiduciaries of an ESOP are not limited to those identified as fiduciaries in the plan's documents. In addition to those individuals, company officers and executives who play a significant role in the plan's operations are deemed to be fiduciaries of the plan as well, and are equally subject to the risk of personal liability for fiduciary breaches occurring in the operation of the plan as are those executives who are actually named as fiduciaries in the plan's documents.

Many such executives, despite being plan fiduciaries and facing the risk of personal exposure as a result, are not even aware – until sued – that they are treated by the law as fiduciaries of the plan, and thus are often referred to colloquially as accidental fiduciaries. The more technical legal term for such individuals is “deemed” or “functional” fiduciary. Regardless of the name given to them, what matters is that they are held to the same standards of prudent conduct as are those expressly named as fiduciaries of the plan, at least with regard to any areas of the plan's operations in which they participate, and are equally subject to personal liability for any breaches of that obligation.

Personal Liability of ESOP Fiduciaries

ERISA expressly declares that “Any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries by this subchapter shall be personally liable to make good to such plan any losses to the plan resulting from each such breach.” Company executives who are identified in ESOP documents as named fiduciaries are often not aware that they are personally liable for any losses to the plan. Further, the executives and officers of a company that is owned, even partly, by an ESOP often play a management role with regard to the company's ESOP as well, and this role can render them fiduciaries without having deliberately or knowingly taken on that role; nonetheless, they still are personally liable for any breaches of fiduciary duty in which they are implicated.

Violations of Fiduciary Obligations

There are many ways to violate ERISA's fiduciary obligations. The most important, with regard to the protections that an ESOP Protection Trust can provide, concern violations of ERISA's duty to act with the care, skill, prudence and diligence of a prudent and knowledgeable person in the field. This is often referred to as the fiduciaries' duty of prudence. With regard to an ESOP and its investment in company stock, this can be understood as the obligation to act knowledgeably and carefully with regard to decisions or actions that impact the value of the employees' ownership interests held in the ESOP.

In determining whether fiduciaries have breached their duty of prudence with regard to a particular investment in a plan, including ownership holdings in an ESOP, courts consider whether the fiduciaries "employed the appropriate methods to investigate the merits of the investment and to structure the investment."⁴ A federal court will consider "whether the fiduciary engaged in a reasoned decision-making process, consistent with that of a prudent man acting in a like capacity."⁵ Even after the original investment decision is made – such as the decision to invest in employer stock – the fiduciaries' duty of prudence continues: "the duty of prudence also requires fiduciaries to monitor the prudence of their investment decisions to ensure that they remain in the best interest of plan participants."⁶

Failing to comply with these duties and obligations, including when electing to invest in employer stock, deciding on the valuation to be given to the company stock, and deciding whether to continue to hold or further invest in company stock, constitutes a violation of ERISA's fiduciary obligations.

Continuing Duties to Monitor and Evaluate

The duties of ESOP fiduciaries continue after the ESOP is established and even after the stock holdings are distributed to participants. Even if those steps in the history of the ESOP are done prudently and do not trigger any fiduciary exposure, the fiduciary liability risks of the plan's fiduciaries continue. There appears to be little doubt that an ESOP fiduciary cannot simply establish the plan, and then allow it to run, effectively, on auto-pilot with regard to the stock it holds. Although the exact scope of a fiduciary's obligation with regard to monitoring plan investments after they have been made is still being developed in the courts, one can safely predict that an ESOP fiduciary will face possible liability for being "asleep at the wheel" if an event occurs that decreases the value of the holdings without the fiduciary having made reasonable efforts to plan for or avoid that outcome. This almost certainly means that an ESOP fiduciary must periodically examine the holdings and the potential risks to the participants and consider whether some corrective or protective action should be taken, at the risk of potential liability if he or she fails to do so. At a minimum, it is likely to require that the fiduciary of an ESOP examine the stock holdings and related decisions if something occurs in the plan's operations or the surrounding industry or market environment that should have triggered investigation on the part of the fiduciaries.

⁴ Tatum v. RJR Pension Inv. Committee, 761 F.3d 346 (4th Cir.2014).

⁵ *Id.*

⁶ *Id.*

This duty on the part of fiduciaries to monitor, to some degree, the investments in the ESOP dovetails with the question of when and whether a fiduciary should consider an ESOP Protection Trust for a particular ESOP. Some ESOPs hold the stock of very successful companies, and others will find that this is true only for awhile, with the holdings later collapsing in value. In the latter case, the plan holdings, and the fiduciary's actions with regard to those holdings, may move from being prudent to being essentially imprudent. As private company stock that is not subject to a liquid market, it can be difficult to either protect the holdings of the participants or provide the retirement or other benefit intended by the plan once the investment has shifted towards being imprudent. Obtaining an ESOP Protection Trust while the investment is still prudent and profitable may provide protection against the risk that the investment will eventually become imprudent, potentially protecting both participants against the loss inherent in such an event and fiduciaries against the potential liability that could arise from that event. Monitoring the ESOP's investments is required by the fiduciary obligations imposed by ERISA, but it is also necessary as a practical matter to determine whether to acquire an ESOP Protection Trust.

Reliance on Experts Will Not Avoid Fiduciary Liability

Running a company is hard, and so is creating and administering an ESOP. Just as with many other areas of a company's operations, outside expertise is often required. Appraisers are needed to value the company and the stock holdings for purposes of the ESOP, and experts in plan administration are often needed to help operate the ESOP. The fiduciaries of an ESOP, however, are not allowed to simply rely, uncritically, on the advice and decisions provided by such experts. Instead, any reliance on the outside experts must be reasonable, and the fiduciaries must critically assess their advice and recommendations. Failure to investigate and analyze the actions of outside experts can constitute a fiduciary breach, and expose ESOP fiduciaries to liability for losses suffered by ESOP participants that are attributable to work of the outside experts.

Avoiding Fiduciary Liability

The duty of prudence imposed on ESOP fiduciaries is high. ERISA's fiduciary obligations have often been described as among the highest known to the law. Nonetheless, the duty can still be met by fiduciaries, so long as they invest the effort needed to properly investigate investment decisions – including whether to acquire or continue to hold employer stock on behalf of the employee participants in an ESOP – to understand them, and to make reasonable decisions concerning them.

A court's analysis of whether an ESOP fiduciary has breached his or her obligations does not occur in a vacuum, but instead depends "on the character and aim of the particular plan and decision at issue and the circumstances prevailing at the time."⁷ There is no set series of steps that a fiduciary making these types of decisions must follow to satisfy his or her fiduciary obligations, and to avoid fiduciary liability. Instead, "courts have found that a variety of actions can support a finding that a fiduciary acted with procedural prudence, including, for example, appointing an independent fiduciary, seeking outside legal and financial expertise, holding meetings to ensure fiduciary oversight of the investment decision, and continuing to monitor and receive regular updates on the investment's performance."⁸ In the words of one court, "although the duty of procedural prudence requires more than a pure heart and an empty head, courts have readily determined that fiduciaries who act

⁷ Id.

⁸ Id.

reasonably—i.e., who appropriately investigate the merits of an investment decision prior to acting—easily” satisfy their fiduciary obligations.⁹

Seen from this perspective, the ESOP Protection Trust may provide additional benefits, beyond simply repaying a portion of the loss in value of an ESOP’s holdings in the event of a collapse in the value of the employer stock held in the ESOP. It can instead provide, as well, evidence of prudent conduct by the ESOP fiduciaries, by documenting that the fiduciaries, in making the decision to acquire and then hold employer stock, had taken this additional available step in an effort to protect the value of the participants’ holdings in the ESOP. Any actions by a fiduciary to protect the investments in a plan are valuable in demonstrating prudent conduct by a fiduciary, and obtaining an ESOP Protection Trust should be no exception.

Insurance

Even a well designed corporate insurance program is unlikely to cover all losses incurred as a fiduciary of an ESOP or other ERISA governed plan, including in particular liability for the loss in value of employer stock held in an ESOP. Typically, insurance programs will not cover the loss in value of the assets held in the ESOP. Fiduciary liability insurance programs may provide coverage of some operational errors with an ESOP that give rise to litigation, but often may not insure against any recovery by the plan’s participants that constitutes lost plan benefits owed to them or, in other words, the loss in the value of the participants’ stock holdings themselves. Policies written by different insurers can vary, and even policies issued by the same insurer can vary from one plan to another, depending on negotiations between the plan sponsor and the insurer. However, as a general principle, fiduciary liability insurance policies are often written to exclude coverage of benefits or other funds actually due to participants under the plan’s terms; in the context of ESOPs, this would typically include the lost value of a participant’s stock holdings in the ESOP.

An ESOP Protection Trust, by repaying a substantial share of any lost stock value, can provide an alternative funding source to repay such losses, in circumstances where the fiduciaries themselves would otherwise have to personally repay the loss and insurance will not cover the loss.

⁹ Id.