



Is There a Problem with ESOPs? Recent Litigation and Enforcement Efforts

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Focus of Today's Presentation

- Closely-held ESOP overview
 - Overview on importance of experts and process, including need for independent valuations
- Trends in DOL enforcement and ESOP litigation
 - DOL enforcement priorities
 - Current issues arising in DOL audits and private litigation
 - Recent decisions in ESOP cases
- Future areas of interest
 - Potential issues and claims in private litigation
- Answering Today's Question: Is there a problem with ESOPs?

Valuation and Process Overview



ESOP Overview – Valuation and Process

- ESOPs unique among employee benefit plans
- Valuation is critical in the closely-held ESOP context
- No market to set the value of company stock
 - ERISA §3 (18): Adequate Consideration = Fair Market Value determined in good faith by fiduciary pursuant to the terms of the plan and in accordance with DOL regulations.
 - At least two components: (1) Substantive (2) Procedural
 - DOL Prop. Reg. 29 C.F.R. § 2510.3-18(b) never formally adopted but sets forth content for valuations and steps to fulfill procedural prudence.
- Purchase or sale of stock must meet ERISA §404 “Prudence” requirement and §406 Prohibited Transaction rules.
 - *Chao v. Hall Holding*, 285 F.3d 415 (6th Cir. 2002)
 - *Howard v. Shay*, 100 F.3d 1484 (9th Cir. 1996)
 - *Donovan v. Cunningham*, 716 F.2d 1455 (5th Cir. 1983)

Valuation Approaches and Methods

- Approaches (methods) to determine fair market value (“FMV”)
 - Income Approach (Discounted Cash Flow Method)
 - Market Approach (Guideline Publicly Traded Company Method; Guideline Transaction Method)
 - Asset Approach
- Methods are subject to critical assumptions
 - Management’s future growth projections
 - Appropriate discount rates and comparable risks
 - Assumed capital structure of the company
 - Any restrictions or limitations on the company and the ESOP’s investment
 - What are comparable companies, if any, and are they comparable
 - Weighting of approaches

ESOP Overview – Reliance on Experts

- The fiduciary makes the investment decision, not the expert.
- *Donovan v. Cunningham*, 716 F.2d 1455 (5th Cir. 1983) – experts are not “magic wands”
 - Need to exercise prudence and care in retaining and overseeing expert’s work
 - Need to ensure experts have access to appropriate, accurate, and current information
- Challenge for fiduciaries
 - Hire appraisers and other experts, in part, because of expertise the fiduciary lacks
 - How then does the fiduciary assess the work of expert?

ESOP Overview – Reliance on Experts

- Before the fiduciary relies on the expert
 - Investigate the expert’s qualifications
 - Make sure the expert has complete, current, and accurate financial information
 - Make certain that reliance on the expert’s advice is reasonably justified under the circumstances
- Reliance on expert is justified when fiduciary
 - Reads the report and supporting documents
 - Understands the report
 - Identifies, questions, and tests the underlying assumptions
 - Verifies that the conclusions are consistent with the data and analyses
 - Verifies that the appraisal is internally consistent and makes sense

Trends in DOL Enforcement and ESOP Litigation

DOL Enforcement Priorities

What Does It Mean

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- Contributory Plans Criminal Project (embezzled contributions)
 - Fraudulent MEWAs
 - Rapid ERISA Action Team (employer bankruptcies)
 - ***ESOPs**
 - Consultant/Advisor Project (fee and compensation conflicts)
 - Participant and Beneficiary Complaints
 - Non-filing and delinquent filing of ERISA filings
 - Meals, gifts, and entertainment
- Increase in the number of DOL reviews and investigations
 - Closer scrutiny of ESOPs
 - Shift in type and depth of questions being asked
 - Increase in DOL lawsuits and amicus brief filings
 - Increased focus on review of valuation reports
 - Related issue: possible regulatory changes to valuation experts' fiduciary status

DOL Enforcement Process

1. Notice
2. Subpoena
3. Interviews/Depositions (management, trustees, etc.)
4. Voluntary Compliance Demand Letter
5. Settlement at Regional Office Level
6. Solicitor Involvement and Settlement
7. DOL Files Lawsuit

Private ESOP Litigation Class Action Process

- Most large private cases are class actions
 - DOL does not need to comply with class requirements of Rule 23
 - Private litigants can bring on “behalf of the plan” under ERISA sec. 502(a)(2)
 - But courts sometimes want procedural protections for participants, and plaintiffs and their counsel have incentives to bring as a class action
- ESOP cases often meet class requirements
 - *E.g.*, valuation affects all stock bought or sold by the ESOP during the period the valuation is in question
 - But disclosure claims may raise reliance issues
 - Can have conflict issues between current and former employees over lawsuit and remedies

Recent Litigation and DOL Enforcement Issues

Litigation Trends

- Recent valuation allegations
 - Unrealistic growth projections
 - Unreliable or out-of-date financials
 - Inconsistent internal assumptions
 - Failure to identify, examine, and test assumptions
 - Failure to appropriately discount for company-specific risks (e.g., dependence on a single customer)
 - Incomparable comparables
 - Inappropriate adjustments to financial statements
 - Narrative at variance with the valuation's conclusions
 - Disregard of price in contemporaneous transactions
 - Control premiums
 - Marketability discounts
 - Minority interests
 - Weirdness, illogic, and heretofore unknown methodologies

Litigation Trends

- Reasonableness of management projections (BCC Capital, SJP, Maran, Sierra Aluminum)
- Employment-related agreements with sellers (McKay, Parrot Cellular)
- Consideration of the FMV of the ESOP note used to pay for the stock (Hans)
- Control premiums (Rembar, Sierra Aluminum)
- FMV and plan restrictions (Hollister)
- Complex transactions, fiduciary duties, and FMV (Tribune and Trachte)
- Measure of damages in ESOP cases (Tribune, Trachte)
- ESOP's subsequent acquisition of stock from participants (Stiefel)
- ESOP-owned company indemnification of ESOP fiduciaries (Sierra Aluminum, Fernandez, Couturier)

- Discounted cash flow valuation method relies on management projections.
- Issues raised include
 - Appraiser's role and ability to rely on management's projections.
 - Fiduciary's duties in checking and vetting projections.
 - What is reasonable and supportable in context?
 - What is risk and discount rate in light of the projections and the business circumstances surrounding those projections?
 - How much of this is hindsight based on the economic downturn from the Great Recession? None, according to DOL.
 - Are recent good years representative of future expectations?
 - Consideration/incorporation of bad years (mean reversion)
 - Realistic assumptions on future growth in light of company's and economy's circumstances?

Litigation Trends

Reasonableness of Projections

- *Solis v. First Bankers Trust, Maran Inc. et al.*, 12-cv-8648 (S.D.N.Y.) DOL lawsuit against fiduciaries for reliance on faulty appraisal. According to allegations, flaws included reliance on unreasonable management projections:
 - “Aggressive” projections envisioned dramatic increase in profits for 2007 to 2011 unlike any performance in preceding five years and that were inconsistent with appraisal’s own description of economy’s direction.
 - Projections assumed steady and inexorable growth without regard to dramatic fluctuations in sales and profits in previous periods, including years in which the numbers declined.
 - The fiduciary and appraiser allegedly failed to engage in any independent exploration of the credibility of management projections.
 - Allegedly failed to consider customer concentration.

Reasonableness of Projections

- *Evolve Bank & Trust v. BCC Capital Partners (So. Cal. Pipeline Construction)*, 12-cv-1901 (C.D. Cal.). Claim brought under California securities law against advisors and ESOP seller alleging they defrauded the ESOP trustee and his financial advisor.
 - Company did infrastructure work in support of residential construction in California. Sale to ESOP occurred in November 2007; market had started turning down by end of 2006.
 - Duff & Phelps valued company at \$20 million at end of 2006 based on projections showing downturn in revenues.
 - ESOP trustee and appraiser were never provided this valuation and instead received management projections showing upturn in revenues and income. Valued company at \$35 million based on these projections.
 - Six weeks after the transaction closed, management provided new projections showing 50% lower revenues for 2008 forward.
 - Company was unable to service ESOP notes and ceased operations in 2010.



Litigation Trends

Employment Related Agreements

- Issues for agreements entered into before ESOP acquired stock
 - Whether entering into employment agreement involved fiduciary conduct or raises a fiduciary claim?
 - Whether the impact of the employment agreement was considered in valuing the stock?
- Issues once the ESOP owns the company
 - Whether entering or continuing of employment agreement involved fiduciary conduct or is part of normal running of the business?
 - Whether agreements raise conflict of interest and self-dealing?

Litigation Trends

Employment Related Agreements

- *McKay v. Tharaldson*, 08-cv-00113 (D.N.D.). Owner entered employment agreement with his ex-wife for a marketing and consulting agreement of \$500,000 a year for 20 years. Agreement was entered before the ESOP acquired stock.
 - Disputed whether agreement was reasonable, ex-wife had previously performed marketing services as company grew.
 - Disputed whether agreement was fully factored into later ESOP valuation.
 - Court granted defendant summary judgment since no breach of fiduciary duty not to bring derivative claim—the claim would not have been successful because the ESOP was not a shareholder when the agreement was entered.
 - A state-law analysis driven by allegations in complaint regarding failure to bring derivative claim and determination that consulting agreement was a “no-cut” contract.

Litigation Trends

Employment Related Agreements

- *Solis v. Webb*, 2012 WL 4466536 (N.D. Cal. 2012) (*Parrot Cellular*). ESOP acquired company valued at \$30 million. The company was valued at only \$7 million two years earlier, and prior to the ESOP's acquisition, entered into deferred compensation agreements with CEO/owner of \$4 million and \$12 million. On motion to dismiss, court ruled
 - Fiduciary duties arose before the ESOP acquired the stock, but no harm or breach of fiduciary duties until the ESOP acquired stock.
 - The DOL adequately alleged that the ESOP paid more than FMV for the stock, including failing to factor in the impact of the \$16 million in deferred compensation agreements on that FMV.
 - Officers and ESOP committee members could not claim they had no liability because they had delegated to an investment manager/independent fiduciary the decision whether the ESOP should buy the stock. They could be liable for knowingly participating in a fiduciary breach and for failing to monitor the fiduciary they appointed.

Litigation Trends

Control Premiums

- *Solis v. First Bankers Trust (Rembar)*, 12-cv-08649 (S.D.N.Y.). ESOP acquired 100% of the company and valuation firm added in a 25% control premium worth \$2.5 million. DOL complaint alleges
 - Cash flows valued using controlling interest basis, so premium was duplicative.
 - Limitations in agreements left control with sellers until ESOP notes were paid off, so ESOP did not have control.
- Control premium also challenged in *Hans* case. Seller kept himself in all key management positions, exercising control in fact, and in so doing fundamentally changed the business plan from a development and management company to solely a management company.
- Plaintiffs and DOL looking at who actually exercises control or “control in fact” versus control by majority ownership.

Litigation Trends

FMV and Plan Restrictions

- *DeFazio v. Hollister*, 854 F. Supp. 2d 770 (E.D. Ca. 2012). Company's articles of incorporation limited shareholders to specified person, that the company had the right of first refusal to acquire the shares at book value, and that other buyers would pay no more than book value. ESOP required sales to be conducted in accordance with these articles.
 - ESOP fiduciaries breached duties by not conducting an independent investigation to determine FMV of the ESOP stock when the stock was sold back to the company to acquire funds for repurchases.
 - But there was no harm since company's articles restricted buyers and the price they would pay to book value.
- *Tribune* considered whether resale restriction can make an ESOP's stock worth less than the company's publicly traded stock.

FMV of Seller ESOP Notes

- *Hans v. Tharaldson*, 2011 WL 7179644 (D.N.D. Oct. 31, 2011). Claim that trustee seller breached fiduciary duties by causing the ESOP to pay more than FMV for his and his family members' stock. ESOP transaction financed with seller notes.
 - Financing to the ESOP: 20 to 30 year terms to maturity, half percent over prime interest, no warrants.
 - Appraisers valued FMV of ESOP notes at 60% to 70% of face = over \$100 million less than face.
 - Defendant argued that notes contained below market terms and should be considered in connection with adequate consideration analysis.
 - Court left open whether it would consider the FMV of the ESOP notes in determining whether the ESOP paid more than FMV for the stock.

Litigation Trends

FMV of Seller ESOP Notes

- *Harris v. GreatBanc Trust Co. (Sierra Aluminum)*, 2013 WL 1136558 (C.D. Cal. Mar. 15, 2013). One of the allegations related to the use of the FMV of the seller notes instead of the face value of the seller notes in determining adequate consideration at the time of the transaction.
 - ESOP (buyer) unadjusted purchase price **\$53MM** (\$10MM in cash and seller notes with a face value of \$43MM)
 - Appraised FMV of shares purchased by ESOP: **\$40.3MM to \$47.7MM**
 - Unadjusted purchase price (\$53MM) greater than FMV of shares (\$40.3MM to \$47.7MM) before factoring in below market interest rate on seller notes
 - Appraised FMV of seller notes \$34.7MM (19.3% discount from face value) to \$37.1MM (13.7% discount from face value) resulting in FMV of consideration paid by ESOP of **\$44.7MM to \$47.1MM**
 - Appraiser opined that the FMV of Consideration paid by ESOP (\$44.7MM to \$47.1MM) fell within the range of FMV of shares purchased by ESOP (\$40.3MM to \$47.7MM); therefore Consideration paid by ESOP does not exceed the fair market value of the shares purchased by ESOP

Litigation Trends Complex Transactions, Fiduciary Duties and FMV

- *Neil v. Zell*, 753 F. Supp. 2d 724 (N.D. Ill. 2010). Tribune Company took on \$8 billion in debt in complex going-private transaction in which ESOP became sole shareholder; bankruptcy later ensued and stock became worthless
 - Unregistered stock subject to trading restriction was not “qualifying employer security” under IRC. Partial summary judgment granted for plaintiffs on prohibited transaction claim.
 - Trustee’s motion for partial summary judgment as to damages denied; damages not limited to principal and interest payments on ESOP note, but no windfall either.
 - Class certified and \$32 million settlement finally approved in January 2012.

Litigation Trends Complex Transactions, Fiduciary Duties and FMV

- *Chesemore v. Alliance Holdings (Trachte)*, 886 F.Supp.2d 1007 (W.D. Wis. 2012). Involves complex transaction whereby company was spun-off using ESOP. Employee accounts in Alliance ESOP holding Alliance stock were transferred to newly-formed Trachte ESOP and exchanged for Trachte stock. Trachte ESOP and Trachte take on additional debt to purchase remaining shares of Trachte from Alliance, and fiduciary of Alliance ESOP received \$2.9M payout as a result of the transaction.
 - After bifurcated bench trial, court finds that fiduciaries of Alliance ESOP and Trustees of Trachte ESOP breached their fiduciary duties.
 - Sellers at Alliance had fiduciary duties to Trachte ESOP since they structured the sale so that the ESOP had no independent advisors.
 - Stock price was for more than adequate consideration. Third party pulled out of acquisition, and business was starting to turn down by the time of the sale. Also failed to include discount for lack of marketability and improperly included \$2 million tax shield in valuation.

- General Observations
 - Once court considering damages, uncertainty resolved in favor of plaintiffs
 - Court will shape an award so as to make injured plan whole while apportioning damages equitably between wrongdoers
 - Courts grapple head-on with valuation
- *Neil v. Zell*, 767 F. Supp. 2d 933 (N.D. Ill. 2011). ESOP issued \$250 million in debt to acquire Tribune. Company contributed and ESOP paid \$15 million on those notes before the company went bankrupt, thereby ending contributions and further payments on the loans.
 - Court refused to cap damages at \$15 million, since the debt was a real debt of the ESOP at the time of the transaction.
 - Court suggested measure of damages based on what would have been available had three years of contributions to the ESOP been prudently invested, including \$250 million in the original investment less debt forgiveness.
 - Case subsequently settled for \$32 million.

- *Chesemore v. Alliance Holdings (Trachte)*, 2013 WL 2445036 (W.D. Wis. June 4, 2013)
- Noted Three Possible Measures of Damage
 - Method 1: Compare actual performance after breach with hypothetical investment
 - Method 2: Difference between purchase price and current value
 - Method 3: Difference between amount paid and FMV
- Plaintiffs urged rescission of the original transaction and recoupment of full purchase price because company collapse caused by ESOP debt.
- Court chose Method 3, plus reinstatement/partial rescission for original Alliance accounts, plus pre-judgment interest.
- Court recognized “the tsunami that was the 2008 financial crisis.”

- *Chesemore v. Alliance Holdings (Trachte)*, 2013 WL 2445036 (W.D. Wis. June 4, 2013)
- Calculation of Difference Between Purchase Price and FMV
 - Corrected errors in original valuation
 - Removed tax benefit because unique to ESOP buyer
 - Removed cash for operating capital (valuator added all cash back to value)
 - Took a 10% discount for lack of marketability
 - Converted to a low, median, high presentation for market-based and DCF (critical of original range structure)
 - Corrected phantom stock calculation to comport with actual formula
 - Adjusted roughly contemporaneous arm's length offer
 - Averaged the two amounts
- Disgorgement of \$2.9M payout to fiduciary considered profits made through use of plan assets in violation § 406



Litigation Trends Acquisition of ESOP Stock From Participants

- *Bacon v. Stiefel*, ---FRD---, 2011 WL 2973677 (S.D. Fla. July 21, 2011). Allegation of fraudulent scheme to conceal value of corporation and recapture stock from ESOP participants prior to merger that greatly increased value of the stock.
 - Class certification denied: Individualized reliance issues defeated certification; court rejected plaintiffs' argument for presumption of reliance due to allegations of fraud or "common scheme."
 - Variations in representations and reliance thereon made class certification inappropriate. Sellers sold for different reasons, including to end risk of owning stock in uncertain economic environment.
- Dispute continues on as individual claims and for securities claims.

Indemnification of ESOP Fiduciaries

- Recent Prior Caselaw - Indemnification of fiduciaries by ESOP-owned company found void under ERISA § 410:
 - *Johnson v. Couturier*, 572 F.3d 1067 (9th Cir. 2009) (100% ESOP owned and company in liquidation).
 - *Fernandez v. K-M Indus. Holding Co.*, 646 F. Supp. 2d 1150 (N.D. Cal. 2009) (partially ESOP-owned and on-going business).
- *Harris v. GreatBancTrust Co.*, 2013 WL 1136558 (C.D. Cal. Mar. 15, 2013). 100% ESOP owned company that is a going concern. Indemnification valid because
 - Indemnification agreement excluded indemnification if found liable of fiduciary breach.
 - Company was a going concern, so its assets were not considered ESOP assets unlike in *Couturier*.
 - DOL's argument that settlement could be used to avoid loss of indemnification from fiduciary breach was not well founded, particularly since defendant could not use settlement to avoid admission of liability unless DOL agreed.
- *Schafer v. MultiBand Corp.*, 2013 WL 607910 (E.D. Mich. Feb. 19, 2013).

Best Practices Extracted from Litigation

- Process is important:
 - Consider engaging independent fiduciary to review and approve transaction. Do not limit authority or ability to act.
 - Document process. Document the information provided valuation experts and fiduciaries.
 - Fiduciaries should encourage valuation experts to test and challenge critical assumptions.
 - Fiduciaries must oversee and, when appropriate, challenge experts to justify assumptions and advice.
- Economic substance is also critical:
 - What is the business case for the valuation? Can the company carry the ESOP debt during an economic downturn? Document and justify assumptions used.
 - Valuation expert must have access to all critical business and financial information.
 - If have employment agreements, document justifications and how these were considered in the valuation.

Future Areas of Interest

Future Areas of Interest

- Complex valuation issues, such as consideration of capital structure, business risk and discount rate, testing reasonableness of management projections, warrants, SARs, synthetic equity, convertible preferred stock, and limitations on ESOP's ownership interests.
- In determining whether the ESOP paid more than adequate consideration for the stock:
 - Whether, when and how courts may factor in the value of the ESOP notes acquired by seller?
- Whether and when courts will allow ESOP-owned companies to indemnify ESOP fiduciaries?
- If DOL adopts a regulation making valuation firms fiduciaries, what is the potential impact on litigation?

Answering Today's Question: Is There A Problem with ESOPs



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