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CHUBB'S ESOP SERIES

2nd Installment

Understanding Mature Employee Stock Option Plans (“ESOP”) and Sustainability Challenges

Authored by Groom Law Group:

Lars Golumbic, Litigation Co-Chair

Andrew Salek-Raham, Practice Leader

Larry Blocho, Associate

ESOP Sustainability Issues

In our [first article addressing ESOP litigation risks](#), we discussed common themes in lawsuits challenging ESOP stock purchase and sale transactions. While transaction-related litigation has historically been the most common form of litigation risk for ESOP sponsors and fiduciaries, the number of lawsuits contesting decisions about post-formation ESOP administration has grown significantly in recent years. This article describes the challenges that ESOP sponsors and fiduciaries face when managing ESOPs for the long-term and provides a preview of the litigation risks concerning these “sustainability” issues.



The Repurchase Obligation

Eligible ESOP participants receive shares of company stock annually based on a formula commonly tied to participants' salaries. Over time, the value of a participant's ESOP account changes based on, among other things, the number of shares allocated to their account, the number of shares outstanding, and the value of the company's stock. When a participant separates from employment or retires, federal law requires the ESOP sponsor to buy back the participant's shares — often called the company's “repurchase obligation.”

A sponsor company must monitor and plan for its repurchase obligation as its ESOP matures. Usually, the repurchase obligation is stable, predictable, and easily satisfied in the years shortly after an ESOP is established. But the repurchase obligation can present challenges as an ESOP matures and account values rise.

For example, as shares are allocated to participant accounts based on compensation, a small number of highly compensated, long-term employees may accrue a large percentage of shares increasing in value annually. In some circumstances, this looming, concentrated, sizeable repurchase obligation is a liability that can threaten to disrupt the company's operations — or even its solvency — should a number of these employees decide to retire or otherwise separate from the company around the same time.

This threat is not merely hypothetical. In *Fish v. GreatBanc Trust Company*, for example, an ESOP established in 1979 faced this precise problem two decades later:

Antioch experienced substantial and prolonged growth in the late 1990s and early 2000s. . . . Along with [the company's] explosive sales growth . . . came a similar rise in share price and number of employees participating in the ESOP. As the share price and number of employees grew, the repurchase obligation grew with it. . . . By 2002, 38 ESOP participants had balances over \$1 million and an additional 28 had balances over \$500,000. Ten percent of the

participants held 80 percent of the ESOP value. . . . [The company's officers] worried about "the cash flow implications of 'big' retirements" . . . [because] there was a possibility that a substantial amount of participants might leave at once, causing a "run on the bank."¹

The concern raised by the company's officers became reality just two years later, as a dramatic increase in the company's per-share value caused a "run" on the ESOP that led to the company's bankruptcy – and a roughly \$60 million loss to the remaining employee-participants left holding worthless shares.²



Managing the Repurchase Obligation

ESOP sponsors must prudently manage their repurchase obligation to ensure that participants are paid when their employment ends and that the sponsor company remains a viable source of wage and retirement income for current and future employee-participants.

ESOP sponsors can retain advisors to help. Certain advisors can conduct a repurchase obligation study to measure the company's current repurchase obligation and predict its future liability. Sponsors can also engage advisors to conduct a sustainability study, which typically includes a repurchase obligation study as a component and also models potential strategies for managing the repurchase obligation. There are a number of available strategies that can be used alone or in conjunction with each other. Some common initial strategies include "recycling" and "redeeming and retiring" shares.

¹*Fish v. GreatBanc Tr. Co.*, No. 1:09-cv-1668, 2016 WL 5923448, at *3, 17-18 (N.D. Ill. Sept. 1, 2016).

²*Fish v. GreatBanc Trust Co.*, 749 F.3d 671, 677 (7th Cir. 2014).

Managing the Repurchase Obligation, continued



Recycling. When a company recycles shares, it repurchases shares from separating or retiring ESOP participants and immediately allocates them to current participants' accounts. Recycling shares allows current participants to receive annual allocations of stock, maintains the same number of shares within the ESOP, and ensures that share value growth is consistent with the company's equity value growth. However, recycled shares are reallocated based on existing share account balances, so participants with larger account balances (i.e., longer-tenured, highly compensated employees) receive

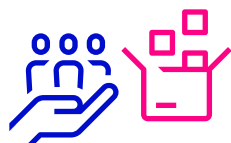
a greater percentage of the recycled shares than participants with smaller account balances (i.e., new and/or lower-compensated employees). Accordingly, over time, recycling shares can create large disparities among employee-participant accounts — or amplify existing disparities — and ultimately lead to higher repurchase obligations. Recycling also necessarily reduces the value of existing ESOP accounts by depleting company assets (to buy out participants) while also leaving the repurchased shares issued and outstanding.



Redeeming & Retiring. When a company redeems-and-retires, it repurchases shares from former ESOP participants and takes them out of circulation (i.e., does not reallocate them to current participant accounts). Redeeming and retiring shares can help maintain steady share value growth and increases an individual employee-participant's ownership percentage over time. However, it can also lead to skyrocketing account balances primarily driven by the shrinking pool of available shares rather than the company's growth. In other words, the growth in per-share value is not entirely caused by organic earnings growth, but in part because the company's total value is distributed across increasingly fewer shares. Redeeming shares also necessarily reduces the pool of shares available to allocate to new and future employee-participants.

Because recycling and/or redeeming and retiring shares can adversely affect share distribution (by concentrating ESOP shares in the hands of fewer participants), as well as significantly increase the company's forecasted repurchase obligations over time, ESOP sponsors may choose to use one or more tools — like “releveraging” transactions, “account segregation,” and extended distribution schedules — to address these effects.

Managing the Repurchase Obligation, continued



Releveraging. When a company enters into a releveraging transaction, it redeems shares from former ESOP participants and then, rather than retiring them, sells them back to the ESOP. Much like an initial ESOP stock purchase, the ESOP borrows funds from the company to finance its purchase. The repurchased shares are held in a suspense account and allocated to employee-participants as the ESOP's loan is repaid. Releveraging transactions create a new pool of shares for new and future employee-participants; realign share value growth with the

company's equity growth; and decrease the ESOP sponsor's repurchase obligation, thereby increasing cash flow and, by extension, the company's ability to reinvest in the business and grow its equity value. However, releveraging requires trustee approval (like an initial stock purchase transaction), requires the ESOP (and by extension, the company) to take on new debt, and decreases the per-share value of stock allocated to current participants in order to provide value to future participants.



Account Segregation/Reshuffling. Account segregation/reshuffling is often used in conjunction with a share recycling policy. In short, the ESOP swaps stock held in former employee-participant accounts for cash held in current employee-participant accounts (typically from annual employer contributions). The cash that is paid into former employee accounts — now “segregated” — can be invested in other market investment vehicles or retained for payout per the plan's rules and applicable regulations. Any appreciation associated with the former employees' shares now accrues to current employees, rather than to former employees whose accounts were segregated. However, account segregation/reshuffling may require large cash contributions from employers to facilitate the stock-cash swap, as well as trigger concerns with respect to IRS discrimination rules.



Extended Distribution Schedule. A company struggling to meet its repurchase obligation in the near term could also amend the plan's rules to extend the ESOP's distribution window — that is, repay former ESOP participants over a longer period of time, thereby spreading out the repurchase obligation across a number of years. While these strategies reduce the immediate impact of the repurchase obligation, the effects may be felt in later years.

The Role of ESOP Sponsors and Fiduciaries

The ESOP sponsor — through its board of directors and/or management — is responsible for selecting which strategies to use to both satisfy annual ESOP distribution requirements (e.g., recycling, redeeming and retiring) and manage the future repurchase obligation liability to ensure that it does not threaten the long-term viability of the company — and by extension, the ESOP (e.g., releveraging, account segregation/reshuffling, extended distribution schedule).

Though ESOP fiduciaries — like an independent trustee — are generally not responsible for managing the company's repurchase obligation, they still have an important function: that of a shareholder monitoring corporate actions to ensure that they are reasonable. This can include participating in discussions about which distribution strategies to employ, analyzing repurchase obligation or sustainability studies the company may commission, and reviewing the rationale for any strategies the company may employ to manage its repurchase obligation. As with any corporate action, an ESOP fiduciary could seek to intervene if it determines that the company's course of action is unreasonable and does not advance shareholder interests.



Litigation Risks

Deciding how best to satisfy ESOP participant distributions and manage the repurchase obligation requires making tradeoffs — some participants will necessarily benefit more than others, no matter which strategies or tools a company might employ. And tradeoffs, unfortunately, can breed lawsuits.

That unfortunate reality has proven true in recent years with respect to mature ESOPs, as plaintiffs' firms have filed an ever-growing number of lawsuits targeting the ways in which ESOP sponsors and fiduciaries have satisfied and managed the company's repurchase liability. These lawsuits include allegations that cash held within the ESOP to facilitate share recycling should have been invested aggressively to maximize participants' earnings, challenges to ESOP sponsor decisions to segregate former employee accounts, and claims that releveraging transactions are per se impermissible.

Because mature ESOP litigation has not been a focal point of the plaintiffs' bar — historically, ESOP litigation risk has concentrated on stock purchase and sale transactions — many mature ESOP sponsors may be underinsured relative to the risk posed by these new theories of liability. Sponsors and fiduciaries of mature ESOPs should be cognizant of this increased litigation risk and plan accordingly to ensure that they are adequately protected should they face such a lawsuit.

Visit <https://www.chubb.com/us-en/business-insurance/fiduciary-liability.html> to learn more about ERISA risks and Chubb's Fiduciary Liability Insurance solutions.

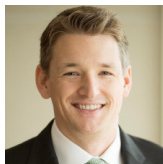
In our next article in the series, we will explore in more detail the litigation risk associated with on-going ESOP administration.



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

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.



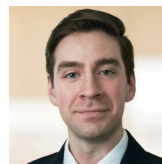
Author

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

Larry Blocho
Associate
Groom Law Group

Larry specializes in ERISA class action matters pertaining to retirement plans. In particular, he has extensive experience representing 401(k) and 403(b) plan sponsors and retirement committees in class action lawsuits challenging investment performance and plan expenses, including claims involving target date funds, proprietary funds, share classes, and recordkeeping fees. Larry has been a member of multiple defense teams securing wins in such cases, including at the motion to dismiss stage, on summary judgment, and at trial. He also has broad experience in other areas of ERISA litigation, including the defense of ESOP class action lawsuits, Department of Labor investigations, and a \$90M+ church plan misappropriation suit.

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