CHUBB'S ESOP SERIES
1st Installment

Leveraged ESOP Transactions: Basics and Litigation Risks

Authored by Groom Law Group:
Lars Golumbic, Litigation Co-Chair
Andrew Salek-Raham, Practice Leader
Paul Rinefierd, Senior Counsel

Executive Summary

Employee stock ownership plans, or "ESOPs," are a form of employee benefit plan that originated as part of the Employee Retirement Income Security Act of 1974, or ERISA, the landmark legislation that Congress enacted to protect and regulate private sector employee benefits. The benefit that ESOPs provide to employee participants is an ownership stake in their employer, which participants receive as annual allocations of their employer's stock.

This article, the first in a series on ESOP litigation risks and considerations, offers an overview of ESOPs, leveraged stock purchase and sale transactions, and highlight many of the regulatory and litigation risks that ESOP fiduciaries, ESOP sponsors, and selling shareholders face in those deals.

Congress and Leveraged ESOP Transactions

When a privately-owned company forms an ESOP — most ESOP companies are closely-held — the ESOP does not automatically have stock to distribute to employee participants. Rather, new ESOPs usually need to buy some percentage of the plan sponsor employer's stock from the shareholders. And because ESOPs also do not automatically start with cash or other assets, ESOPs frequently need to buy stock with loans, in "leveraged" transactions. Typically, leveraged ESOP stock purchase transactions are negotiated and agreed to by one or more selling shareholders and a trustee that is engaged to represent the ESOP.

When enacting ERISA, Congress recognized there was a conflict between its desire to encourage leveraged ESOPs, on the one hand, and requirements in ERISA regarding "prohibited transactions," on the other hand.[1] To facilitate the creation of leveraged ESOPs, Congress expressly carved out of ERISA's prohibited transaction rules ESOP transactions that are for "adequate consideration," which ERISA defines as the "fair market value" of the stock as determined by the ESOP's trustee "in good faith."

Since enacting ERISA in 1974, Congress has taken many other measures to demonstrate its commitment to encouraging companies to create ESOPs. For instance, Congress has passed a series of tax incentives for companies and their private owners to establish and maintain ESOPs. As recently as 2022, in the SECURE 2.0 Act, Congress directed the U.S. Department of Labor (the "Department") to issue a regulation further defining the fiduciary standards for creating ESOPs and to start an employee ownership initiative to further their growth.[2] Historically, the Department has attempted to regulate ESOPs informally through widespread investigations and lawsuits as part of its ESOP National Enforcement Project.[3]

ESOP Stock Purchase Transaction Process

Every ESOP transaction is different in terms of structure, timeline, and specific deal terms, though many transactions share certain characteristics. Here, we provide a broad overview of commonly observed steps in an ESOP deal.

When a company first forms an ESOP, the plan does not start with company stock or its own assets, so the ESOP will need to buy stock to start providing benefits (in the form of future stock allocations) to its employee participants. In a typical deal, the company will hire an independent trustee to represent the ESOP in the stock purchase transaction. The trustee will in turn hire advisors to assist the trustee in evaluating the proposed transaction. Trustees generally hire a financial advisor to perform an appraisal of the company and/or the stock that the ESOP is potentially buying. Trustees often also hire legal advisors to perform legal due diligence and assist with negotiating transaction terms.

Next, the trustee and its advisors will request financial and legal due diligence information from the company, such as historical financial statements, financial projections, key contracts and leases, and other information needed to appraise the company and its stock. It is fairly typical for trustee teams to conduct site visits of subject companies to meet management and raise diligence questions face to face.

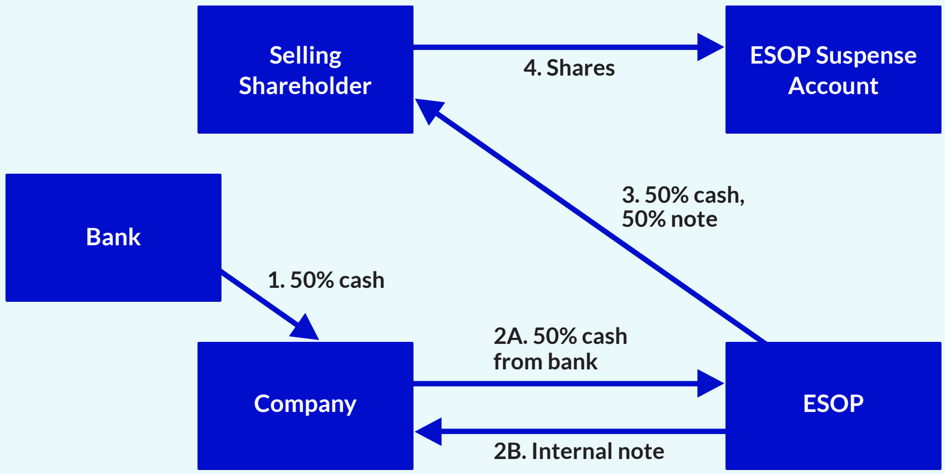
In a typical leveraged ESOP transaction, the sponsor company will loan the ESOP the funds necessary to buy company stock. The ESOP guarantees the loan by pledging the stock it is buying as collateral, for which shares are held in suspense while the loan is outstanding. The company will make annual contributions to the ESOP (which are tax deductible), and the ESOP then pays the same amount of the contribution back to the company as a payment on the loan. Each time the ESOP makes a loan payment, the ESOP releases a pro rata portion of the collateral shares from suspense and allocates the released shares to employee participants' individual accounts. This process gradually transfers ownership of the shares to the ESOP over the life of this loan, the terms of which control how quickly ownership is transferred. This "round tripping" loan (funds move from the employer to the ESOP and back to the employer again), is often referred to as the ESOP's "internal loan."

A company sponsoring an ESOP will often finance a leveraged transaction (e.g. obtain the money it will lend to the ESOP for the internal loan) with third-party debt — typically, loans from third-party lenders like banks, or notes that the company issues to the selling shareholder. For transactions involving unsecured, subordinated, or otherwise riskier debt requiring a higher rate of return, the company often offers lenders a type of synthetic equity called "warrants" in exchange for accepting a lower cash interest rate. In ESOP stock purchase transactions, warrants give their holders the right to receive in cash the amount that the company's stock value has risen above a set "strike price" at a given future date. If the company's stock value is not above the strike price when the warrant holder turns in his or her warrants, then the warrants are worth nothing. Such third-party loans are often referred to as the "outside" or "external" loan because it involves repayment to an external creditor.

ESOP transactions can be structured many different ways. One simple, two-step example is below.

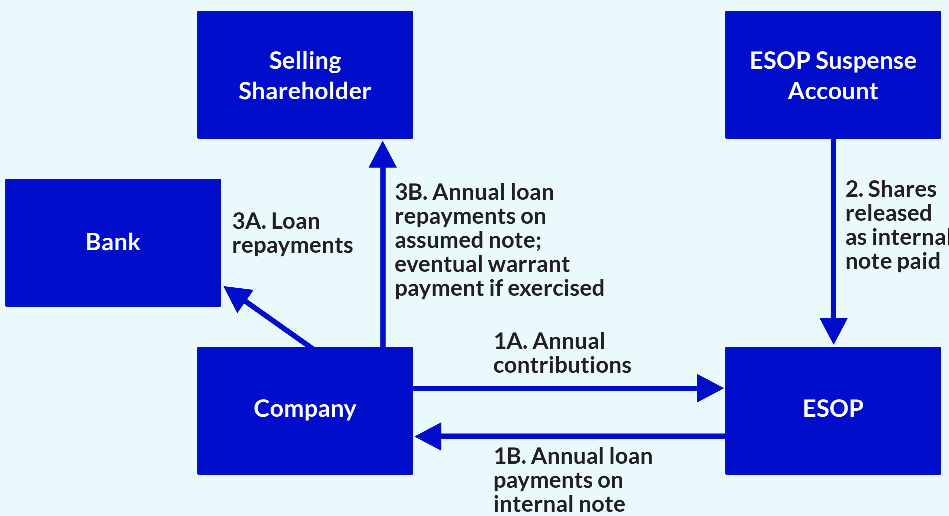
Step 1

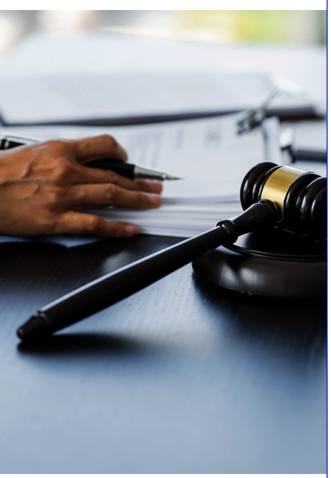
The company borrows 50% of the purchase price from an outside lender (e.g., bank) and lends it to the ESOP, which uses that money to pay the selling shareholder for stock. The ESOP issues a note to the selling shareholder for the other 50% of the purchase price.



Step 2 & Ongoing Amortization

The company assumes the note that the ESOP issued to the selling shareholder for 50% of the purchase price. Oftentimes, the company will add warrants to the assumed note to compensate the selling shareholder for the note's below market interest rate. The company annually contributes funds to the ESOP, which the ESOP uses to pay its debt to the company, releasing shares from suspense to participant accounts over time.





Litigation and Regulatory Risks Posed by Leveraged ESOP Transactions

While leveraged stock purchase transactions are of fundamental importance to ESOPs, they pose many litigation risks to trustees, selling shareholders, and ESOP sponsors.

Much of the risk and uncertainty stems from a lack of specific standards. As far back as 1974, Congress directed the Department to promulgate regulations to further define what “adequate consideration” means, and how an ESOP trustee can reasonably assure itself that a proposed ESOP transaction complies with ERISA. But the Department has yet to issue any final regulation. Back in 1988 the Department issued a proposed regulation on adequate consideration, but it was never finalized under the Administrative Procedures Act. Some courts and litigants consider the 1988 proposed regulation persuasive authority, but courts are not required to follow or give any weight to the proposed regulation. More recently, in the SECURE 2.0 Act of 2022, Congress renewed its direction to the Department to promulgate final regulations that provide guidance to trustees and the larger ESOP industry.[4]

In the waning days of the Biden Administration, the Department released a draft regulation, as well as a safe harbor provision covering certain types of transaction structures. But the Trump Administration withdrew them before they were published in the Federal Register. As of this writing, the Department currently plans to issue a new proposed regulation interpreting the adequate consideration standard in January 2026.[5]

Cases involving ESOP transactions often turn on whether a court believes an ESOP paid more than “fair market value” for company stock and, depending on the size of a challenged transaction, ESOP cases can present the specter of tens of millions of dollars in potential liability. In the absence of guidance from the Department, the ESOP industry has weathered decades of investigations brought by the Department and class action lawsuits brought by opportunistic plaintiffs’ firms seeking to exploit the ambiguity inherent in the broad statutory concept.

Several of the Department’s investigations have been resolved with “process agreements”: settlements that include provisions reflecting the Department’s preferences for how trustees are to consider and document ESOP stock purchase transactions. The Department has, in the past, pointed to these process agreements as guidance for the broader ESOP industry, even though they are not binding on anyone beyond the parties to the agreements.

The Department has also litigated some ESOP cases against ESOP trustees and selling shareholders, with mixed results. For instance, the Department prevailed after a sixteen-day trial in a case in the District of Arizona (*Su v. Bensen*). And the Department lost a trial in the District of Hawaii (*Walsh v. Bowers*). When the Department is not litigating directly, it has occasionally entered into information sharing arrangements with private plaintiffs’ firms that are suing ESOP trustees or selling shareholders. In at least one case (*Harrison v. Envision Management Holding, Inc. Board of Directors*), it came to light that the Department and the plaintiffs’ firm entered into a written “common interest agreement” to share information about the litigation, even though the Department was not formally involved in the case.

Plaintiffs in ESOP cases usually challenge stock purchase transactions by alleging that the ESOP paid too much for the employer’s stock. To support these allegations, plaintiffs will criticize the appraisal that the trustee received from its financial advisor, often with valuation expert opinion. Plaintiffs’ valuation experts frequently raise similar points, which include:

- Plaintiffs often allege that the trustee’s financial advisor relied on financial projections (which are typically provided by the sponsoring company’s management) that were too “rosy” and overstated how the company would be reasonably expected to perform in the future.
- Plaintiffs commonly claim that the ESOP paid for “control,” even though the ESOP did not actually acquire the ability to “control” the company after the stock purchase transaction (e.g. the ESOP purchased a minority interest or the selling shareholder retains some management control while seller notes are outstanding). Plaintiffs allege that the financial advisor should have applied a “discount for lack of control” or “minority discount” and arrived at a lower conclusion of fair market value.

- Plaintiffs also sometimes allege that the financial advisor either did not apply a "discount for lack of marketability," or applied a discount that was too low. Plaintiffs argue that there would be limitations on the ESOP's ability to sell company stock in the future, so the financial advisor should apply a significant discount that results in a lower fair market value conclusion.
- Plaintiffs have also challenged the use of warrants in ESOP deals, alleging that they dilute the value of the ESOP's ownership interest and that trustees should reduce the ESOP's purchase price by the value of any warrants.

Lawsuits involving ESOP transactions involve unique liability dynamics among the typical defense group. Because the independent trustee has the discretion to cause the ESOP to enter into the challenged transaction, Plaintiffs virtually always name the trustee as a defendant and target the prudence of its decision and decision-making process. But — despite engaging the independent trustee to insulate themselves from fiduciary liability — plaintiffs also often sue sponsor-side directors and management on the theory that they had a duty to monitor the trustee's performance, breached that duty to monitor by failing to ensure that the trustee acted prudently, and are therefore jointly and severally liable under ERISA for the trustee's breach.

Second Stage Stock Purchase Transactions

Some companies opt to create ESOPs that initially hold some amount less than 100% of the outstanding company stock, and over time the ESOP may buy additional stock in a "second stage transaction." These transactions may also be leveraged, and they present unique litigation risks.

As an example, an ESOP initially buys 40% of the sponsoring employer's stock when the ESOP is first formed. Ten years later, the ESOP buys an additional 40% of the employer's stock in a second leveraged transaction. After the transaction, the ESOP will continue allocating shares to employee participant accounts. But now there are two different groups of participants — those who had already received allocations of stock after the first purchase transaction, and those who will be receiving allocations in the future. The first group might allege that the second stage transaction harmed them, because the additional debt that the company took on to finance the second transaction would decrease the company's equity, and in turn decrease the fair market value of stock that the first group is holding.

Although not necessary, sometimes parties structure second stage transactions with "price protection" for certain existing shareholders that ensures the value of their stock will not fall as a result of the second stage transaction leverage. Whether to use price protection is not a straightforward decision. The tool effectively shifts the economic impact of the second stage transaction from one group of participants to another, which leads to a risk that at least some participants will bring suit alleging harm from the second transaction.

Conclusion

Leveraged ESOP transactions are necessary for ESOPs to be able to function and provide benefits to employee participants. But these transactions can present many thorny issues and risks to ESOP trustees and sellers alike. Stakeholders in the ESOP industry have been involved in a years-long effort to get meaningful guidance from the Department that will reasonably mitigate the risk of litigation — both from the Department and from a hyperactive plaintiffs' class action bar. That effort is ongoing. In the meantime, ESOP sponsors, fiduciaries, and selling shareholders must stay aware of the litigation risks associated with otherwise routine stock purchase transactions.

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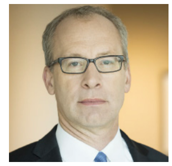
[1]Congress barred a broad swath of "prohibited transactions" in ERISA Section 406 – essentially, any transaction that involves the use of plan assets – unless the transaction fits into an exemption enumerated in ERISA Section 408. An ESOP's purchase of employer stock fits the definition of a prohibited transaction unless the transaction is for no more than "adequate consideration." The exemption is flipped – no less than "adequate consideration" – in the context of an ESOP stock sale transaction.
[2]Secure 2.0 Act of 2022, Section 346.
[3]See U.S. Department of Labor, Enforcement, available at https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/enforcement.
[4]Secure 2.0 Act of 2022, Section 346(c)(4)(B).
[5]Office of Information and Regulatory Affairs, Office of Management and Budget, Reginfo.gov, available at https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=202504&RIN=1210-AC20.



Fiduciary Leader
Alison L. Martin
Senior Vice President and Fiduciary Product Manager
Chubb

Alison L. Martin is a Senior Vice President and the Fiduciary Product Manager for Chubb Insurance's North American Financial Lines, where she is responsible for crafting Fiduciary Liability Insurance for all varieties of organizations, including publicly traded and privately held companies, not for profit companies and multiemployer plans. She has over 25 years of experience in underwriting Fiduciary Liability Insurance and handling ERISA class actions. Prior to joining Chubb, Alison was a trial lawyer and a Member of the Board of Governors for the Western Pennsylvania Trial Lawyers Association. As Chubb's Fiduciary Product Manager, she speaks extensively at events, educating people on fiduciary obligations and exposures and transferring risk for these exposures through the use of fiduciary liability insurance.

Author
Lars Golumbic
Principal, Litigation Co-Chair
Groom Law Group

Lars Golumbic serves as the co-chair of the Groom Law Group Litigation group. His ERISA litigation practice includes the defense of "excessive fee" and ESOP class actions brought against plan sponsors, fiduciaries, and service providers. Lars also represents health plan sponsors and health insurers in actions brought under the Mental Health Parity and Addiction Equity Act. Additionally, Lars defends plan trustees, fiduciaries, companies and their board members, and service providers in Department of Labor investigations and enforcement proceedings instituted by the federal agency. He has appeared in dozens of federal courts across the country as part of his active ERISA litigation practice.

While the focus of Lars' national practice is in ERISA litigation, Lars also represents plan fiduciaries and other stakeholders in matters concerning plan funding, restructuring, withdrawal liability, and plan termination.

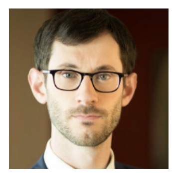
Lars serves as a member of the Groom Law Group Executive Committee.

Author
Andrew Salek-Raham
Principal, Litigation Practice Leader
Groom Law Group

Andrew specializes in the defense of ERISA class action lawsuits and U.S. Department of Labor enforcement actions. More specifically, Andrew frequently represents plan fiduciaries, plan service providers, plan sponsors, and directors and officers in lawsuits involving employee stock ownership plans, particularly "overvaluation" suits, and other defined contribution plans, including fee and imprudent fund selection suits. His experience spans all phases of federal litigation, including motions practice, class certification, discovery, mediation, and trial.

In addition to his litigation practice, Andrew represents clients involved in U.S. Department of Labor retirement plan investigations.

While in law school, Andrew was a summer associate at Groom and an intern in the Virginia Attorney General's Office. Andrew was a teacher in Houston, Texas, through Teach for America before attending law school.



Author
Paul Rinefierd
Senior Counsel
Groom Law Group

Paul Rinefierd's practice includes federal litigation as well as representation in federal agency investigations.

Paul focuses on substantive issues raised in several burgeoning areas of ERISA litigation, assisting with defending religiously-affiliated hospital systems in class actions challenging the ERISA/Tax Code church plan exemption. He is also involved in litigation related to the reasonableness of investment options and related fees in 401(k) plans. In addition, he has analyzed the sufficiency of pleadings in several cases involving the nondiscrimination provision of the Affordable Care Act.

Paul has experience navigating clients through responding to subpoenas and more informal document requests from federal agencies, in particular the Department of Labor. Paul has represented a variety of entities at multiple stages of agency investigations, from collecting and producing documents to responding to agency findings.

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