ESOP Report

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Board of Directors Enacts Important Changes to TEA Governance Structure

Structure Is Streamlined, Functions Added to Provide New Ways for Members to Contribute to Association's Public Policy Initiatives

Like almost anything, an association's governance structure periodically needs to be checked to ensure it is operating effectively and continues to meet the evolving demands of an ever-changing world. With that in mind, last fall the Board of Directors convened a special committee and tasked it with reviewing The ESOP Association's governance structure and providing recommendations for improvements, if needed.

The committee includes past and current board members who are intimately familiar with TEA's governance structure, and whose names will be familiar to many. The group is chaired by Dave Fitz-Gerald, immediate past Chair of TEA's board, and includes current Board Chair Gary Shorman, Former Chair of the Professional Advisory Committees Lynn Dubois, Secretary/Treasurer Karen Ellis, and Corporate Member At-Large Derrick Vick.

Like the Board of Directors itself, the committee includes both corporate and professional members.

In its review, the committee quickly noted two fundamental aspects of TEA's governance:

1. It has long lacked a comprehensive structure that enables both corporate and professional members to provide input on public policy direction and initiatives.

2. It has long included both a Board of Directors and a Board of Governors. This is an unusual structure that was carried over from the 1970s, when TEA was formed by the merger of two separate entities with two separate boards.

After conducting a thorough review and considering modern governance best practices, the committee determined that TEA's governance structure needed to evolve, and the committee recommended several important modifications.

The committee's recommendations were brought before the full board, which approved them unanimously. Those

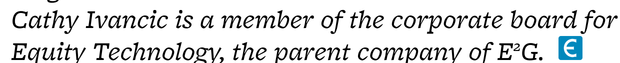
happened during 2020 when Equity's employee owners experienced the unexpected death of a wonderful friend and co-worker.

Employee owners asked the family how they could best remember their beloved co-worker. Because he was an outdoor enthusiast, the company adopted an acre in the Cuyahoga Valley National Park.

"When we are able to be together again in person, we plan on bringing employee owners together in this beautiful location," said Riley.

Action, Not Talk

Equity Engineering Group has grown its business in part because of its commitment to its core beliefs. The stories Riley shared show that the company did more than just talk about its beliefs; they found new and innovative ways to preserve the human connections that are needed to strengthen those core beliefs.



Cathy Ivancic is a member of the corporate board for Equity Technology, the parent company of E^{2}G.

Legal Update

Arbitration Clause Lessons

By Mike Scheier, Partner, Keating Muething & Klekamp
Reviewed by Julie Govreau, Senior Vice President and General Counsel, GreatBanc Trust Company

On March 4, 2021 the United States Court of Appeals for the Second Circuit reversed a district court opinion compelling arbitration of a breach of ERISA fiduciary duty lawsuit against a third party investment manager of a 401(k) profit sharing fund (*Cooper v. Ruane Cunnif & Goldfarb, Inc.*, No. 17-2805, 2d Cir. Mar. 4, 2021).

In holding that the specific arbitration clause did not encompass the plaintiff-participant's breach of fiduciary duty claims, the Second Circuit provides plan sponsors and trustees with guidance on best practices for increasing the likelihood a court will enforce an arbitration/class action waiver plan provision in a representative ERISA section 502(a)(2) lawsuit.

The Second Circuit Case

As a condition of employment, plan sponsor DST required employees to enroll in an ERISA-regulated 401(k) profit-sharing plan. The plan included a profit-sharing account (PSA). Employee participation in the PSA was mandatory, and all participants were bound to keep PSA assets in a fund managed by the defendant, Ruane Cunniff & Goldfarb, Inc.

As required by ERISA section 102(a), the plan provided employees with a summary plan description (SPD). The SPD stated that if Ruane breached its fiduciary duties, "you may file suit in a federal court." The SPD did not mention arbitration.

When the plaintiff-participant became a DST employee in 2008, he received a copy of DST's employee handbook. The handbook contained an arbitration clause stating that "all legal claims arising out of or relating to employment, application for employment, or termination of employment, except for claims specifically excluded under the terms" were subject to arbitration.

The excluded claims included those for ERISA-related benefits under the plan. The plaintiff signed an acknowledgment that he agreed to be bound by the arbitration clause if he did not opt out in writing within 30 days. He did not opt out.

Ruane was the PSA's asset manager and did not dispute its fiduciary status. Under Ruane's management, almost 30% of the plan's total assets were invested in shares of a pharmaceutical company. Between 2014 and 2016, the share value dropped significantly, reducing the value of PSA's holdings from a 52-week high of $414.7 million to $97 million. The plaintiff's lawsuit followed in March 2016.

> ***On appeal, the Second Circuit found that the arbitration clause did not apply to the plaintiff's breach of fiduciary duty claims.***

The plaintiff brought the lawsuit on behalf of the plan, pursuant to ERISA section 502(a)(2), and seeking redress for, among other things, Ruane's breach of ERISA section 404 fiduciary duties and relief under ERISA section 409. The plaintiff alleged that Ruane breached its fiduciary duty to the plan and its participants through poor management and imprudent investment of plan assets.

Ruane moved to compel arbitration based on the DST employee handbook, arguing that the plaintiff's claims were "related to" his employment and therefore governed by the arbitration clause. The district court granted the motion.

On appeal, the Second Circuit found that the arbitration clause did not apply to the plaintiff's breach of fiduciary duty claims. In interpreting the phrase "relating to employment" as used in the arbitration clause, the Second Circuit determined the plaintiff's claims fell outside the scope of the provision. The nexus between the claims for breach of fiduciary duty under ERISA and the plaintiff's

occupation were, according to the court, insufficient to require arbitration.

The interpretation of the phrase "relating to employment" was the crux of the decision. The court found that the substance of the plaintiff's claim was unrelated to his work performance at DST, and the breach of fiduciary duty claims were not unique to the plaintiff.

The court relied in part on a Ninth Circuit False Claims Act case holding that "in the context of an employment arbitration agreement, a claim will 'relate to' employment only if the merits of that claim involve facts particular to an individual plaintiff's own employment." While the court acknowledged the plaintiff's stake in the plan was compensation for employment, it stated this was not a sufficient connection to transform plan wide ERISA prudence claims against a fiduciary into a claim "relating to" individual employment.

The court also reasoned that non-DST employees—such as outside plan fiduciaries, beneficiaries, or the Department of Labor—could have brought claims that were identical to the plaintiff's claims in federal court under section 502(a)(2). The court determined this bolstered its view that the ERISA breach of fiduciary duty claims brought on behalf of the plan under section 502(a)(2) are of a different nature than claims "relating to employment" or the specifically excluded section 502(a)(1)(B) individualized benefits claim.

The SPD reference to a participant's ability to bring a claim against plan fiduciaries in federal court also played a part in the court's reasoning.

This decision rested solely on linguistic interpretation of a contractual arbitration clause, and admittedly did not address the enforceability of an arbitration clause specifically applicable to claims brought in a representative capacity under section 502(a)(2).

Even so, the court hinted that an arbitration clause curtailing a participant's statutory right to bring a representative action may raise enforceability issues under the Supreme Court's decision in *American Express Co. v. Italian Colors Restaurant, et al.* (570 U.S. 228, 236, 2013). (This case suggested that an arbitration clause that prevents "effective vindication" of a statutory right may be invalid.)

This is because the Second Circuit decision in *Coan v. Kaufman,* (457 F.3d 250, 261, 2d Cir. 2006) requires that a representative action under section 502(a)(2) include procedural safeguards like those in Federal Rule 23 class actions, which the arbitration clause prohibits. As a result, a participant faces a Catch-22: an arbitration challenging fiduciary conduct under ERISA sections 502(a)(2) and 409 must have *Coan* safeguards, but this would result in dismissal of the arbitration since that would violate the arbitration clause's prohibition of collective actions.

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The court suggested, without deciding, that the arbitration clause would therefore prohibit “effective vindication” of the statutory right Congress provided to participants in section 502.

Conclusions

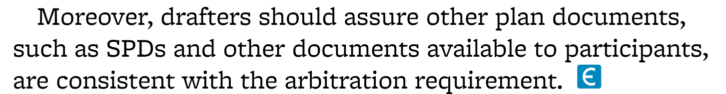
In *Cooper*, the Second Circuit panel left for another day whether arbitration clauses applicable to section 502(a)(2) participant claims for redress under section 409 are enforceable in federal courts within its jurisdiction (which includes New York, Connecticut, and Vermont). The court did, however, express skepticism in that regard.

That skepticism is noteworthy because courts in the Third, Fourth and Fifth Circuits have adopted the *Coan* rationale, indicating that defending arbitration clauses may be an uphill battle. For more information, see *Dorman v. Charles Schwab Corp.* (934 F.3d 1107, 9th Cir. 2019), which held an arbitration/class action waiver clause enforceable to compel individual arbitration of a section 502(a)(2) representative claim.

Even so, the *Cooper* decision has limited relevance in the larger enforceability question working its way through the federal appellate courts.

Cooper does, however, provide important guidance to plan sponsors and fiduciaries like trustees: If an enforceable arbitration clause is the goal, do not rely on general, employment related arbitration provisions. (See also *Simon v. Pfizer Inc.*, 398 F.3d 765 (6th Cir. 2005), which offered a similar holding to *Cooper* applicable to claims in Ohio, Kentucky, Michigan and Tennessee.)

Moreover, drafters should assure other plan documents, such as SPDs and other documents available to participants, are consistent with the arbitration requirement.



TEA Publishes New Issue Brief on Control Premiums in ESOP Valuations

Brief Offers Key Insights on a Timely Challenge

By Tim Lee, Managing Director, Mercer Capital; Jeff Tarbell, Director, Houlihan Lokey; Chuck Coyne, Managing Director, Empire Valuation Consultants LLC

The ESOP community has been deluged with valuation issues underscored in numerous publicly disclosed DOL Fiduciary Process Agreements, dating from 2014 to the present. One recurring issue is the value of ownership control acquired and held by an ESOP.

Conventionally, the value of a controlling ownership position in a business generally is more valuable than a minority position. The value of control and the use of control premiums have been debated over the years, resulting in guidance from various valuation-centric professional bodies.

The operative question for ESOP stakeholders is this: When and how should the value of control be considered and quantified in ESOP transactions and valuations? Recognizing the need for updated guidance on the value of control, The ESOP Association has just released Issue Brief #24.

This article summarizes the primary takeaways from that new Issue Brief.

Control Premiums: Past and Present

Under longstanding practice, a premium for control has been used by some valuation practitioners as a discrete adjustment to transform an initial non-control valuation into a control valuation. The quantification and application of control premiums are complex and fact dependent. Control premiums remain a point of contention for the DOL and for private plaintiffs concerning allegations of prohibited transactions under ERISA, where an ESOP has allegedly paid more than fair market value for an ownership position.

ESOP BRIEF #24

The Value of Control in ESOP Transactions & Plan Year Valuations

Valuation practitioners have long recognized that a controlling ownership position in a business entity is generally more valuable than a non-controlling ownership position. In fact, data from public merger and acquisition (M&A) transactions supports the notion that the ability of a control owner to influence certain aspects of a business entity may enhance the value of the owner's interests by increasing the owner's expected cash flows or decreasing the perceived risk of those cash flows.

In order for an appraisal to capture the increased value of a controlling ownership interest, many valuation practitioners adopt the convention of quantifying an increment of value commonly referred to as the *control premium*. The control premium may be added to an indication of value that otherwise does not adequately reflect the value of the owner's prerogatives of control. Application of a control premium is a topic of discussion—and occasional dispute—in numerous business valuation disciplines including, but in no way limited to, ESOP appraisals and fairness opinions.

Collectively, virtually all disciplines under the broader business valuation umbrella recognize reasonable quantification and substantiation of valuation premiums and discounts such as the control premium. In the ESOP context, the Department of Labor (DOL) and private-party plaintiffs have increasingly challenged the notion of control—and the valuation procedures used to quantify control—in ESOP transactions and valuations. The practice of applying an explicit control premium adjustment has been repeatedly challenged by the DOL and others. Common critiques of the explicit control premium adjustment include: (1) a control premium is appropriate only if the ESOP obtains particular indicia of control, namely the ability to appoint the majority of a company's board of directors; (2) a control premium is inappropriate if any aspect of control was captured in the initial valuation by means of valuation assumptions, including assumptions related to the cash flows; and (3) a control premium is inappropriate if a “real-world buyer,” such as a private-equity buyer, would not have paid for the specific attributes of control that the ESOP may have obtained.

The application of a control premium in connection with an ESOP stock transaction is also addressed in the growing number of fiduciary process agreements between the DOL and certain trustees. Also, the ongoing questions about control adjustments have garnered attention from the collective leadership of The ESOP Association's advisory committees. While the use and application of an explicit control premium adjustment for ESOP-related transaction and plan year valuation purposes is not *per se* improper, developments and concerns on the topic of control require a thorough understanding of financial control, as well as the methods by which control (or the lack thereof) is ascertained by valuation professionals. The ESOP Association and its advisory committees respectfully offer this Issue Brief with the goal of providing summary guidance and perspective to those in the ESOP community. This Issue Brief offers a synopsis of considerations about control premiums and trends in best practices for considering and valuing control in ESOP transactions and ESOP valuations.

Foundation and Background

ESOPs are governed by the Employee Retirement Income Security Act of 1974 (ERISA), which addresses an ESOP's purchase, sale, and valuation of closely held stock held by ESOPs. ERISA requires that ESOP appraisals in connection with transactions or annual administrative valuations be performed on a *fair market value* basis. Any discussion of control in connection with ESOPs—and any scrutiny of an ESOP transaction to determine if a control premium is being reasonably applied, must give due consideration to the fair market value standard of value required under ERISA.

The term *control* requires careful consideration of the context in which the term is used. In the context of an appraisal, the initial value estimate resulting from the use of various approaches and methods is commonly referred to a *control value* or a *non-control value*. The initial estimate of value may not have adequately accounted for all of the various prerogatives of control (or lack thereof), despite the terminology used to characterize that value.

The term *control premium* also may be subject to different meanings depending on the context in which the term is used. A control premium is commonly defined as “An amount or a percentage by which the pro rata value of a controlling interest exceeds the pro rata value of a non-

Historically, support for the existence and magnitude of control premiums has been cited from publications that document the valuation differences of acquired businesses on a pre-merger and post-merger basis. However, the use of discrete control premiums has evolved towards the analysis of the cash flows and other potential benefits the business is expected to achieve in connection with the ESOP transaction. Such items are the