NEWPORT INSIGHTS

# RULES AND REG'S CORNER

In January 2025, the U.S. Department of Labor, under the auspices of the outgoing Biden Administration, proposed two changes that could affect private ESOPs, including a potential revision to the definition of the term "adequate consideration" as cited in the ERISA code.

For more details about these proposals and their status under the new Trump Administration, please scroll down to the rest of the article.

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# The Proposed (and Withdrawn) "Adequate Consideration" Regulation and ERISA Prohibited Transacted Exemption for ESOP Formations

**A Brief Summary**

As one of the last regulatory efforts of the Biden Administration, the U.S. Department of Labor (the "DOL") released (for publication in the Federal Register on January 22, 2025) two important proposals affecting private ESOPs. The first, a "**Proposed Regulation Relating to [the] Application of the Definition of Adequate Consideration**" (the "Proposed Regulation"), is the long-awaited revised proposed rule defining the ERISA Section 3(18) statutory term of "adequate consideration" as it applies to non-publicly traded employer securities in the determination of fair market value in connection with ESOP transactions. The Proposed Regulation was developed at the direction of Congress under Section 346(c)(4)(B) of the SECURE 2.0 Act of 2022, and was intended to replace a 1988 proposed regulation never finalized by the DOL. The second, entitled "**Proposed Safe Harbor Class Exemption for Initial Acquisition of Employer Common Stock by ESOPs from Selling Shareholders,"** was proposed by the DOL on its own authority. This was intended to provide ERISA Section 406(a) party in interest and Section 406(b)(1) and (3) fiduciary prohibited transaction relief in ESOP formation transactions described under ERISA Section 408(e) for transactions involving "qualifying employer securities" for which there is no readily tradable market (specifically, the sale of non-publicly traded employer stock by a founder of the business).

Both proposals have been withdrawn in accordance with the new Trump Administration's executive order issued on January 20, 2025 (the "Executive Order)[1] directing a freeze on all pending regulatory projects. However, given the importance of these issues to the ESOP community, the insight that the proposals provide on the DOL's current thinking on these issues, and the strong possibility that similar (if not identical) proposals may later be issued by the new Administration, a brief summary of the relevant terms of the proposals is set forth below.

# Proposed Regulation Defining "Adequate Consideration"

## Scope

The Proposed Regulation, by design, is narrower than the 1988 Proposed Regulation, and covers only "adequate consideration" in the context of direct or indirect acquisitions of shares by an ESOP (as opposed to all other non-publicly traded securities or other properties). While the DOL formally withdrew the 1988 Proposed Regulation and solicited comments on the extension of this definition to other assets, the DOL stated that it would not "intend to contest parties' reasonable and good faith reliance on the 1988 proposal in situations that fall outside the current proposal."

## Requirements

The Proposed Regulation states that in order for a transaction to satisfy the statutory requirements of ERISA Section 3(18)(B), (i) the value assigned must be the "fair market value" of the securities; and (ii) that fair market value must be the result of a "prudent determination made by the plan trustee or named fiduciary pursuant to a prudent process."

- **Fair Market Value**: The Proposed Regulation specified the usual "arm's length transaction" standard between a knowledgeable willing buyer/willing seller, which was to be determined on a cash basis without any increase in value related to debt incurred in the transaction, is as of the date of such transaction, and is part of a process of valuation that is conducted in good faith.

- **"Prudent Process"**: The Proposed Regulation required the trustee or named fiduciary to (i) hire a "qualified independent valuation advisor" through an objective, documented process to determine both independence and competence in valuation; (ii) "prudently oversee" the preparation of a valuation report satisfying a number of detailed conditions (most of which mirror the DOL's litigation settlement "process agreements" and recent modifications of the prohibited transaction exemption procedures); and (iii) determine that it was prudent to rely on the valuation report in determining fair market value (including the accuracy of the information, the reasonableness of the assumptions, including future performance, and a "proper accounting" of factors such as controlling/non-controlling interests and discounts for lack of marketability).

- **Qualified Independent Valuation Advisor**: Consistent with the DOL's litigation position, the advisor must be "independent" of all the parties to the transaction (including the trustee and the plan sponsor).

## Withdrawal of 1988 Proposed Regulation

While the DOL specifically intended to withdraw the 1988 Proposed Regulation, the Executive Order stayed that effort, and the 1988 Proposed Regulation is still "pending."

# Proposed Safe Harbor Class Exemption for Initial Acquisition of Employer Common Stock by ESOPs from Selling Shareholders

## Background

The DOL, on its own authority, simultaneously issued the "Proposed Safe Harbor Class Exemption for Initial Acquisition of Employer Common Stock by ESOPs from Selling Shareholders" (the "Proposed Exemption"), and as was made clear in both documents, intended the Proposed Exemption and the Proposed Regulation to be complementary (including, unusually, issuing a joint "Regulatory Impact" analysis of both proposals).

The Proposed Exemption generally provided relief from ERISA's prohibited transaction provisions for an initial acquisition of non-publicly traded stock for (a) any "Selling Shareholder"; (b) an "Independent Trustee" (that is, a trustee of the ESOP that is independent of the issuer); (c) an "Independent Appraiser" of the securities "that represents the interests of the ESOP"; and (d) a "Monitoring Fiduciary" (that is, a fiduciary that has the authority to hire/fire the Independent Trustee).

## General Conditions for Exemptive Relief

- No commissions or Selling Shareholder expenses are to be paid by the ESOP or the Company.
- The transaction is not designed to evade Federal law or otherwise cause the plan to pay more than "fair market value".
- The transaction is set forth in a written contract.
- The Independent Trustee must not engage in the transaction if the transaction is not "reasonably expected to result in the ultimate release of [stock]" worth at least as much as what was paid, plus a "reasonable return" (which was undefined).

## Conditions for Selling Shareholders

- The Selling Shareholder must not have authority to participate in the ESOP's decisions to engage in the "Covered Transaction" or negotiate the terms of the engagement of advisor.
- The Selling Shareholder must take steps to ensure that they are not provided information on the ESOP's deliberations, and all communications with the Independent Appraiser are monitored by the Independent Trustee.

- All representations and information provided by the Selling Shareholder must be materially accurate, complete and current, and the Selling Shareholder must be prepared to attest to this.

### Other Conditions

- **Independence/Compensation Requirements**
    - Neither the Independent Trustee, the Independent Appraiser, nor any affiliate may have previously performed any work for the Employer or Selling Shareholder, nor may the compensation exceed more than 2% of the Independent Trustee's or Independent Appraiser's gross revenue for the prior tax year.
    - The Independent Trustee must not be indemnified for any breach of fiduciary duty by the ESOP or other parties, and while advancement of legal fees is permitted, the Independent Trustee must post "adequate security" for the amounts advanced.
    - The Independent Appraiser may not disclaim liability for its work, including any negligence carve-out, and may not take any direction from any party other than the Independent Trustee.
- **Appraisal Reports Criteria**: In addition to an exhaustive list of requirements, the Independent Appraiser was specifically held to consider whether any of the individuals providing information had conflicts of interest, and disclose in the report if that had any impact on the determination of Fair Market Value.

> Take in tandem, the DOL's [Proposed Regulation and Proposed Exemption] seemed to raise the bar even further on ESOP formation transactions, and perhaps intentionally narrow even further the qualified service providers/fiduciaries willing or able to work on these transactions.

## Conclusion

While the Proposed Regulation, on its face, was not a significant departure from the prior 1988 Proposed Regulation, when taken in connection with the Proposed Exemption, the combination imposes significant restrictions on any ESOP formation transactions and presents significant risks for any fiduciaries and appraisers engaging in the transactions.

Most institutional appraisers, especially those part of larger organizations, would be precluded from involvement in these transactions if any affiliate, for example, had any prior business dealings with the plan sponsor or Selling Shareholders, even if totally unrelated to the transaction (including any entity acquired by the appraiser, in much the same way as the acquisition of an investment advisor convicted of a crime disqualifies the acquirer from serving as a "qualified professional asset manager" or QPAM). Limitations on liability disclaimers (also a common contractual feature for appraisers) would disqualify an appraiser under the Proposed Exemption. For Institutional Trustees, the new requirements of having insurance equal to 20% of the ESOP purchase price, and not being advanced legal fees to defend litigation without posting some type of bond securing these obligations, is far in excess of any prior statutory or administrative requirement imposed by the DOL on fiduciaries, and there is uncertainty about the availability of such insurance products in the market.

Taken in tandem, the DOL's approach seemed to raise the bar even further on ESOP formation transactions, and perhaps intentionally narrow even further the qualified service providers/fiduciaries willing or able to work on these transactions. While the Proposed Exemption was described as a safe harbor by the DOL, and not the exclusive means of satisfying the determination of "adequate consideration" in ESOP formation transactions, it seems clear that the DOL was attempting to steer formation transactions along a relatively narrow path. Time will tell whether the features of these proposals will be adopted by the new Administration.

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