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The DOL and ESOP Trustees – There’s No Love Lost

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If you eavesdrop on any conversation between an ESOP-experienced ERISA attorney and an ESOP trustee, you’ll likely hear this question: “When do you think the DOL will let up?” The truth is that the end is not in sight. For most of the last decade, the DOL has outpaced ESOP participants to the courthouse.



In this environment, what is an ESOP trustee to do? Many ESOP experts will tell you that understanding the recent court judgments and settlement agreements is the most important next step. These documents are where an ESOP trustee will find nitty-gritty guidance regarding the ERISA fiduciary process that the DOL apparently expects of ESOP trustees. Never mind that these judgments and agreements are supposed to bind only the DOL and the particular ESOP trustee involved. Never mind that this same guidance cannot be found in applicable regulations. ESOP trustees and attorneys report that in recent DOL audits, trustees have even been asked whether their process follows the “GreatBanc Agreement.” In effect, the DOL is regulating via litigation and investigation.

What’s in the DOL settlement agreements?

Since the DOL and GreatBanc Trust Company disclosed their settlement agreement in the summer of 2014,

other agreements have followed, each adding their own wrinkles. The DOL’s public disclosure of these agreements illustrates the fiduciary processes it expects of ESOP trustees not only in a transaction setting but also in annual valuations conducted in routine plan administration.

The protocols outlined by these agreements show that the DOL expects ESOP fiduciaries to conduct rigorous due diligence and to document their discussions and decisions on (1) the valuation advisor’s independence, (2) the evaluation and selection of the valuation advisor, and (3) their review of the valuation report. While the categories are broad, the requirements outlined are detailed. And it is these detailed requirements that are causing ESOP trustees and advisors to significantly change their practices.

Required independence of the valuation advisor

The agreements establish requirements to ensure the independence of the valuation advisor and prohibit an ESOP trustee’s use of a valuation advisor who previously worked for any party to the transaction other than the ESOP or the trustee. The prohibited work includes preliminary valuations for a company thinking about establishing an ESOP. ESOP trustees must now document a detailed fiduciary due diligence process to evaluate not only the qualifications of the valuation advisors but also the trustee’s history and the history of every party to the transaction to demonstrate that there are no conflicts of interest.

Documenting the evaluation and selection of the valuation advisor

The agreements set out requirements for a formal, documented due diligence process for evaluating and selecting the valuation advisor, including production of a detailed written report of how a particular valuation advisor was chosen stating their qualifications, references, any criminal history, other advisors

considered, and other factors relevant to the selection of the advisor. In addition, the DOL requires repeating the valuation advisor selection process with a subsequent transaction affecting the ESOP without specifying a rationale for the requirement other than the passage of time. Thus through these settlement agreements, the DOL has attempted to establish standards for selecting a valuation advisor. Some standards, however, like the intervals between the repetitions of the selection process, are not consistent among the agreements and create only confusion.

The valuation report and detailed review

With respect to the ESOP trustee's oversight of the valuation itself, the agreements contain long lists of reporting and disclosure requirements for any valuation report relied upon by an ESOP trustee. Highlights of the lists include:

- Documentation of projection calculations,
- Descriptions of how the plan provisions and eligible plan population affect the repurchase obligation,
- Descriptions of risks to an ESOP sponsor's financial performance,
- Analysis of any loans in comparison to recent loans given to executives, and
- Identification of any conflicts of interest.

It is arguable that the reporting and disclosure requirements within a valuation report are already standard practice for ESOP valuation advisors. Additionally, the DOL wants to see that ESOP trustees are challenging the assumptions used and the resulting projections to make sure they are solid, which means documenting their thorough review and understanding of the report. This may be a big challenge for a small business leader who does not have the background, much less the time to properly review and challenge the report according to the DOL standards.

The bottom line is that ESOP trustees must not only hire competent valuation advisors, they must also challenge their valuation reports. The DOL expects to see an ESOP trustee engage with the valuation report and advisor

and to document that engagement. Such engagement lengthens the timeline for an ESOP transaction or a routine annual valuation with a compliant report which may limit the ESOP trustee's choice of a valuation advisor. All of these factors will likely raise the costs of the transaction and the valuation due to the significant additional work required.

The DOL's actions will likely result in fewer valuation advisor options for ESOP trustees, higher costs, and—ultimately—a decline in employee ownership. That's a shame for good companies that want to transition ownership to their employees while providing them with retirement benefits at the same time.

Recommended action steps for ESOP trustees

If you haven't already done so, revisit the qualifications of your valuation advisor and assess their compliance with the DOL's standards for ESOP trustees. Engaging a peer consultant to review the valuation reports and your advisor's level of compliance is an effective way to verify your advisor's qualifications.

Regularly audit your processes as a trustee to uncover any gaps in your own compliance with the DOL's standards that you need to address.

Questions? To assist you with meeting the DOL's requirements for ESOP trustees, contact the Findley consultant you normally work with, or contact Sheila Ninneman at sheila.ninneman@findley.com, 216.875.1927.