LAW360

Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Unsatisfying Answers In 4th Circ. Retirement Plan Ruling

By **Chelsea Mikula and Scott Stitt** (March 28, 2019, 12:32 PM EDT)

Chelsea Mikula

On March 21, 2019, in Brundle v. Wilmington Trust, the U.S. Court of Appeals for the Fourth Circuit affirmed decisions from the U.S. District Court for the Eastern District of Virginia that Wilmington Trust NA breached its fiduciary duties by causing the employee stock ownership plan to overpay for Constellis Group Inc. stock by $29.8 million. The decision, written by U.S. Circuit Judge Diana Gribbon Motz, was joined by Chief Circuit Judge Roger Gregory and Circuit Judge Henry Floyd, with no dissent.

The panel affirmed what it characterized as the “meticulous factual findings” of the trial court that found a breach of fiduciary duty, damages and attorneys’ fees.

Scott Stitt

The court began its opinion by discussing the benefits of employee stock ownership plans to both employees and employers, providing deferred compensation to the employees (an ownership interest in the company they work for) and a “valuable tax deduction” to the employer. But the court’s decision will likely harm employee stock ownership plans.

Because this case, like many other employee stock ownership plan cases, focused on whether the plan had paid “adequate consideration” under the Employee Retirement Income Security Act for the shares purchased — which after Constellis will increasingly be ascertained on a case-by-case basis, rather than guided by principles that have been clearly articulated for employee stock ownership plan fiduciaries and others who intend to create and encourage employee stock ownership plans.

The three initial takeaways from the Constellis decision all concern the lack of guidance for employee stock ownership plan fiduciaries.

The first takeaway is that the U.S. Department of Labor has never adopted regulations that define “adequate consideration.” The DOL published proposed regulations in 1988, which define adequate consideration as “fair market value” as determined in “good faith.” But the court’s decision called the proposed regulations “not binding,” underscoring the lack of regulatory guidance from the government agency with the responsibility to provide the needed guidance.

In the absence of a binding regulation, litigation on a case-by-case basis will continue to be the result.

The lack of regulation — and the court's acknowledgment that there is no binding regulation — will increase litigation in the absence of regulatory standards. It will be regulation by litigation, rather than regulation by regulation.

The second takeaway from the case is the high level of factual detail relied upon by the Fourth Circuit in its decision. The district court, and the Fourth Circuit, focused on four primary valuation issues: (1) the valuation firm's alleged failure to consider an earlier, lower valuation of Constellis stock that was completed months before the employee stock ownership plan transaction; (2) the reliability of the projections prepared by Constellis management and used by the valuation firm; (3) the appropriateness of a 10 percent control premium when the selling shareholders — as a term of the transaction — retained a majority of seats on the board of directors; and (4) the use of "rounding" in the valuation of Constellis stock, when the rounding was upward.

Much of the court's opinion focuses on the fact that the district court found that Wilmington failed to thoroughly probe the "gaps and internal inconsistencies" in the valuation report, favorably citing the district court's extensive "careful" findings. And the Fourth Circuit noted that it was the cumulative nature of the four mistakes that warranted a finding of breach, and recognized each one individually "might not be dispositive."

Each of those four issues was extremely fact-specific. For example, whether the board was controlled by its owner after the closing, the employee stock ownership plan, required a factual record that included provisions of the agreements, the trustee's testimony about its role on behalf of the employee stock ownership plan, the appropriateness of a control *premium*, or whether a lack of control *discount* was more appropriate.

It should be unsurprising that the Fourth Circuit was reluctant to conclude that the district court clearly erred when making the factual findings with respect to control at Constellis. But it is difficult to apply much of those highly fact-specific determinations in future cases. The issue of control therefore remains unresolved for future employee stock ownership plan cases.

In addition, the court focused on other facts that supported its conclusion, such as the length and amount of the trustee's due diligence. The court highlighted the fact that the due diligence period was less than two months, that Wilmington employees only met three times to discuss the transaction, and that Wilmington violated its own internal policy of waiting 48 hours after receiving a valuation to discuss it. The court also highlighted that the negotiations "lasted little more than five hours" and that Wilmington's meeting to review the valuation lasted "for half an hour."

These fact-specific findings do not provide guidance to employee stock ownership plan fiduciaries going forward; they merely highlight issues identified by the court in this case that resulted in an adverse outcome for Wilmington. In future cases, how much longer than 30 minutes should fiduciaries review and question the valuation opinion — 45 minutes? 75 minutes? 90 minutes? "Longer than 30 minutes" appears to be the unsatisfying answer from this case.

Similarly, the court criticized the relationship between the investment bank that advised the sellers, the employee stock ownership plan's trustee and the trustee's valuation firm, asserting that they "maintained significant long-term business relationships, having worked together on more than 20 ESOP deals" and quoting the DOL's brief that the employee stock ownership plan community is "a very incestuous community."

Left unsaid, of course, is that if the employee stock ownership plan trustee and the valuation firm had never worked together, the lack of experience would likely have been held against them. These facts — the number of employee stock ownership plan transactions that highly experienced plan professionals completed — discourages experienced professionals from promoting employee stock ownership plans in the absence of published guidance.

The third takeaway from the case concerns the use of warrants in employee stock ownership plan transactions. The court noted this was a “unique” transaction because the sellers of Constellis only sold 90 percent of the shares of Constellis to the employee stock ownership plan and then exchanged the remaining 10 percent for what the court called “equity-like” warrants. The court stated this “unique” structure would allow the sellers to “to retain de facto control of Constellis.”

The use of warrants, and other features like stock appreciation rights, is a recurring issue in employee stock ownership plans and related litigation. The district court’s and the Fourth Circuit’s conclusion that the warrants in this “unique” case were problematic does not answer the question of what type of warrants would be acceptable in future transactions.

In summary, this case presents numerous issues for employee stock ownership plan professionals and companies considering adopting an employee stock ownership plan to review and consider. But there are very few answers provided, other than fact-specific conclusions that provide little guidance for employee stock ownership plan professionals faced with different terms in future transactions — and likely future litigation.

Chelsea R. Mikula is counsel and Scott J. Stitt is a partner at Tucker Ellis LLP.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.