

STUDENT NOTE: THE DEPARTMENT OF LABOR'S HIDDEN BALL IN CUP GAME: ESOP TRUSTEES' EVER-CHANGING DUTIES IN ESOP TRANSACTIONS

GRIFFIN O'GARA*

INTRODUCTION

In 1963, over 4,000 South Bend, Indiana employees were left with next to nothing when their employer, the Studebaker Corporation, closed its South Bend manufacturing plant and defaulted on its employees' pension plans.¹ Adjusted for inflation, these employees lost approximately \$151 million dollars.² This corporate indiscretion was one of the driving forces behind the United States Congress passing the Employee Retirement Income Security Act of 1974 (ERISA).³ ERISA provides the statutory framework for the federal government to regulate single-employer pension plans.⁴

With ERISA, Congress delegated the authority to administer and enforce fiduciary responsibilities of employer-sponsored retirement plans to the Department of Labor.⁵ ERISA's delegation gives the Department of Labor the power to ensure employers, like the Studebaker Corporation, cannot mishandle or abuse their employees' retirement savings as they had before ERISA.⁶ The Department of Labor often uses this authority to investigate Employee Stock Ownership Plans (ESOPs).⁷ An ESOP "is an employee benefit plan that gives workers ownership interest in the company in the form of shares of stock."⁸ In addition to reliance on Department of Labor oversight, ESOP transactions must have independent business valuation firms determine the fair market value of

* J.D. Candidate, 2024, Indiana University Robert H. McKinney School of Law; B.S.B.A. 2018, University of Dayton – Dayton, OH.

¹ James A. Wooten, "The Most Glorious Story of Failure in the Business": *The Studebaker-Packard Corporation and the Origins of ERISA*, 49 BUFF. L. REV. 683, 730–31 (2001).

² *Id.* at 731; CPI Inflation Calculator, U.S. BUREAU OF LABOR STATISTICS, https://www.bls.gov/data/inflation_calculator.htm (place "15,000,000" in "\$" field; then place "March 1963" in the date field; then click "Calculate").

³ *Id.* at 683.

⁴ 29 U.S.C. § 1001b.

⁵ 29 U.S.C. § 1134(a); *see also* U.S. DEP'T LAB., *Investigative Authority*, [<https://perma.cc/YLV7-J6DH>].

⁶ U.S. DEP'T LAB., *Fact Sheet: What is ERISA*, [<https://perma.cc/VX9D-D438>].

⁷ *See, e.g.*, Agreement Concerning Fiduciary Engagements and Process Requirements for Employer Stock Transactions, U.S. Dep't Lab. v GreatBanc Tr. Co., Case No. 5:12-cv-01648-R-DTB (2014) [<https://perma.cc/279Q-PXRJ>].

⁸ Akhilesh Ganti, *Employee Stock Ownership Plan (ESOP): What It Is, How It Works, Advantages*, INVESTOPEDIA (July 20, 2022), [<https://perma.cc/XX6M-K2L7>].

the business to ensure the employees do not overpay.⁹ In 2010, the Department of Labor proposed a regulation that would extend fiduciary responsibility to independent business valuation firms in ESOP transactions.¹⁰ Practitioners in the ESOP space fought the proposal fiercely.¹¹ Ultimately, the Department of Labor withdrew its proposal in 2011—¹² a victory for the valuation industry.

However, over the next several years, the Department of Labor conducted several investigations of ESOP trustees in ESOP transactions.¹³ Under the threat of adjudication, the Department of Labor pushed ESOP trustees into settlement agreements, in which the parties agreed to additional procedures and protocols surrounding business valuations in ESOP transactions.¹⁴ The new procedures and protocols are tied to ESOP trustees' fiduciary duties, which carry steep penalties if violated.¹⁵ Although the new protocols are not found in ERISA or any regulation, the new ESOP trustee duties have become the standard for ESOP trustees in ESOP transactions.¹⁶

As an administrative agency, the Department of Labor has several policy-making tools available when addressing a policy objective within its Congressionally defined purview.¹⁷ For instance, the Department of Labor can exercise its semi-judicial tool of administrative adjudication or its semi-legislative tool of rulemaking.¹⁸ Creating new fiduciary standards for ESOP trustees by publishing the contents of settlement agreements is a use of the Department of Labor's adjudicative powers, where the Department of Labor's rulemaking powers may be a better fit to address the problem. By allowing the Department of Labor to rewrite the fiduciary

⁹ See generally An Introduction to ESOP Valuations, AEGIS FIDUCIARY SERVICES, LLC (Sept. 23, 2022), [<https://perma.cc/YE7U-SACZ>].

¹⁰ Laura Miller Andrew et al., *DOL Releases Proposed Rule to Expand Definition of an ERISA Fiduciary*, SMITH GAMBRELL RUSSELL (Oct. 26, 2010), [<https://perma.cc/QP3V-YETH>].

¹¹ Chris Baysden, *AICPA asks Congress to block change in DOL fiduciary rule for ESOP appraisers*, J. ACCT. (August 2, 2013), [<https://perma.cc/Z3LE-B9PC>].

¹² *Id.*

¹³ See Holland & Knight, *Something Old, Something New and Something Borrowed in Latest DOL Process Agreement*, HOLLAND & KNIGHT (Mar. 5, 2020), [<https://perma.cc/V7EC-PVQT>].

¹⁴ See *id.*

¹⁵ See, e.g., U.S. DEP'T LAB., WILMINGTON TRUST SETTLEMENT AGREEMENT AND RELEASE (2020) [[HTTPS://PERMA.CC/Q4DS-NRD9](https://perma.cc/Q4DS-NRD9)].

¹⁶ See Allison Wilkerson & J. Christian Nemeth, *Settling the Standard for Prudence? Fall Brings New Guidance for ESOP Trustees*, MCDERMOTT WILL & EMERY (Nov. 6, 2017) [<https://perma.cc/2F6E-GXQR>].

¹⁷ See M. Elizabeth Magill, *Agency Choice of Policymaking Form*, 71 U. CHI. L. REV. 1383, 1386 (2004).

¹⁸ See *id.*

duties in an ESOP transaction using its power of adjudication after failing to accomplish its goals through rulemaking, the United States Government has stymied the growth of ESOPs, missing out on the societal benefits associated with employee ownership. However, the United States has recently taken positive steps forward and should continue to incentivize ESOPs.¹⁹

Part I of this Note defines an ESOP and the relevant steps to set up an ESOP. Part II explains the business valuation step in ESOP transactions. Part III follows with the duties of an ESOP trustee during an ESOP transaction. Part IV analyzes the Department of Labor's recent settlement agreements with ESOP Trustees and the new procedures and protocols they established. Part V looks at the powers of the Department of Labor as an administrative agency and how it uses its powers in its oversight of ESOPs. Part VI details how implementing ESOPs can help fight wealth inequality and the unique opportunity to implement more ESOPs than ever before. Part VII provides updates on some of the most recent actions congress has taken involving ESOPs and how the changes will affect the ESOP environment moving forward. Finally, Part VIII proposes how the Department of Labor should exercise its oversight of ESOP transactions to generate the best outcome for society and other actions the United States Government should take to incentivize ESOPs. The measures proposed in this Note call for the Department of Labor, Congress, and the American public to closely consider the benefits of implementing ESOPs and to take the appropriate actions to clarify the processes of establishing ESOPs.

I. EMPLOYEE STOCK OWNERSHIP PLANS (ESOPs)

A. *What is an ESOP*

An ESOP is a retirement plan where an employer gives its employees the ability to obtain ownership in the employer's company.²⁰ ESOPs come in many shapes and sizes.²¹ Large corporations can use them to avoid tax liabilities through partial non-leveraged ESOP transactions²² or as a defense against hostile corporate takeovers.²³ The primary type of ESOP transaction focused on in this Note involves a privately owned

¹⁹ See 29 U.S.C.A. § 3228.

²⁰ Ganti, *supra* note 8.

²¹ Kevin Long, *ESOPs: The Three Types*, EMP. BENEFITS L. GRP. PC (June 29, 2019), [<https://perma.cc/SAB5-V7ZK>] (describing different types of ESOPs).

²² *Id.*

²³ Troy Adkins, *How can a Company Resist a Hostile Takeover?*, INVESTOPEDIA (May 7, 2022), [<https://perma.cc/JK6H-SGHN>].

company transferring one hundred percent of its ownership to its employees through an ESOP. A leveraged buyout is a common way to structure this kind of transaction.²⁴ In a leveraged buyout, an ESOP purchases shares of the company from the owner using funds loaned by a financial institution.²⁵ To secure its loan, the financial institution will hold the ownership stock as collateral.²⁶ As the ESOP pays off the loan, the lending institution release shares of the company from the loan collateral, and the ESOP distributes the shares to the participating employees.²⁷

A business must consider many nuisances, and it may take many years before a business finally decides to implement an ESOP.²⁸ Once the decision to move forward with implementation is made, a business will need to complete several steps to establish an ESOP.²⁹

B. *Creating an ESOP*

Many of the steps to create an ESOP happen concurrently but for simplicity, each step is often described separately. First, the company develops a written plan to govern the operations of the ESOP.³⁰ The written plan answers fundamental questions like which employees are eligible to participate in the ESOP, how the employer's stock will be allocated to the participants, and what the vesting schedule will look like.³¹

After completing the written plan, the business creates a trust to represent the employees.³² An independent trustee is designated to manage the trust by following the written plan.³³ Eventually, the pre-ESOP owner (or owners) of the business will likely sell at least some of their shares to the trust.³⁴ The trust will then issue the shares to the employees participating in the ESOP according to the written plan.³⁵

²⁴ See John A. Wilhelm, *Considerations in Establishing a Leveraged ESOP*, VENABLE LLP, [https://perma.cc/FM4Z-R6DM].

²⁵ *Id.* at 1.

²⁶ *Id.*

²⁷ *Id.*

²⁸ *Id.* at 2–3.

²⁹ George D. Lambert, *Is an ESOP Right for Your Business*, INVESTOPEDIA (Oct. 21, 2020), [https://perma.cc/3PBQ-7ZEK].

³⁰ Employee Ownership Foundation, *How to Establish an ESOP*, EMP. OWNERSHIP FOUND., [https://perma.cc/M9QY-LU3B].

³¹ *Id.*

³² See Trica Equity, *ESOP Trust – How to Set Up an ESOP Trust*, TRICA EQUITY (July 30, 2021), [https://perma.cc/QLQ9-9C59].

³³ See Will Stewart, *The Role of an ESOP Trustee, and how to Choose One*, PCE COMPANIES [https://perma.cc/7W27-UFE7].

³⁴ See Trica Equity, *supra* note 32.

³⁵ *Id.*

Before the trust can buy the shares, the trustee must determine the company's fair market value.³⁶ Determining the company's fair market value helps ensure the employees do not overpay for the business.³⁷ Business valuations have become a hotbed of issues for ESOP transactions in the form of litigation initiated by the Department of Labor.³⁸ Therefore, following the Department of Labor's guidance for evaluating a business's fair market value is crucial to avoid future litigation. However, even when all precautions are taken, business valuations can still fall apart and cause a headache for all parties involved.

II. BUSINESS VALUATIONS

When a trustee is tasked with evaluating a business's fair market value, the trustee seeks out a business valuation firm or an independent appraiser.³⁹ Every business valuation firm will follow its own principles in determining a business's fair market value. Two common approaches are the income approach and the market approach.⁴⁰

A. *The Income Approach*

The income approach measures the value of a business by projecting a business's future cash flows and determining the value of those future cash flows in the present.⁴¹ A valuation method under the income approach is the Discounted Cash Flow method or DCF.⁴² To conduct a DCF valuation, a business valuation firm will determine a set of inputs to use in conjunction with a formula to determine the business's value.⁴³ Inputs vary from valuation to valuation, but common inputs include the weighted average of various forecasted future cash flows and one or multiple discount rates for the cost of future capital.⁴⁴ All inputs

³⁶ Jennifer F. Cote, *Fiduciary Review of ESOP Valuations*, FROST BROWN TODD (Feb. 4, 2021), [<https://perma.cc/U478-XFKL>].

³⁷ *Id.*

³⁸ *Id.*

³⁹ Alex Mumblat, *ESOP Valuations Explained*, CSG PARTNERS (Sept. 29, 2021), [<https://perma.cc/XDH5-HNM2>].

⁴⁰ Kayleigh Biloki, *Income, Asset, Market ... Why Different Valuation Approaches Matter*, MARCUM LLP (Jan. 7, 2022), [<https://perma.cc/56YV-AL6C>].

⁴¹ *Id.*

⁴² *Id.*

⁴³ Aswath Damodaran, *Discounted Cash Flow Valuation: The Inputs*, [<https://perma.cc/EUY4-UF7S>].

⁴⁴ *Id.*

have many factors and require effective forecasting and analysis to be accurate.⁴⁵

Marc Asbra provides an example of an income approach valuation in “Business Valuations 101 for Litigators.”⁴⁶

Figure 1⁴⁷

	Year 1	Year 2	Year 3	Total
LA OpCo Earnings (\$ mil)	\$1.19	\$1.22	\$1.25	
Expected Growth Rate	-1.0%	3.0%	2.5%	
Earnings Multiplier [(1 + g) + (r - g)]	n/a	n/a	11.4 x	
Value of LA OpCo at End of Year 3	n/a	n/a	\$14.28	
Total Earnings + Residual Value	\$1.19	\$1.22	\$15.54	
Present Value Factor @ 11.5%	0.8969	0.8044	0.7214	
Present Value of Total Earnings + Residual Value	\$1.07	\$0.98	\$11.21	\$13.26

Figure I shows the valuation of “LA OpCo,” a company that earned \$1.2 million last year. Figure 1 forecasts the growth rate for LA OpCo over the next three years in row two. In Year 1, the expected growth is -1% for forecasted earnings of \$1.19 million; in Year 2, the expected growth rate is 3% for forecasted earnings of \$1.22 million; and in Year 3, the expected growth rate is 2.5% for forecasted earnings of \$1.25 million. In valuations, the expected growth rate is analyzed meticulously. Business appraisers will look at the company's historical performance and compare it to external benchmarks to help better forecast future growth rates.⁴⁸ However, *forecasted* growth is not always accurate. Differences in forecasted and actual growth will make the valuation less reliable. Next, Figure 1 determines an earnings multiplier in row three. As with forecasted growth rates, the earnings multiplier is a critical assumption that a business appraiser will make by assessing the risk of LA OpCo not meeting its forecasted growth numbers, industry trends, and many other factors. Much work will go into determining the multiplier in a business valuation. Still, it is an assumption based on factors that can not be entirely relied upon.

After deciding a multiplier of 11.4 is appropriate, Figure 1 applies the multiplier to the forecasted earnings in Year 3 to forecast the residual value of LA OpCo’s future earnings after Year 3. The total value of earnings and residual values in Year 1 is \$1.19 million, in Year 2 is \$1.22 million, and in Year 3 is \$15.54 million. Since the earnings and residual values are future values, Figure 1 applies a discount rate – shown in row six – to account for the present value of the earnings and residual values.

⁴⁵ *Id.*

⁴⁶ See Marc Asbra, *Business Valuation 101 for Litigators*, 15 Expert Witnesses (2018).

⁴⁷ *Id.* at 9–10.

⁴⁸ Marc Asbra, *Business Valuation 201 for Litigators*, 15 Expert Witnesses 1, 2 (2019).

After discounting the values and adding them together, Figure 1 determines the value of LA OpCo is \$13.26 million. Business appraisers put a lot of work into determining the business valuation.⁴⁹ Still, as Figure 1 shows, key inputs like the expected growth rate and multiplier are only forecast and can not be relied on one hundred percent.⁵⁰

B. *The Market Approach*

In comparison, the market approach evaluates a business's value by comparing it to similar companies.⁵¹ A common valuation method under the market approach is the Guideline Company Method.⁵² The Guideline Company Method takes the subject business and compares it to similarly situated publicly traded companies.⁵³ Then, the business valuator will determine inputs such as earnings before interest, taxes, depreciation, and amortization (EBITDA), earnings per share, or several other business metrics and multiply the inputs by a multiple similar to the guide company's multiple.⁵⁴

Figure 2 shows an example of a market approach valuation from Asbra's "Business Valuations 101 for Litigators."⁵⁵

Figure 2⁵⁶

	Comparable Companies			Selected for LA OpCo
	A	B	C	
Stock Price per Share	\$13.15	\$22.50	\$43.25	
Earnings per Share	\$1.10	\$1.40	\$3.30	
P/E Multiple, as Calculated	12.0 x	16.1 x	13.1 x	
Adjustment for LA OpCo Characteristics	+ 5%	- 25%	- 10%	
P/E Multiple, as Adjusted	12.6 x	12.1 x	11.8 x	12.0 x
LA OpCo Earnings per Share				\$2.00
Value of LA OpCo per Share				\$24.00
Number of LA OpCo Shares (in mil)				0.60
Value of LA OpCo (\$ mil)				\$14.40

Figure 2 again uses LA OpCo, which earned 1.2 million last year. Figure 2 also informs us that LA OpCo has 600,000 outstanding shares. Since Figure 2 represents a market approach valuation, Figure 2 selects

⁴⁹ See Damodaran, *supra* note 44.

⁵⁰ See *id.*

⁵¹ Paul Barnes, *Business Valuation – The Basics*, KROLL (Jun. 5, 2017), [https://perma.cc/WC7Z-3EV2].

⁵² *Id.*

⁵³ *Id.*

⁵⁴ *Id.*

⁵⁵ Asbra, *supra* note 47, at 8.

⁵⁶ *Id.*

three similar companies – A, B, and C – to compare to LA OpCo. A, B, and C’s share prices, earnings per share, and multiples are known because they are publicly traded companies. Figure 2 then compares LA OpCo to each company and determines an adjustment number in row four. The adjustment numbers try to accurately predict how LA OpCo will perform compared to A, B, and C. The adjustment to A’s multiple is +5% signaling the appraiser believes LA OpCo is better situated than A. The adjustment to B’s multiple is -25%, signaling that the appraiser believes B is better situated than LA OpCo. The appraiser can not be certain that LA OpCo will do better than A and worse than B, but based on the appraiser’s analysis that is their conclusion. The adjusted multiples for A, B, and C are in row five. Figure 2 then averages the adjusted multiples and determines twelve is the appropriate multiple for LA OpCo. Figure 2 and Figure 1 both use the same LA OpCo with earnings of \$1.2 million, but Figure 2 determines LA OpCo’s value is \$14.40 million. The different assumptions and procedures in evaluating the same company through the income and market approaches turned into a \$1.04 million difference in value.

No matter which methods an independent business valuation firm uses, it is a safe bet that no two methods will give the firm the same valuation.⁵⁷ Even using the same method with slightly different inputs will create vastly different valuations.⁵⁸ To deal with the variability, business valuers will often use multiple valuation methods to get a range of valuations that give the valuers a sense of what a high-end and low-end valuation could be.⁵⁹ But, even when the business valuers use multiple methods and define a range, the range is heavily dependent on the accuracy of the appraiser’s forecast. In addition to all the variables already discussed in business valuations, ESOPs add additional hurdles for independent business valuers to consider.⁶⁰

C. ESOP Specific Considerations

Control price, leveraged ESOP debt, and repurchase obligations are three ESOP-specific considerations that are critical in determining the value of a business in an ESOP transaction.⁶¹ Control price or a control premium is an increase in the value of a business because the buying party is receiving total control of the business.⁶² This premium is especially tricky

⁵⁷ *Id.* at 6.

⁵⁸ See Asbra, *supra* note 47.

⁵⁹ *Id.* at 6, 8.

⁶⁰ Claren O’Bannon, *The Intricacies of ESOP Valuations*, WIPFLI (Jan. 20, 2022), [<https://perma.cc/3HY7-9BKS>].

⁶¹ *Id.*

⁶² *Pizzella v. Vinoskey*, 409 F. Supp. 3d 473, 514-15 (2019).

in ESOP transactions because the ESOP's written plan will often limit the participants' control over the company.⁶³ For example, in *Pizzella v. Vinoskey*, the ESOP trustee and independent business appraiser were found jointly liable for \$6.5 million.⁶⁴ In *Pizzella*, the ESOP was purchasing one hundred percent of the company's stock.⁶⁵ However, because of the corporation's bylaws, the existing majority on the board of directors and the majority of the ESOP trustees could not be removed by the ESOP participants.⁶⁶ The participants gained more control by acquiring one hundred percent of the company's owners.⁶⁷ Still, since they could not effectively remove the existing trustees and board members, total control was not acquired.⁶⁸ The independent business appraiser was held liable because his valuation did not accurately reflect the lack of total control.⁶⁹

Leveraged ESOP debt is another ESOP-specific wrinkle in many ESOP transactions.⁷⁰ Due to the structure of a leveraged buyout, briefly described in Section I (A), the company takes on increased debt to buy the business from the owners. The increased acquisition debt creates a significant debt obligation for the company and can add risk to the company's survival. Factoring in the large addition of debt from a leveraged buyout can also complicate an ESOP transaction.⁷¹

Furthermore, ESOPs often have repurchase obligations they must meet.⁷² Repurchase obligations are the business's responsibility to buy back the shares of the business from employees when they decide to leave the company or cash out their earned stock.⁷³ Since the business is required to repurchase the shares, the business's repurchase obligation can hurt the business's cash flows.⁷⁴ The possibility of a business's repurchase obligation drying up its cash reserves must also be considered when valuing a business for an ESOP transaction.⁷⁵

Independent business appraisers will fret the inputs to a business valuation.⁷⁶ Still, many of the inputs are only forecast based on the best

⁶³ *Id.* at 493.

⁶⁴ *Id.* at 531.

⁶⁵ *Id.* at 486.

⁶⁶ *Id.* at 515.

⁶⁷ *Id.* at 514.

⁶⁸ *Id.* at 515.

⁶⁹ *Id.* at 530.

⁷⁰ O'Bannon, *supra* note 61.

⁷¹ *Id.*

⁷² *Id.*

⁷³ Aaron Juckett, *ESOP Repurchase Obligation: Why It Matters & How to Plan*, ESOP PARTNERS (Dec. 14, 2021), [<https://perma.cc/M6YC-CMES>].

⁷⁴ *Id.*

⁷⁵ O'Bannon, *supra* note 61.

⁷⁶ *See* Damodaran, *supra* note 44.

available information.⁷⁷ Independent appraisers and business valuation firms are not omnipotent and cannot accurately foresee increases in the cost of capital or accurately predict the future financial performance of a company.⁷⁸ Exit multiples, one of the most important inputs, are often decided by looking at the standard multiple for an industry, but not necessarily a specifically tailored number for an individual business.⁷⁹ A slight difference in the exit multiple will generate drastically different final valuations.⁸⁰

Between selecting the appropriate valuation method, choosing the correct inputs, and correctly forecasting the values of the different inputs, business valuation firms are tasked with creating a persuasive painting of the future and not executing a repeatable and accurate science. Therefore, ESOP trustees must prudently select an independent business appraiser to evaluate the business the ESOP is purchasing. However, even when a trustee prudently selects an entity to appraise the business, and the independent appraiser does everything in its power to value the business's present value accurately, the valuation may still turn out to be significantly different from the value of the company years down the road by no fault of the business valuator or the ESOP trustee.

The recent settlement agreements between the Department of Labor and ESOP trustees are chiefly concerned with protocols to ensure the ESOP trustee is prudently selecting a business valuation firm that will make sure the ESOP is paying fair market value for the business.⁸¹ Even though business valuations are more art than science, the Department of Labor continues to hold ESOP trustees liable for inaccurate business valuations based on their fiduciary duties.⁸² Therefore, it is essential to understand ESOP trustees' responsibilities to the employees participating in the ESOP.

III. ESOP TRUSTEE'S FIDUCIARY DUTIES UNDER ERISA

A. ESOP Trustees' Prudent Person Standard

⁷⁷ See *id.*

⁷⁸ See *id.*

⁷⁹ Asbra, *supra* note 47, at 6–7.

⁸⁰ See *id.*

⁸¹ See Grossman, *supra* note 15.

⁸² See Holland & Knight, *Comparison of Great Banc Trust Company (GB) Process Agreement, First Bankers Trust Services (FBTS) Settlement Agreement, Joyner Settlement Agreement, Alpha Investment Consulting Group (AICG) Settlement Agreement, Lubbock National Bank (LNB) Settlement Agreement, and Farmers Bank of Danville (FNB) Process Agreement*, HOLLAND & KNIGHT, [<https://perma.cc/2BFB-MJUJ>].

ESOP trustees have fiduciary duties to the participants in an ESOP.⁸³ “[W]hen an ESOP fiduciary’s decision to buy . . . the employer’s stock is challenged . . . ESOP fiduciaries are subject to the same duty of prudence that applies to ERISA fiduciaries in general”⁸⁴ The duty of prudence is often called the prudent person standard and is laid out in 29 USC 1104:

[A] fiduciary shall discharge [their] duties with respect to a plan solely in the interest of the participants and beneficiaries and – (A) for the exclusive purpose of: (i) providing benefits to participants . . . and (ii) defraying reasonable expense of administering the plan; (B) with the care, skill, prudence, and diligence under the circumstances then prevailing a prudent man acting in a like capacity and familiar with such matters⁸⁵

Generally, under ERISA, the prudent person standard is held to create the duty of acting as a prudent expert.⁸⁶ What a prudent expert would do in any situation is a difficult question that appears when fiduciary duties are involved. The answer to such a question changes, often due to hindsight.

Before 2014, when the first of several settlement agreements between the Department of Labor and ESOP trustees were entered into, ESOPs had been around for roughly fifty-eight years.⁸⁷ The 2014 settlement agreement between the Department of Labor and GreatBanc Trust changed standards that had been in place for years.⁸⁸ After the GreatBanc settlement, ESOP trustees, acting as prudent experts, could no longer use a business valuation firm that either the buyer (the ESOP trust) or the seller (the business owner) had ever used before.⁸⁹ The Department of Labor then, in part because GreatBanc had used a business valuation

⁸³ Mumblat, *supra* note 37.

⁸⁴ Fifth Third Bancorp v. Dudenhoeffer, 573 U.S. 409, 412 (2014).

⁸⁵ 29 U.S.C. § 1104 (2019).

⁸⁶ Julia Kagan, *Prudent Expert Act*, INVESTOPEdia (Jan. 23, 2022), [https://perma.cc/9M26-C8QH].

⁸⁷ The Menke Group, *The Origin and History of ESOP and Its Future Role as a Business Succession Tool*, THE MENKE GRP., [https://perma.cc/BCS5-9UUU].

⁸⁸ See Agreement Concerning Fiduciary Engagements and Process Requirements for Employer Stock Transactions, U.S. Dep’t Lab. v. GreatBanc Tr. Co., Case No. 5:12-cv-01648-R-DTB (2014) [https://perma.cc/279Q-PXRJ].

⁸⁹ *Id.* at 13.

firm that they or the employer had used in the past, penalized GreatBanc to the tune of \$5.25 million.⁹⁰

While one of ESOP trustees' chief fiduciary duties is to act as a prudent expert to the benefit of the ESOP participants, that standard is constantly changing.⁹¹ Creating a new rule that requires prudent experts not to use the same business valuation firm for more than one ESOP transaction calls into question whether the Department of Labor is fairly applying the prudent expert standard.

B. *Prohibited Transactions*

Another duty that ESOP trustees need to be aware of is the prohibited transaction rules in ERISA.⁹² ERISA Section 1106(a)(1)(A) makes a transaction between the plan and a party in interest a prohibited transaction.⁹³ Section 1108(e)(1) creates an exception to the party in interest transaction rules for ESOPs as long as the ESOP can prove that the ESOP paid no more than adequate consideration for the employer's stock.⁹⁴ Adequate consideration is often synonymous with fair market value.⁹⁵ Not only must the ESOP trustee prudently select the business valuation firm, but the ESOP trustee must also review the business valuation and confirm that the business valuation is no more than fair market value.⁹⁶

The trustee must act as a prudent expert, loyal to the beneficiaries, and ensure that the ESOP does not pay more than the fair market value of the employer's business. But with the variability and uncertainty in business valuations⁹⁷, how does a trustee determine what prudent action is in selecting a business valuator or accurately determine a fair market valuation of a business? The Department of Labor keeps hiding the ball by creating new rules for ESOP trustees to follow through adjudicative settlement agreements with ESOP trustees.⁹⁸

⁹⁰ Ameet Sachdev, *Lisle-based GreatBanc Trust pays \$5.25 million to settle lawsuit*, CHICAGO TRIB. (Jun. 3, 2014 at 4:35p.m.) [<https://perma.cc/CU58-2RR9>].

⁹¹ See Holland & Knight, *supra* note 83.

⁹² The ESOP Association, *ESOP Fiduciary Rules*, THE ESOP ASSOCIATION, [<https://perma.cc/L2CE-MX9R>].

⁹³ 29 U.S.C. § 1106.

⁹⁴ 29 U.S.C. § 1108.

⁹⁵ See Law Insider, *Full and Adequate Consideration Definition*, LAW INSIDER, [<https://perma.cc/V8GQ-6R2B>].

⁹⁶ Cote, *supra* note 36.

⁹⁷ See Section II.

⁹⁸ See Holland & Knight, *supra* note 83.

IV. THE SETTLEMENT AGREEMENTS

In 2014, the Department of Labor released to the public an agreement (“the GreatBanc Settlement”) between the Department of Labor and GreatBanc Trust Company (“GreatBanc”).⁹⁹ In the GreatBanc settlement, GreatBanc agreed to implement new policies and procedures whenever GreatBanc serves as a fiduciary in an ESOP transaction.¹⁰⁰ These new policies and procedures can be viewed as what the Department of Labor believes a prudent expert should do when acting as a trustee in an ESOP transaction.¹⁰¹ A few of the new requirements include (1) selecting a valuation advisor that has not performed work for (a) the plan sponsor, (b) the seller (if the ESOP is a buyer), or the buyer (if the ESOP is a Seller), (2) the trustee or appraiser must provide a written opinion to the reasonableness of the projected inputs used by the appraiser, and (3) the trustee must complete a document that addresses sixteen topics related to the business valuation.¹⁰² As discussed in Section III (A), the new procedures laid out in the GreatBanc Settlement go against what market practice was at the time. Effectively in the GreatBanc Settlement, the Department of Labor redefined the prudent expert standard for the entire ESOP practice.

Since the GreatBanc settlement, the Department of Labor has continued on its course and released five subsequent settlement agreements.¹⁰³ The subsequent agreements have added more procedures necessary for an ESOP trustee to fulfill their duty to act as a prudent expert.¹⁰⁴ For example, in the first of the subsequent agreements, *Acosta v First Bankers Trust Services Inc.*, the Department of Labor adds additional requirements for the selection of an independent appraiser.¹⁰⁵ Following the First Bankers Trust settlement agreement, ESOP trustees are required to provide a written list of three references that the trustee checked with and provide the references’ views on the valuation advisor.¹⁰⁶ Also, ESOP

⁹⁹ Agreement Concerning Fiduciary Engagements and Process Requirements for Employer Stock Transactions, U.S. Dep’t Lab. v GreatBanc Tr. Co., Case No. 5:12-cv-01648-R-DTB (2014) [<https://perma.cc/279Q-PXRJ>].

¹⁰⁰ *Id.*

¹⁰¹ Louis Joseph, *DOL Settlement Agreement Provides ESOP Transaction Guidance*, HOLLAND & KNIGHT (September 28, 2017), [<https://perma.cc/X6WY-3GTC>].

¹⁰² Agreement Concerning Fiduciary Engagements and Process Requirements for Employer Stock Transactions, U.S. Dep’t Lab. v GreatBanc Tr. Co., Case No. 5:12-cv-01648-R-DTB (2014) [<https://perma.cc/279Q-PXRJ>].

¹⁰³ Holland & Knight, *supra* note 13.

¹⁰⁴ *Id.*

¹⁰⁵ *Acosta v. First Bankers Tr. Servs., Inc.*, No. 1:12-cv-08648-GBD (S.D.N.Y. Sept. 21, 2017) (consent order and judgment).

¹⁰⁶ *Id.* at 11.

trustees are now required to do a background check into any regulatory proceedings or investigation the valuation advisor was the subject of.¹⁰⁷

In the most recent of the five subsequent agreement between the Department of Labor and an ESOP trustee, *Scalia v. The Farmers National Bank of Danville*, the Department of Labor highlighted specific considerations a trustee must consider when approving a business valuation.¹⁰⁸ Specifically, when an ESOP purchases a controlling interest in the employer's business, a trustee must determine to what degree the ESOP's control is inhibited.¹⁰⁹ The ESOP trustee must consider whether the ESOP obtains the rights to vote its shares; appoint and remove company officers; acquire, lease, or liquidate company assets; and other powers listed in the agreement.¹¹⁰ The ESOP trustee must ensure that the business valuation adequately reflects restricted control.¹¹¹

While all of the new procedures have become standard for ESOP trustees today, the procedures were not standard at the time of each settlement.¹¹² There are several problems with the Department of Labor creating new industry standards by using its adjudicative powers through industry binding process agreements. First, parties to ESOP transactions are unclear on what precautions they must take to ensuring a business valuation accurately reflects the fair market value.¹¹³ Second, the risk of future litigation for parties in ESOP transactions increases.¹¹⁴ Third, industry-wide rules should be made through regulation, not adjudication.¹¹⁵

The pros and cons of agencies using adjudication or rulemaking has gotten a great deal of attention from academics and the courts.¹¹⁶ A deeper dive into the Department of Labor's powers as an agency is essential to determine how it should use its administrative powers to create industry-wide standards for parties in ESOP transactions

¹⁰⁷ *Id.*

¹⁰⁸ *Scalia v. The Farmers National Bank of Danville*, No. 1:20-cv-674 (S.D. Ind. Feb. 28, 2020) (consent order and judgement).

¹⁰⁹ *Id.* at 14–15.

¹¹⁰ *Id.*

¹¹¹ *Id.*

¹¹² Robert J. Grossman, *Heed Vital Guidance on ESOP Valuation Provided in Greatbank Trust*, Valuation Strategies 4 (2015).

¹¹³ The ESOP Association, *The ESOP Association Petitions U.S. Department of Labor to Undertake Congressionally Mandated Rulemaking*, THE ESOP ASSOCIATION (Sep. 22, 2022), [<https://perma.cc/G2JH-DD28>].

¹¹⁴ *Id.*

¹¹⁵ *Id.*

¹¹⁶ See Magill, *supra* note 17.

V. THE DEPARTMENT OF LABOR'S ADMINISTRATIVE POWERS

A. Agencies' Administrative Powers

Agencies like the Department of Labor are granted powers through the legal instruments that create them.¹¹⁷ The powers granted to agencies generally fall into two categories, adjudication and rulemaking.¹¹⁸ Adjudication is the execution of judicial powers to settle disputes that arise in formal or informal hearings. Adjudication allows agencies to speak on a particular matter between two or more parties. Regulation or rulemaking is the execution of legislative powers. The courts have found that congress may delegate its legislative powers in special circumstances to allow an agency to create rules in areas of its expertise.¹¹⁹

When an agency has been granted powers of adjudication and rulemaking, courts often give the agencies a decision on which power to use significant weight.¹²⁰ Still, one of the key issues in deciding whether an agency should use its adjudicatory powers or rulemaking powers is how broad the implications of the solution will be.¹²¹ For example, suppose the agency wishes to make a holding binding only on the parties to the dispute. In that case, the agency should favor adjudication to solve the problem. But, if the agency wishes to create a rule that will “be obeyed by the affected public,”¹²² the proper exercise of power would be rulemaking. While courts will often defer to an agency's choice of which power to use, an agency's decision to use adjudication in an improper situation could amount to an abuse of discretion by the agency.¹²³

As discussed earlier, the Department of Labor has created new rules that the ESOP community must obey through its adjudicative power.¹²⁴ The settlement agreements generally state that they are not binding on other parties.¹²⁵ However, once the Department of Labor issued the settlement agreements to the public, the ESOP community took note and adjusted their protocols.¹²⁶ In addition, the Department of Labor built upon its settlement agreements in each subsequent agreement, which

¹¹⁷ *Id.* at 1387.

¹¹⁸ *Id.* at 1383.

¹¹⁹ See *Whitman v. Am. Trucking Ass'n*, 531 U.S. 457 (2001).

¹²⁰ See *N.L.R.B. v. Bell Aerospace Co. Div. of Textron*, 416 U.S. 267 (1974).

¹²¹ See *N.L.R.B. v. Wyman-Gordon Co.*, 394 U.S. 759 (1969).

¹²² *Id.* at 766.

¹²³ *Bell Aerospace Co. Div. of Textron*, 416 U.S. at 294.

¹²⁴ See *Holland & Knight*, *supra* note 13.

¹²⁵ Agreement Concerning Fiduciary Engagements and Process Requirements for Employer Stock Transactions, U.S. Dep't Lab. v GreatBanc Trust Company, Case No. 5:12-cv-01648-R-DTB (2014) [<https://perma.cc/279Q-PXRJ>].

¹²⁶ See *Grossman*, *supra* note 113.

shows a developing body of protocols to be followed by the general ESOP community.¹²⁷ Effectively the settlement agreements created rules that must be obeyed by all ESOP trustees. If the settlement agreements contain rules to “be obeyed by the affected public,” why would the Department of Labor choose to use adjudication instead of rulemaking?

B. The Department of Labor’s Choice of Adjudication

It is not unusual for an agency to prefer to use its powers of adjudication over rulemaking. Adjudication is often seen as the quicker and easier way for an agency to operate.¹²⁸ If the Department of Labor used rulemaking in its oversight of ESOPs, it would have to provide notice to all parties active in the ESOP space and allow for public participation in the rulemaking process.¹²⁹ By choosing to operate through adjudication, the Department of Labor can skip these steps and get straight to making “nonlegislative rules.”¹³⁰ With the increased speed of adjudication, the Department of Labor can quickly adapt to new issues in the ESOP space, and ideally better protect ESOP participants from evolving methods of fraud.

On the more cynical side, by choosing to use adjudication, the Department of Labor can pursue fines for violating rules that did not exist when the violating actions occurred.¹³¹ For example, in the case of ESOPs, ESOP trustees have been found liable for violating fiduciary duties that did not exist during the transaction in question.¹³² “ERISA Section 502(l) provides that in any case in which there is a recovery from a fiduciary pursuant to a settlement agreement with the Secretary [of Labor] of a claim of a fiduciary breach, the Secretary is required to assess an additional payment equal to 20% of the recovery amount.”¹³³ In the Wilmington Trust agreement, the Department of Labor agreed to lessen the recovery to ten percent, but still received \$8 million from Wilmington Trust.¹³⁴ In the Farmers National Bank of Danville agreement the Department of Labor again lessened the recovery under ERISA Section 502(1) to ten

¹²⁷ Holland & Knight, *supra* note 83.

¹²⁸ SEC v. Chenery Corp., 332 U.S. 194, 202–03 (1947).

¹²⁹ SARAH LAMDAN, PUBLIC INSTITUTIONS: ADMINISTRATIVE LAW CASES & MATERIALS (2020), [<https://perma.cc/C763-8D9R>].

¹³⁰ *Id.* at 3.1.1.

¹³¹ See U.S. DEP’T LAB., WILMINGTON TRUST SETTLEMENT AGREEMENT AND RELEASE (2020) [[HTTPS://PERMA.CC/Q4DS-NRD9](https://perma.cc/Q4DS-NRD9)].

¹³² See *id.*

¹³³ *Id.* at 5.

¹³⁴ *Id.*

percent and received \$54,545.45.¹³⁵ Altogether the choice to use adjudication requires less forethought, allows the Department of Labor more freedom to exercise its powers, and brings in a significant amount of money.

C. *Benefits of Rulemaking*

While rulemaking generally moves slower than adjudication, it also has its benefits. First, proceeding through rulemaking would allow for public participation.¹³⁶ ESOP transactions are complex, and letting the entities that work with ESOPs daily shape the Department of Labor's oversight of ESOPs could yield better results.

Second, rulemaking would clearly define the procedures and protocols ESOP trustees must follow during ESOP transactions.¹³⁷ Currently, the Department of Labor could issue new protocols required to meet the fiduciary duty of a prudent expert at any moment through adjudication.¹³⁸ As a result, ESOP trustees carry the risk that following all the current rules might not be enough to avoid liability in the event a business valuation is inaccurate. A definitive statement of the necessary steps in valuing a business through rulemaking would minimize the risk of future litigation and lessen the cost of establishing an ESOP.

Whether the Department of Labor is abusing its discretion by choosing adjudication over rulemaking in its oversight of ESOP is debatable. There are certainly pros and cons to each power.¹³⁹ Therefore, the Department of Labor and the public must continue to weigh the pros and cons of how the Department of Labor oversees ESOPs. In that consideration, it is essential to understand the benefits of implementing ESOPs.

VI. BENEFITS OF ESOPs

A. *ESOPs Combating Wealth Inequality*

Wealth inequality is one of the most significant problems facing the United States today.¹⁴⁰ ESOPs have been shown to combat wealth inequality in two ways. First, ESOPs help less wealthy individuals obtain

¹³⁵ *Scalia v. The Farmers National Bank of Danville*, No. 1:20-cv-674 (S.D. Ind. Feb. 28, 2020) (consent order and judgement).

¹³⁶ LAMDAN, *supra* note 130.

¹³⁷ *Id.*

¹³⁸ *See* Holland & Knight, *supra* note 83.

¹³⁹ LAMDAN, *supra* note 130.

¹⁴⁰ *See* INEQUALITY, (last visited Nov. 27, 2022) [<https://perma.cc/Q3YN-AHEE>].

more wealth.¹⁴¹ One of the most significant factors in ESOP assisting participants in accumulating wealth is that typically, an employer's ownership interest in an ESOP is not purchased by participants but is often given to them as a benefit for their service.¹⁴² This allows employees to earn wealth without diverting their income from necessities like food and housing. In addition, "company stock appears to come on top of, and not in place of, other compensation."¹⁴³

The Institute for the Study of Employee Ownership and Profit Sharing surveyed 195 employee-owners at a total of twenty-one companies offering ESOP participation to their employees.¹⁴⁴ One of the more exciting and relevant findings of the survey was that the 25th percentile of ESOP account values for the survey participants was \$89,500.¹⁴⁵ While the 25th percentile of retirement account values nationally is \$10.¹⁴⁶ The dramatic difference in account values gives a bright outlook on the ability of ESOPs to help grow wealth.

Another finding of the survey that shone brightly in favor of ESOPs and wealth development is the median account values broken down by income bracket.¹⁴⁷ The median ESOP account value for the income bracket of \$28,500.01 to \$37,000 is \$135,000.¹⁴⁸ The median ESOP account value for the income bracket of \$37,000.01 to \$45,500 was \$165,000.¹⁴⁹ The median ESOP account value for the income bracket of \$45,500.01 to \$53,500 was \$269,500.¹⁵⁰ The account values for employees in these income brackets show that ESOPs are helping employees grow wealth in ways that the general public is not.

ESOPs are also an outstanding way to fight wealth inequality because they diversify participants' asset portfolios.¹⁵¹ One of the most significant spikes in wealth concentration contributing to wealth inequality occurred after the 2008 financial crisis. Critical characteristics of wealth

¹⁴¹ See JANET BOGUSLAW & LISA SCHUR, BUILDING THE ASSETS OF LOW AND MODERATE INCOME WORKERS AND THEIR FAMILIES THE ROLE OF EMPLOYEE OWNERSHIP (2019).

¹⁴² Trout CPA, *Employee Stock Ownership Plans (ESOPs) Frequently Asked Questions*, TROUT CPA (April 16, 2021), [<https://perma.cc/F6XE-K2FA>].

¹⁴³ Steven F. Freeman, *Effects of ESOP Adoption and Employee Ownership: Thirty years of Research and Experience*, ORGANIZATIONAL DYNAMICS WORKING PAPERS 2, 6 (2007), [<https://perma.cc/XJB2-5DPS>].

¹⁴⁴ JANET BOGUSLAW & LISA SCHUR, *supra* note 142.

¹⁴⁵ *Id.* at 13.

¹⁴⁶ *Id.*

¹⁴⁷ *Id.* at 11.

¹⁴⁸ *Id.*

¹⁴⁹ *Id.*

¹⁵⁰ *Id.*

¹⁵¹ *See id.*

inequality in the United States responsible for the 2008 spike were portfolio heterogeneity and asset price exposures.¹⁵² In the bottom fifty percent of households, eighty percent of their wealth is tied up in nonfinancial assets, mainly cars.¹⁵³ In the middle class, from the fiftieth percentile of wealth to the ninetieth, two-thirds of household assets consist of nonfinancial assets, primarily houses and cars.¹⁵⁴ In the top ten percent of wealthy households, nonfinancial assets are roughly a quarter of household assets, with the bulk of the assets coming from stocks and business equity.¹⁵⁵ Since, the majority of wealth for the bottom ninety percent of households is tied up in houses and nonfinancial assets, their wealth is highly dependent on housing prices.¹⁵⁶ However, the top ten percent of households carry most of their wealth in stocks and business equity, making them less dependent on housing prices.¹⁵⁷

In the 2008 financial crisis, houses were among the hardest-hit asset classes.¹⁵⁸ Unlike stocks, houses took much longer to rebound from their losses.¹⁵⁹ From 2008 to 2016, “The bottom 50% lost 15% of wealth relative to 2007 levels, mainly because of lower house prices.¹⁶⁰ By contrast, the top 10% were the main beneficiary from the stock market boom and were relatively less affected by the drop in residential real estate prices.”¹⁶¹ The effects of the wealth losses by the bottom ninety percent and the gains from the top percent have increased wealth inequality in the United States.

ESOPs allow less affluent employees to obtain business equity assets as part of their overall wealth. By diversifying lower-class household asset portfolios, less wealthy households are less susceptible to an unstable housing market and can reap the benefits of business equity like the top ten percent of households. ESOPs are a powerful tool for the United States to tackle wealth inequality by allowing employees to obtain wealth without diverting income away from necessities and diversifying employee owners' asset portfolios. There has also never been a better time to start incentivizing ESOPs than now.¹⁶²

¹⁵² See Moritz Kuhn et al., *Income and Wealth Inequality in America, 1946-2016*, 128 J. POL. ECON. 3469, 3506 (2020).

¹⁵³ *Id.*

¹⁵⁴ *Id.*

¹⁵⁵ *Id.* at 3506–07.

¹⁵⁶ *Id.*

¹⁵⁷ *Id.*

¹⁵⁸ *Id.*

¹⁵⁹ *Id.* at 3514.

¹⁶⁰ *Id.* at 3506–07.

¹⁶¹ *Id.* at 3514–15.

¹⁶² See Mark Hall, *Unsexy But Thriving Businesses: The Hidden Opportunity Gifted To Us By Baby Boomers*, FORBES (Jan. 25, 2022, 9:30 AM), [<https://perma.cc/RR45-S9SW>].

B. ESOPs as a Succession Tool

ESOPs are also in a stronger position to be implemented in society than ever before. Over 1.1 million small businesses will change hands over the next fifteen years as their aging owners act on their exit plans.¹⁶³ Many of these small businesses will not be in a position to sell themselves to private equity firms or their competitors.¹⁶⁴ Therefore, when many of the owners of these small businesses retire, their businesses will dissolve, and their employees will have to find new jobs.¹⁶⁵

However, if the parties involved in regulating, enforcing, and implementing ESOPs can streamline the processes around implementing ESOPs, many retiring owners could use ESOPs as an exit strategy. Simplifying the processes around ESOPs would help keep thousands of jobs, and businesses open. Also, it would allow the retiring owners to convert their hard work growing businesses into assets instead of dissolving. Unfortunately, a complex and unpredictable oversight structure by the Department of Labor propagates risk and administrative costs in ESOP transactions, disincentivizing ESOPs as a viable exit strategy for many small businesses.¹⁶⁶

The federal government and many state governments recognize the opportunity ESOPs provide these small businesses and their stakeholders to reshape the wealth distribution in the United States.¹⁶⁷ The win-win dynamic for employers and employees has created one of the few points of bi-partisan support in our current political landscape.¹⁶⁸ However, ESOPs are still an underappreciated tool by the public and legal community.¹⁶⁹ While considering how the Department of Labor oversees the creation and administration of ESOPs, lawmakers and the public should consider the potential benefits to society and the current opportunity in front of the United States, with over 1.1 million small businesses ready to change hands in the coming years.

¹⁶³ *Id.*

¹⁶⁴ Tennessee Valley Group, *Most retiring business owners cannot sell their business*, TENN. VALLEY GRP. (Feb. 4, 2019), [<https://perma.cc/79JS-Z8NB>].

¹⁶⁵ *Id.*

¹⁶⁶ The ESOP Association, *supra* note 114.

¹⁶⁷ See BUTCHER JOSEPH & CO., *WHAT'S DRIVING ESOP MOMENTUM?* 6 (2021), [<https://perma.cc/PS4V-EJPP>].

¹⁶⁸ *Id.*

¹⁶⁹ The ESOP Association, *supra* note 114.

VII. CONGRESS'S MOST RECENT ACTIONS

While there is still much that needs to be done, Congress has recognized the opportunity in front of the United States and taken recent actions to promote ESOP.¹⁷⁰ Before the end of 2022, Congress passed the Consolidated Appropriations Act, 2023, also called the fiscal year 2023 omnibus appropriations bill, which included two sections with major implications for the future of ESOP.¹⁷¹

A. Section 346 Workers Ownership, Readiness and Knowledge (WORK)

The first section involving ESOPs is Section 346, Worker Ownership, Readiness and Knowledge (WORK).¹⁷² The WORK section has two major effects related to ESOPs. First, the WORK section gives \$50 million to the Department of Labor over five years.¹⁷³ The Department of Labor is directed to use the \$50 million to provide grants to state and local entities for the funding of new and existing programs focused on educating employers and employees on the benefits of employee ownership and technical assistance for employees trying to become employee-owners.¹⁷⁴

Second, the WORK section directs the Department of Labor to issue formal guidance on “acceptable standards and procedures to establish good faith fair market value for shares of a business to be acquired by an employee stock ownership plan”¹⁷⁵ As mentioned in Part III of this Note, business valuations are more an art than a science. ESOPs, in particular, face ESOP-specific challenges in valuing a company’s stock. By directing the Department of Labor to provide guidelines for independent business valuers in ESOP transactions, Congress is trying to clarify ESOP transactions and lessen the risk of future litigation due to inconsistent standards of stock valuations in ESOP transactions.¹⁷⁶

¹⁷⁰ Paul Mulholland, *ESOPs Fables: What Does the Omnibus Do for Employee Ownership?*, PLANSPONSOR (Dec. 21, 2022), [<https://perma.cc/3GJJ-PVRN>].

¹⁷¹ *Id.*

¹⁷² Bernie Sanders, *Sanders Longstanding Legislation to Help Workers Expand Employee Ownership Passes the Senate in 2023 Omnibus*, (Dec. 22, 2022), [<https://perma.cc/6N2S-AX6G>].

¹⁷³ 29 U.S.C. § 3228(g).

¹⁷⁴ 29 U.S.C. § 3228(c)(2).

¹⁷⁵ 29 U.S.C. § 3228(c)(4)(B).

¹⁷⁶ See The ESOP Association, *supra* note 114.

B. *Section 401 Amendments Relating to Setting Every Community Up for Retirement Enhancement Act of 2019*

The second section that affects ESOPs is the Setting Every Community Up for Retirement Enhancement (SECURE) 2.0 Act.¹⁷⁷ The SECURE 2.0 act also has two effects on ESOPs. First, the SECURE 2.0 Act will allow owners of S Corporations to defer ten percent of their gains from selling their ownership shares to an ESOP if they invest their gains back into stocks or bonds of another U.S. company.¹⁷⁸ Currently, owners of S Corporations who sell their ownership shares to an ESOP can not defer any of the gains from their shares.¹⁷⁹ However, C Corporation owners who sell their ownership shares to an ESOP and reinvest their gains can defer one-hundred percent of their gains.¹⁸⁰ It is common for S Corporations to reorganize from an S Corporation to a C Corporation before executing an ESOP transaction. In turn, the legal expenses are increased and, ultimately, the cost of an ESOP transaction, but increasing the deferral from zero to ten percent for S Corporation owners is a step in the right direction.

Second, the SECURE 2.0 Act has a “very narrow” provision¹⁸¹ that allows small community banks to more easily trade their ESOP shares without formally evaluating the shares every time they trade.¹⁸² In essence, an exclusion designed to make ESOPs more attractive to community banks and allow community banks with ESOPs to operate more efficiently.

C. *The National Defense Authorization ACT (NDAA)*

In addition to Congress’s more recent passing of the Consolidated Appropriations Act, 2023, Congress also passed the National Defense Authorization Act (NDAA), which president Biden signed on December 27, 2021.¹⁸³ The NDAA created a program that allowed companies which have one hundred percent ownership through an ESOP to be awarded sole source awards on follow-on contracts with the Department of

¹⁷⁷ Mulholland, *supra* note 171.

¹⁷⁸ *Id.*

¹⁷⁹ *Id.*

¹⁸⁰ *Id.*

¹⁸¹ *Id.*

¹⁸² *Id.*

¹⁸³ Robert Johnson et al., *ESOP Client Alert – Game Changer: 100% ESOP-Owned Government Contractors Eligible for Sole Source Awards on Follow-On Contracts*, KAUFMAN & CANOLES (Jan. 7, 2022), [<https://perma.cc/3GXQ-5FRR>].

Defense.¹⁸⁴ Sole source awards are extremely attractive agreements for government contractors which allow a single government contractor to supply the products or services requested by the government exclusively.¹⁸⁵ Previously sole source awards had requirements that excluded some ESOP-owned companies from being considered.¹⁸⁶ Now any company which is one hundred percent owned by an ESOP will have the ability to get awarded sole supplier status, incentivizing owners to sell their business to ESOP and creating a better business environment for existing ESOPs to thrive.¹⁸⁷

Congress passing legislation incentivizing the creation and encouraging the prosperity of ESOPs is a good sign for the future. The United States Legislature has taken strong steps in a positive direction by including ESOP provisions in the National Defense Authorization Act and the Consolidated Appropriations Act, 2023. However, additional steps could be taken to realize the benefits to society through employee ownership via ESOPs.

VIII. PROPOSAL

The current oversight of ESOPs by the Department of Labor, precisely the scrutiny placed on ESOP trustees and the unsettled duties of ESOP trustees in ESOP transactions, creates a level of risk that disincentives employers from pursuing ESOPs.¹⁸⁸ To help promote ESOPs to the 1.1 million employers looking for exit strategies in the coming years, all parties involved need to think carefully about how we proceed.¹⁸⁹

Several changes in how the United States handles ESOPs could result in considerable increases in ESOP adoption. First, the Department of Labor should halt its practice of creating new expectations for parties to ESOP transactions through adjudication. The Department of Labor's adjudication powers should continue to enforce the proper use of ESOPs, but the focus should be on punishing bad actors instead of punishing parties for good faith mistakes in forecasting business valuation. Using adjudication to create new protocols and then enforcing the new protocols

¹⁸⁴ *Id.*

¹⁸⁵ Ramiro Delgado, *What are Sole Source Contracts*, COLEY (Feb. 14, 2019), [<https://perma.cc/2LCW-RCQU>].

¹⁸⁶ *Id.*

¹⁸⁷ Johnson et al., *supra* note 184.

¹⁸⁸ The ESOP Association, *supra* note 114.

¹⁸⁹ Hall, *supra* note 163.

on parties to ESOP transactions before the protocols were in place is unfair and stymies the implementation of ESOPs.¹⁹⁰

Second, through rulemaking, the Department of Labor should create a clear expectation of the protocols to be followed by ESOP trustees in ESOP transactions. The recent settlement agreements have made good additions to prudent experts' protocols during ESOP transactions. However, how the Department of Labor created the new protocols is not fair to the ESOP community. The Department of Labor should go through proper notice and comment to clarify and solidify the protocols for parties to ESOP transactions. The comment period for the ESOP community will also help contribute to the best rules being put in place. The rulemaking proposals should include the procedures and protocols implemented through the recent settlement agreements and any proper protocols the Department of Labor believes would help streamline the ESOP implementation process while protecting all parties to the transactions. The comment period will give the Department of Labor all the information it will need to better select what protocols should be implemented.

Third, Congress and ESOP experts should continue looking for ways to incentivize the implementation of ESOPs outside the streamlining and clarification of the processes involved. A straightforward approach to establishing an ESOP should be the minimum expectation. Congress passing legislation like the National Defense Authorization Act, the WORK act, and the SECURE 2.0 act are good examples of legislation that can incentivize ESOP beyond clearly defining the requirements for creating an ESOP. Giving ESOPs preference in government contracts, extending tax credits to different business structures, and funding additional ESOP education are all excellent ways to incentivize ESOPs. All parties should consider more ways to incentivize ESOP, as Congress has in the last several years.

Another incentive that could create positive benefits for society is extending the tax benefits of one hundred percent ESOP-owned businesses to businesses that are less than one hundred percent owned by ESOPs. One of the most significant drawbacks to implementing an ESOP through a leveraged buyout is the increase in acquisition debt. By allowing ESOPs that do not fully own the business to receive tax advantages, companies that could not cash flow the full one hundred percent owned debt obligation could consider implementing an ESOP with less than one hundred percent ownership.

ESOPs are an underused tool for improving society. However, if the Department of Labor can change its current preferences in overseeing

¹⁹⁰ The ESOP Association, *supra* note 114.

ESOP transactions and move to a more streamlined approach with less uncertainty for parties to ESOP transactions, we could see a massive boost in ESOP implementation as baby boomers execute their succession plans.

IX. CONCLUSION

The Department of Labor's current oversight of ESOPs is stemming the use of ESOPs as a powerful tool for fighting wealth inequality. The Department of Labor creates uncertainty and risk for all parties involved in ESOP transactions by constantly changing the prudent expert standard for ESOP trustees.¹⁹¹ The risk created by the Department of Labor's ever-changing standards increases transaction costs and insurance premiums for businesses trying to implement ESOPs, often ruling ESOPs out of business owners' succession plans.¹⁹²

Courts grant administrative agencies deference in using their adjudicative or rulemaking powers. Still, an agency like the Department of Labor can abuse its discretion when it is clear that the circumstances call for the agency to use one power instead of the other. The Department of Labor's interest in extracting enormous fees from its enforcement of ERISA in ESOP transactions is averse to others' interest in a clearly defined ESOP valuation process.

Whether or not the Department of Labor is outside their discretion, the American public must closely consider how Congress and the Department of Labor treat ESOPs in the future. The United States is taking great strides by passing the Consolidated Appropriations Act, 2023, and other such legislation as far as they have affected ESOPs. However, the progress can not stop with the United States government's recent actions. As the United States enters a period where baby-boomer business owners and executives begin to retire en mass, Congress must continue incentivizing ESOPs as a succession planning tool for the retirement silver tsunami coming.

Most importantly, the Department of Labor must rethink the last fifteen years of its *ad hoc* creation of new fiduciary standers for ESOP trustees through non-binding settlement agreements. The Department of Labor needs to follow Congress's directive in the WORK act and issues formal guidance on how to give a good faith valuation of businesses with or attempting to start an ESOP.

The state of ESOP affairs is heading in the right direction. If advocates continue to push for clear guidance from the Department of Labor and positive incentives from Congress ESOPs will be able to help

¹⁹¹ *Id.*

¹⁹² *Id.*

the retiring baby boomers exit their businesses smoothly. As a result, employee owners will obtain more diversified and growing retirement accounts, which will help tackle the United States' wealth inequality and push the United States in a better direction.