Fiduciary Lessons From DOL's Win In Employee Stock Case

By **Gregory Brown, William Delany, Louis Joseph and Chelsea McCarthy**

In Acosta v. Vinoskey et al., the U.S. District Court for the Western District of Virginia recently awarded the Sentry Equipment Erectors Inc. employee stock ownership plan $6.5 million for the ESOP's overpayment for the founding shareholder's 52% interest in Sentry Equipment Erectors. The selling shareholders (Adam Vinoskey and a related trust) and the ESOP trustee were held jointly and severally liable.[1]

Gregory Brown

The court held that the ESOP trustee had breached its duty of prudence and duty of loyalty to the ESOP and had committed a prohibited transaction by overpaying for the company stock held by Vinoskey and a related trust. It also held that Vinoskey was a knowing participant in the prohibited transaction and, thus, was jointly and severally liable with the ESOP trustee.

William Delany

Factual Background

The transaction occurred on Dec. 20, 2010, less than six weeks after the independent trustee, Evolve Bank & Trust NA, was first contacted about the transaction. Based on this time frame and other factors, the court concluded that the ESOP trustee's due diligence was rushed and cursory, noting that the parties were motivated by tax reasons to close the transaction by Dec. 31, 2010. In fact, the transaction closed before the ESOP trustee received the final valuation report and without negotiation over the price to be paid for the company stock.

Louis Joseph

The ESOP had been established in 2004 and, prior to the 2010 transaction, the ESOP held 48% of the outstanding shares of the company, with Vinoskey and his related trust holding the remaining 52%. After discussing matters with his advisers, Vinoskey decided to sell that 52% to the ESOP at a proposed price of $406 per share, which resulted in a total purchase price of nearly $21 million for the 51,000 shares sold to the ESOP. He instructed his attorney to contact Evolve Bank & Trust to act as independent trustee in the transaction, and his attorney contacted them on Nov. 9, 2010.

Chelsea McCarthy

On Nov. 18, 2010, Evolve representatives visited the company's headquarters and, after meeting with company management, Vinoskey, and some other employees, had its engagement letter executed. Evolve had previously, on Nov. 11 and 13, interviewed by phone representatives of Capital Analysts Inc. and decided to retain CAI as its appraiser for the transaction. CAI was formally engaged on Nov. 29. Evolve also agreed to have the company's legal counsel serve as its counsel on behalf of the ESOP. While it is not clear which due diligence documents were furnished to Evolve, its representatives reviewed everything furnished and reviewed CAI's prior appraisal reports regarding the company.

Evolve's only visit to Sentry to interview its management and employees, as well as the Vinoskeys as sellers, occurred on Nov. 18. While Evolve recommended a five-person board of directors with two independent directors, this was not included in the transaction documents and was not implemented after the transaction closing.

The transaction ultimately closed on Dec. 20, 2010, with no negotiation about the transaction price. At the time of closing, Evolve had not seen the final valuation report from CAI and, thus, did not verify that certain requested revisions in the report had been made. Evolve resigned as the trustee immediately after the closing.

In 2014, several years after the closing, Vinoskey forgave $4.6 million of the $10.3 million ESOP note he received at the 2010 closing.

Valuation Issues

The crux of the court's criticism focused on the process and valuation methodology and assumptions of the ESOP trustee's financial adviser. The court criticized the trustee for apparently overlooking indications that the financial adviser completed his appraisal with an eye toward reaching a predetermined value commensurate with the seller's initial offering price. The court was also critical that the trustee settled on a final purchase price prior to reviewing the appraiser's final appraisal.

As to the valuation itself, the court found it significant that the financial adviser only used the capitalization-of-earnings methodology and did not use the discounted-cash-flow, or DCF, methodology. The adviser believed the DCF analysis to be unhelpful where the company did not have a history of developing detailed financial projections. The court found it significant that the trustee had expressed concern over sole reliance on the capitalization-of-earnings methodology but did not urge its financial adviser to work with the company to develop projections, or insist that the company either develop its own projections or hire a third-party firm to help it do so.

In addition, the court criticized a number of assumptions used in the financial adviser's capitalization-of-earnings analysis:

- The assumption that the ESOP had acquired total control of the company where the selling shareholders were ongoing trustees of the ESOP and directors of the company;
- The working capital assumption, which the court found unrealistic in light of the company's historic and projected working capital requirements;
- The use of a three-year look-back period instead of five to six years in assessing the company's earning capacity;
- The add-back of ESOP contributions and health care expenses when calculating the company's cash flow where there was no reasonable expectation that the related adjustments would actually occur;
- The add-back of land value and cash to company value, which had not been used in prior valuations of the company; and
- The use of an unusually low discount rate relative to prior and subsequent valuations of the company.

The court rejected the U.S. Department of Labor's position that a 20% lack-of-control discount should be applied and instead applied a 5% discount because the ESOP participants had some elements of control, including the ability to instruct the ESOP trustee on the voting of ESOP shares on important corporate issues such as mergers and asset sales.

Conclusions of Law

The court concluded that Evolve failed to notice and investigate several concerning issues in the CAI report, including CAI's control assumption, CAI's working capital assumption, CAI's use of a three-year look-back period, CAI's add-back of ESOP contributions when calculating Sentry's cash flows, CAI's add-back of one-half of health care expenses in calculating Sentry's cash flows, and CAI's unusually low discount rate.

The court further held that Evolve breached its fiduciary duty by not pursuing and resolving those issues by, for example, including provisions in the transaction documents requiring expansion of the board size to five, requiring two independent directors, and reviewing the final report prior to closing to verify that CAI had adequately addressed Evolve's concerns regarding the add-backs, the working capital assumption, and the discount rate.

The court also ruled that Evolve did not have sufficient time to thoroughly conduct its due diligence. This resulted in a rushed process in advance of closing, with only a modest amount of time spent meeting with management and conferring with CAI about its report. The frequency and duration of the meetings resulted in the court's conclusion that Evolve was not fully engaged and found that Evolve's deficient process caused the ESOP to overpay for Vinoskey's stock and therefore caused a loss to the ESOP.

Finally, the court also found that "fair to both sides" testimony of the trustee representative at trial, Evolve's failure to seriously challenge CAI's pro-seller assumptions, and Evolve's lack of negotiation established that Evolve breached its duty of loyalty to the ESOP.

Vinoskey's Joint and Several Liability for Evolve's Fiduciary Breaches

The court held Vinoskey liable along with Evolve for the ESOP's losses based on two different claims asserted by the DOL.

First, the court held Vinoskey liable as a party in interest to the ESOP who had knowingly participated in Evolve's breach. The court found that Vinoskey had seen CAI's valuation report prior to the closing of the transaction, knew that he was being overpaid for the stock being sold, and that these facts were sufficient to support a determination of liability as a knowing participant in a fiduciary breach.

Second, the court found that even though Evolve had been appointed as independent fiduciary with sole authority to act on behalf of the ESOP in connection with the transaction, the fact that Vinoskey had remained as a trustee of the ESOP before, during and after the transaction was sufficient to impose co-fiduciary liability on him as a result of his failure to prevent or correct Evolve's fiduciary breaches.

Damages

While the court criticized the ESOP trustee and its financial advisers on the health care expense and ESOP contribution add-backs, it did not assign specific amounts of damages to these items because it felt that the record was underdeveloped on these issues. The court applied a 5% lack-of-control discount because the ESOP acquired some elements of control, such as the ability to conduct the ESOP trustees votes on important corporate matters such as mergers and asset sales, and rejected the DOL's recommended 20% discount. Further, the court refused to offset Vinoskey's 2014 forgiveness of $4.6 million of ESOP debt against the amount of damages, citing Perez v. Bruister[2] and Henry v. U.S. Trust Company of California NA.[3]

The court's decision on not allowing the debt forgiveness to be used as an offset amount in calculating damages is disappointing. In a footnote the court notes that it would have permitted such an offset but for the weight or authority disfavoring such an offset. By deferring to questioning the weight of authority and not following its own viewpoint, the court has provided the ESOP with a windfall for which there is no statutory authority in ERISA or its legislative history.

Indeed, Section 409 of the Employee Retirement Income Security Act provides for making a plan whole for its losses, not providing a windfall. As a result, Vinoskey may end up paying twice on his $4.6 million ESOP debt forgiveness under his joint and several liability. The obvious consequence of such a result is that a seller holding an ESOP note may be disincentivized to forgive any portion of that note.

It is unclear how the court would have treated the forgiveness of the ESOP debt if the forgiveness had resulted from Vinoskey negotiating the forgiveness with an independent trustee at, for example, arm's-length. It is also unclear how the debt reduction would have been treated if it had resulted from a clawback provision in the 2010 stock purchase agreement.

Key Takeaways

The decision highlights the following considerations that were key to the court's holding:

- Absence of evidence of a thorough and deliberate due diligence;
- Failure to consider a discounted cash flow analysis, even where the company has not traditionally prepared detailed projections;
- Failure of the appraiser to be responsive to the trustee's concerns before closing the transaction;
- Lack of a robust discussion with the appraiser on the issue of ESOP control for valuation purposes; and
- Lack of any evidence or record of negotiation of the ESOP purchase price.

Thus, fiduciaries and their advisers will want to create a thorough written record (emails and logs, etc.) of due diligence efforts, detailing checklists, data rooms, meetings, phone calls and other communications between the trustee, its appraiser, and company management and advisers. Similarly, a written record tracking negotiations of transaction price and terms is advisable.

Finally, fiduciaries should consider documenting all discussions and resolution of valuation methodology (discounted cash flow, capitalization of earnings, comparable public company analysis, etc.) and assumption (discount rates, company-specific risk premiums, normalizing adjustments, etc.) issues, including, but not limited to, control premiums. Many of these considerations are set forth in the GreatBanc settlement and process agreement,[4] which post-dated the transaction involved in Vinoskey.

As mentioned above, a selling shareholder needs to consider the risk of paying twice if that shareholder agrees to a reduction of an ESOP note. Further, where an independent trustee is appointed for a proposed transaction, incumbent trustees who are also selling shareholders should be removed or should resign during the pendency of the transaction (rather than simply recuse themselves from the ESOP decision-making process) so as to avoid possible co-fiduciary status or joint and several liability.

In light of this decision on the control issue, practitioners should consider incorporating post-closing corporate governance changes in transaction documents (stock purchase agreement, etc.), including board of director and officer additions and changes, setting forth the timing deadlines. In addition, consideration should also be given to requiring that the ESOP have an independent trustee with discretionary voting power (except where a participant pass-through vote is required). These features may help bolster the case for not having a lack-of-control discount.

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[1] Patrick Pizzella, Acting Secretary of Labor, U.S. Department of Labor, v. Adam Vinoskey, et. al., Case No. 6-16-cv-00062.

[2] 823 F.3d 250 (5th Cir. 2016).

[3] 569 F.3d 96 (2d Cir. 2009).

[4] EBSA News Release Number 14-1043-NAT (June 3, 2014).