The DOL's Latest Move

On June 2, 2014 GreatBanc Trust Company and the Department of Labor entered into a monetary settlement agreement in the case of Perez v. GreatBanc Trust Company, United States District Court for the Central District of California, 2014. In addition to the monetary settlement, GreatBanc and the DOL agreed to a set of policies and procedures ("Process Requirements") that GreatBanc must follow in the future when it is engaged to purchase or sell employer securities that are not publicly traded (see PDF.) What are the new Process Requirements?

First, for GreatBanc, it has made a written commitment to DOL to follow these Process Requirements. If GreatBanc fails to follow these procedures in the future, it presumably would be subject to some enforcement action from DOL. However, the Process Requirements are not a consent decree.

Second, for all other ERISA trustees, the Process Requirements do not create any direct obligation. The Process Requirements are not: (i) an amendment to the law (ERISA), (ii) a DOL regulation, (iii) a DOL advisory opinion, or (iv) a DOL Field Assistance Bulletin. That means, for example, the DOL could not cite these as legal authority or introduce the Process Requirements in court and ask a judge to find a trustee in violation of the Process Requirements.

Perhaps the best way to think about the Process Requirements is to consider them an insight into what the DOL expects of an ESOP Trustee when it is evaluating a purchase or sale of employer securities. Certainly, the DOL's press release makes clear it is expecting fiduciaries to adhere to these procedures. However, there are requirements created here for which the DOL has no statutory or even regulatory authority. For that reason, other trustees will need to decide whether to fully comply or perhaps modify the Process Requirements.

We have reviewed the Process Requirements and believe they can be sorted into three categories: (i) procedures which create new, substantive requirements that are likely to materially impact a trustee's business model and ways of doing business, (ii) procedures that require more extensive documentation of matters already covered in most valuation reports or trustee records, and (iii) procedures we believe most trustees currently follow and for which no new work will be required.

We have focused on matters in the first category and provide below a description of these items and then some observations about particular effects of the requirements:

I. New Material Requirements or Changes:

A. Paragraph B of the Process Requirements prohibits the use of a valuation advisor who has ever performed work for:

1. The plan sponsor;
2. The seller (if the ESOP is a buyer), or buyer (if the ESOP is a seller);
3. The investment bank or other consultant who is structuring the transaction.

Observation: As applied to GreatBanc, this would prohibit the trustee's use of an appraiser who provided a preliminary valuation to a committee of a "to-be-formed-ESOP." It would also prohibit the trustee's use of an appraiser who had provided gift tax valuations to the seller in the past. As written, this limitation has no time limit. Notwithstanding this broad statement, a prudent trustee may conclude enough time has passed or other developments have occurred that make it prudent to select that appraiser. The fact that an investment banker recommends the same appraiser for more than one of its transactions would not be a conflict violation. However, the trustee would need to document that it created and followed a process to select the appraiser, rather than simply accepting a recommendation from the investment banker.

B. Paragraph D.2. requires either the trustee or the appraiser to provide a written opinion as to the reasonableness of the projections used by the appraiser. This written opinion cannot be conclusory. It must contain the reasons why the trustee or appraiser is concluding the projections are reasonable, and must specifically address a number of items listed in the Process Requirements.

Observation: The financial services industry has never provided opinions on the reasonableness of projections for obvious reasons. Presumably, this will fall to the trustees. Of course, many trustees have always believed they could not rely on projections unless they believed the projections were reasonable in nature. The DOL did not require GreatBanc to obtain a "quality of earnings" report, which some had heard was a goal of DOL. This makes sense, as a quality of earnings report addresses historical earnings, not projections.

C. Paragraph D.8. directs GreatBanc to consider (i) plan provisions regarding benefit distributions, (ii) the duration of the ESOP loan, and (iii) the age and tenure of the ESOP participants. GreatBanc is then required to consider how these three items might affect: (i) repurchase liability, (ii) prudence of a stock purchase, or (iii) the fair market value of the stock purchased.

    Observations: Trustees have often considered projected repurchase liability in evaluating the prudence of a transaction. However, it is possible the DOL is suggesting that a company with an older work force, or one that provides accelerated payout of benefit distributions, might be worth less because its obligation to repurchase shares may arise sooner than for another company. That would seem to violate the fair market value definition of Rev. Rul. 59-60 and subsequent DOL positions.

D. Paragraph D.9. requires the inclusion of a number of financial fairness considerations that the appraiser must consider. These items are standard in a well written fairness opinion used in a complex transaction. However, these factors may not be relevant in a simple minority interest purchase transaction.

    Observation: Would a trustee be required to incur the expense of a financial fairness opinion in a transaction in which there are no material fairness issues to be addressed?

E. Paragraph E. addresses financial statements. It requires the trustee to seek <u>audited</u> financial statements for the 5 previous fiscal years. It is worded in a way that almost creates a presumption that it is unreasonable to rely on unaudited financial statements, but allows the trustee to rely on unaudited statements if the trustee determines such reliance is reasonable and carefully documents its reasoning. Even if a plan sponsor has 5 years of audited financials, the Process Requirements make clear that any unaudited financial statements for any gap period between the date of the last audit and the transaction date are subject to the same “presumption against reasonableness” that the trustee will need to overcome.

> **Observations:** Trustees have always had a preference for audited financial statements and have had to consider the risks associated with moving ahead without them. The Process Requirements do not prohibit the trustee from engaging in a transaction without audited financial statements.

F. Paragraph G seems to create a new “Trustee Report” that will constitute an analysis of the Valuation Report. There are 16 specific items that are required to be documented. For each of the 16, the trustee must state its conclusion and then document its reasoning.

> **Observation:** While we do not know exactly what the DOL will require of GreatBanc in this Trustee Report, it appears to us the Trustee Report may be as extensive, and as detailed, as some Valuation Reports.

G. Paragraph H.2. requires the documentation of the Trustee’s evaluation of the Valuation Report to include disclosure of material points on which personnel disagreed and why, as well as stating whether any personnel ever expressed the view that information provided was inconsistent.

> **Observation:** It is pretty easy to see how this requirement will actually discourage, rather than encourage, critical assessment of the valuation report. Trustees should adopt a documentation approach that balances the need for an open discussion of concerns with the desire to create complete documentation. Plaintiff’s firms would be delighted to see documentation of disagreements among members of a fiduciary committee.

H. Paragraph I.3. requires the preservation of all notes of all consideration of the proposed transaction. This would seem to be in conflict with the practice that at least at formal meetings, all attendees agree that the approved minutes speak for everyone as an accurate summary of the meeting.

Observations: If trustees violate basic governance practice by following the Process Requirements on this point, committee members may have conflicting notes on matters that were ultimately resolved to everyone's satisfaction that may undermine the credibility of the approved minutes of the meeting.

I. Paragraph J prohibits the discounting of an ESOP promissory note in determining whether the ESOP has met the fair market value test of the adequate consideration requirement. As this is a somewhat unusual approach, this may be of no consequence to trustees.

Observations: This seems to be a rare practice and the prohibition will not materially change practices. It is interesting to note that the short reference to this point in the Process Requirements is the only item in the 11 page document that is even relevant to the DOL arguments made in the case that was the subject of this settlement.

J. Paragraph K directs GreatBanc to consider negotiating for a claw-back or other purchase price reduction in the event of "significant corporate events" or "changed circumstances." The DOL in the past has refused to provide guidance on whether such arrangements are themselves prohibited transactions.

Observation: It is difficult to know the scope of what might be permissible in this area. Unfortunately, the use of the term "changed circumstances" reveals that the DOL views itself as free to apply 20/20 hindsight to second guess fiduciaries in a manner not permitted under ERISA. ERISA is designed to judge fiduciary actions by what was known at the time the decision was made, not by what changes become evident after the fact.