

Legal and Regulatory Update Track 2A

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Hugler v. First Bankers Trust Inc. (USDC SDNY 3/30/2017)

- Motion for summary judgment – by both parties – denied (Hugler was acting secretary of Department of Labor)
- 2005 transaction
- Motions are granted if the pleadings, discovery materials before the court and in the affidavit show that there is no genuine issue of any material fact and it's clear that the moving party is entitled to judgment as a matter of law
- A fact is material when it might affect the outcome of the suit under the governing law. Factual disputes that are irrelevant or unnecessary are not material and cannot preclude summary judgment

Hugler v. First Bankers Trust Inc. (USDC SDNY 3/30/2017)

Material issues of fact included:

- The valuation firm's independence - allegedly the appraiser was required to be hired as a condition of the trustee's appointment; the appraiser allegedly performed preliminary valuation work for the selling shareholder; and the appraiser's conclusions regarding the company's financials were the result of negotiations with the seller's agents prior to the use of trustee being appointed
- The independence of the trustee
- Whether the evaluation report properly took into account an agreement governing the voting of ESOP shares to control the board in favor of the seller
- The discount rate calculations used by the appraiser
- Whether or not the DOL failed to establish that the ESOP suffered an actual economic loss

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Hugler v First Bankers Trust Inc. (USDC SDNY 3/30/2017)

Interesting alleged facts regarding the material issues

- Transaction promoter/investment banker establishes a estimate of value including the 10% control premium
- Negotiations of pricing prior to issuing written opinions
- "Limitations Agreement" provided that shares would be voted to keep seats on the board for the seller while the debt was in place
- 2009 recession resulted in buy back of shares by canceling note and giving up suspense shares and purchase of allocated shares back for a nominal stock value
- Court rejected arguments that this was not a loss to the ESOP

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Petersen v. Commissioner
(USTC Docket No. 15184-14 6/13/2017)

Case of first impression for the Tax Court

- Accrual basis S corporation accrued certain items of compensation, including vacation pay, and bonuses of approximately \$1M each in 2008 and 2009
- These amounts were paid by January 31 of the following tax / calendar year
- Normally accrued expenses would be deductible in this fashion
- IRC section 267(a)(2) contains exceptions where the amounts are payable to related cash basis tax payers. Such amounts deductible in the tax year when the cash basis taxpayer reports the income

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Petersen v. Commissioner
(USTC Docket No. 15184-14 6/13/2017)

- Related persons under IRC section 267(b) included the ESOP and its participants
- IRC section 276(c)(1) treats shares owner by a trust as constructively owned by its beneficiaries
- Tax court recognized the ESOP as a trust
- Tax court let them off the hook for penalties based on a "good faith effort" to have estimated its tax liabilities

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Brundle v. Wilmington Trust N.A. 15-cv-1494 (E.D. Va. 3/13/17)

Trustee entered into a prohibited transaction by approving a purchase for more than FMV

Plaintiffs allege the ESOP overpaid by \$100M. Court determines overpayment was \$29M due to:

- 10% lack of control discount
- SARS not factored into FMV
- Rounding in FMV calculations

Court finds a straight FMV prohibited transaction; but does not find that trustee committed a prohibited transaction by acting on behalf of a party whose interests were adverse to the ESOP or its participants

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Brundle v. Wilmington Trust N.A. 15-cv-1494 (E.D. Va. 3/13/17)

Court found that the trustee:

- rushed its evaluation of the ESOP's shares,
- failed to follow its own procedures and
- failed to adequately vet their appraiser's conclusions – i.e., didn't probe the appraiser on its reliance on the company's projections
- Didn't investigate a separate valuation report that had been prepared for the company by another advisor (at a lower price)

Court made a lot of comments regarding the advisors having very close relationships

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Brundle v. Wilmington Trust N.A.
15-cv-1494 (E.D. Va. 3/13/17)

- Investors Rights Agreement gave seller / warrant holders control of the board (3 of 5 seats). Appraisal contained one sentence re the control premium
- Terms of ESOP plan document kept control over a sale of the company out of the trustees hands
- "Two different purposes" argument about other appraisal being ignored was not acceptable

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Brundle v. Wilmington Trust, N.A.
(USDC ED VA 6/23/2017)

- Opinion on hearing for the measure of damages and setting awards of fees
- Prior opinion (March 2017) held that trustee's breach was based on paying too much for the shares in original purchase
- Defendants argue in this hearing that subsequent sale of the ESOPs shares at a \$20M profit should reduce the measure of damages
- Court holds that that is an erroneous measure of damages

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Brundle v. Wilmington Trust, N.A.
(USDC ED VA 6/23/2017)

- Court refers to sale gain as a "separate benefit" or success the trustee brought to the ESOP
- Defense argues for measure of damages based on pension plan measures of damages – rejected by the court
- Court also rejected debt cancellation as reducing the measure of damages
- Measure of damages must be linked to the action causing the loss – the price overpaid in the purchase transaction. The amount paid minus the court determined value is the correct measure

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Pfeifer v Wawa
214 F. Supp 3d. (USDC ED Pa 1/11/17)

- Pre existing ESOP plan allowed terminated participants to hold their accounts in stock until age 68, then sell back under put options like other participants
- August 2015, plan is amended to move terminated employees (not retired employees) out of stock and into cash
- September 2015, terminated participant shares "sold" subject to a \$50 transaction fee, with proceeds moved to 401k plan, to the extent they do not elect a distribution
- Terminated participant plaintiffs sue for violation of anti cutback rule and breach of contract
- Court rules that forced "sale" was not a cutback since being invested in stock is not a vested right

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Pfeifer v Wawa 214 F. Supp 3d. (USDC ED Pa 1/11/17)

- Forced "transfer" was not an involuntary distribution, since they had the right to elect to take it or not; but as transfer it fails because in order for an involuntary transfer to occur, the balance after transfer must be the same as before the transfer (they were \$50 short). Treas. Reg. 1.414(l)-1(d)(3), (m)(1), (o)
- Plaintiffs allege that their rights to benefits were "fixed" as of their date of termination in 2009, and subsequent amendment after their termination date breaches the "unilateral contract" in federal common law of ERISA
- Plaintiffs seeking equitable relief to apply the terms of the plan prior to amendment (they want to hold the stock until retirement age – since its appreciating)
- Defendants argue the right to amend was reserved in the plan (reservation of rights). Court would not dismiss on this ground

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Kindle v Dejana No. 14-cv-6784 (EDNY Feb. 28, 2017)

Motions for summary judgement denied. Court found triable issues of fact regarding:

- whether trustees refusal to provide prior evaluations was improper failure to provide complete and accurate information
- whether trustee unreasonably failed to detect life insurance arrangement error or question the discrepancies between the transaction value and prior values
- whether trustees relationships with buyer side individuals through business dealings "tainted his decision-making as ESOP's trustee to the detriment of the ESOP and its participants"
- 2003 Atrium Inc. ESOP formed and purchased stock in Atrium from Dejana brothers. IVA was ongoing appraiser for ESOP

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Kindle v Dejana
No. 14-cv-6784 (EDNY Feb. 28, 2017)

- IVA opined that the fair market value of the ESOP's Atrium stock was: \$7,241,000 as of June 30, 2008; \$7,376,000 as of June 30, 2009; and \$7,524,000 as of June 30, 2010
- In 2011, Peter Dejana decided to purchase the ESOP's Atrium stock pursuant to the terms of a "buyout option agreement" that he had with the ESOP
- Sipala was appointed as "temporary trustee" to ensure Dejana "didn't get into any trouble." Sipala hired M&S to be the ESOP's new appraiser. However: 1) Sipala was friends with the executive vice president and secretary of Atrium, Dejana Industries, and various other Dejana Group companies; 2) Sipala worked with Peter Dejana in connection with an acquisition of another entity, and hoped to serve as Dejana Industries' "M&A advisor" if the acquisition came to fruition; 3) Sipala served as an intermediary between Dejana in an indirect equipment leasing arrangement, for which Dejana paid \$10,000 per year; 4) Sipala intermingled other Dejana-related communications with their ESOP-related communications

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Kindle v Dejana
No. 14-cv-6784 (EDNY Feb. 28, 2017)

- Sipala was not concerned with the disparity between the 2010 IVA valuation of \$7,524,000 and M&S's valuation of \$4,190,000 because "he thought the prior valuation conducted by IVA showed a higher fair market value because it did not apply the proper standard"
- Disputes regarding whether the Sipala defendants provided M&S with complete and accurate information, and
- Whether the Sipala defendants' reliance upon M&S's valuation was reasonably justified

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Regulatory Update: Reintroduction Of Schedule E To Form 5500

- Changes to Form 5500 proposed by Department of Labor, Treasury Department, and Pension Benefit Guaranty Corporation
- Proposed Revisions published in Federal Register on July 21, 2016 (Vol. 81, at p. 47534)
- Sought public comments until October 4, 2016
- Agencies propose to re-introduce Schedule E to improve information on ESOPs

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Regulatory Update: Reintroduction Of Schedule E To Form 5500

- Schedule E would be required reporting under Title I of ERISA and the Code
- Schedule would be open to public inspection (BUT questions related to Code §404(k) subject to different disclosure process – to protect answers from public disclosure)

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Regulatory Update: Reintroduction Of Schedule E To Form 5500

- Proposed Schedule E divided into four parts, with questions based on:
 - Part I: Whether an ESOP acquired stock by securities acquisition loan;
 - Part II: Whether the stock is readily tradable on an established market;
 - Part III: Whether the ESOP has outstanding securities acquisition loan; and
 - Part IV: Miscellaneous questions

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Proposed Schedule E: Part I

- Part I questions apply only if ESOP acquired common or preferred stock with proceeds of securities acquisition loan
- Several relate to transaction valuations – in whether ESOP paid a control premium where, in fact, it did not acquire a controlling interest
- Others focus on suspense account mechanics, allocation method following release, and under what conditions preferred stock, if any, may be converted

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Proposed Schedule E: Part II

- Part II applies only if ESOP acquires stock that is not readily tradable on established market
- With respect to each acquisition of stock, would ask:
 - Relationship of seller of stock to the employer
 - Whether seller is a party-in-interest or disqualified party (as defined under prohibited transaction rules)
 - Total consideration paid
 - Date of transaction

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Proposed Schedule E: Part II (continued)

- Also includes valuation-related questions:
 - Whether stock valued by independent appraiser
 - If not, identity of person who valued stock
- Questions related to valuation method (DCF, market comparables, etc.)
- Takeaways: Agencies are interested in identifying possible issues with stock acquisitions, especially whether stock properly valued and whether prohibited transactions may have occurred

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Proposed Schedule E: Part III

- Questions related to ESOPs with outstanding securities acquisition loans
- Proposed Schedule E would differ from 2008 Schedule E (only asked whether ESOP had outstanding loan) – now also would ask:
 - Basic information regarding amount and date of the loan
 - Interest rate
 - Lender's relationship to plan and plan sponsor
 - Whether the lender is a disqualified person/party-in-interest
 - Whether loan was guaranteed by disqualified person/party-in-interest

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Proposed Schedule E: Part IV

Miscellaneous Questions

- Whether employee elective deferrals were used to satisfy securities acquisition loan
- Other questions re: compliance concerns (from 2008 Schedule E):
 - Whether ESOP is maintained by an S corporation
 - Whether there are any disqualified persons under Code §409(p)(4)
 - Whether any unallocated securities (or proceeds) were used to repay exempt loan
 - Whether plan paid dividends deductible under §404(k)

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Perez v. First Bankers Trust et. al.
No. 12 – CV 04450 (D.N.J. 3/31/17)

- Not a published decision – cannot be cited as precedent. Anecdotal value only
- FBTS purchased 38% of the stock of SJP for the ESOP for \$16M from its CEO
- SJP was a subcontractor that performed site preparation for construction – primarily in the residential housing market
- CEO / Seller later settles with the Department of Labor and writes off \$9M of the notes owed to him from the sale
- 17 day trial ensues against the trustee

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Perez v. First Bankers Trust et. al.
No. 12 – CV 04450 (D.N.J. 3/31/17)

Lengthy analysis of factual record points to a litany of elements concluding in a breach:

- Trustee overly relied on advisors, and failed to conduct its own due diligence
- Trustee meetings were cursory and relied on appraisers opinion that the value was proper
- Did not probe or verify the data and projections the appraiser used
- Did not question that the financial projections were straight out of the sellers' advisors offering memo
- Crucial industry analysis was missing from the valuation report that was being reviewed

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Perez v. First Bankers Trust et. al.
No. 12 – CV 04450 (D.N.J. 3/31/17)

- Failed to investigate the softening in the housing market in the 1st Quarter of 2007
- Members of trustee's team lacked finance and investment expertise and misunderstood each others' responsibilities
- Not a particular error, just the totality of the mis-steps

Measure of damages NOT reduced by write down of seller note – because that doesn't change that the ESOP paid too much on the transaction date

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Perez v. First Bankers Trust et. al.
No. 12 – CV 04450 (D.N.J. 3/31/17)

- *Despite FBTS's purported expertise and capacity for conducting the requisite diligence in an ESOP transaction, FBTS did little more than delegate all of its responsibilities to third parties*
- *In sum, FBTS relied entirely on information provided by its valuation advisor, Prairie, who in turn relied entirely on information provided by the seller and his financial advisor, Duff & Phelps*
- *By merely retaining Prairie and SFE&G, holding proforma meetings that lacked substantive review of the Transaction, and engaging in cursory informal*
- *Accordingly, a prudent investor would have recast projections from the April 11, 2007 Draft Valuation Report after having completed at least some independent due diligence*

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Acosta v. FBTS Settlement Agreement (Maran, Inc.)

- Recall that in June 2014, GreatBanc and the DOL signed a formal "Agreement Concerning Fiduciary Engagements and Process Requirements for Employer Stock Transactions" or "Fiduciary Process Agreement"
- Acosta / Maran settlement Modifies and expands these requirements – binding only on FBTS

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New Settlement Agreement Modifies

Fiduciary Process Agreement

- A. Selection and Use of Valuation Advisor - General
- B. Selection of Valuation Advisor – Conflicts of Interest
- C. Selection of Valuation Advisor – Process
- D. Oversight of Valuation Advisor – Required Analysis
- E. Financial Statements
- F. Fiduciary Review Process – General
- G. Fiduciary Review Process – Documentation of Valuation Analysis
- H. Fiduciary Review Process – Reliance on Valuation Report
- I. Preservation of Documents
- J. Fair Market Value
- K. Consideration of Claw-Back
- L. Other Professionals

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Additions To "The Process"

- Selection and Use of Valuation Advisor. Document what steps trustee took – including who – to determine that the valuation advisor received complete, accurate, and current information and to ensure FBTs understood the advice of the valuation advisor

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Appraiser Independence

- Conflicts of Interest. Not previously performed work for any party to the Transaction including a "preliminary valuation" – or **a committee of the plan sponsor**, any counterparty to the ESOP involved in the transaction

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Financial Statements

- Trustee may approve a transaction notwithstanding the lack of unqualified audited financial statements (including interim financial statements that update or supplement the last unqualified audited financial statement) only if the stock purchase agreement includes a provision requiring the selling or purchasing shareholder(s) who is (are) **an officer, manager, or member of the board of directors of the plan sponsor to compensate the ESOP for any losses or other harms caused by or related to financial statements that did not accurately reflect the plan sponsor's financial condition.**
- Query: a "SOX" certification?

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Fiduciary Review Process

- Determine whether projections are reasonable
- Account for the unreasonableness in its valuation
- Ensure info received from Corp is complete – including past valuations and audit letters and prior loan defaults

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Debt And FMV - New

- "[t]he principal amount of the debt financing the Transaction, irrespective of the interest rate, cannot exceed the plan sponsor's securities' fair market value
- not cause an ESOP to engage in a leveraged stock purchase Transaction in which the principal amount of the debt financing the Transaction exceeds the fair market value of the plan sponsor's securities acquired with that debt, irrespective of the interest rate or other terms of the debt used to finance the Transaction

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Control In Fact - New

- If a Transaction in which the ESOP cedes any degree of control to which it would otherwise be entitled based on its ownership interest, including but not limited to the unencumbered ability to vote its shares
- Must document any consideration received in exchange for such limitation on the ESOP's control (or how the limitation on control is otherwise reflected in the purchase price) and why it is fair to the ESOP

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Pre Approved ESOP Documents

- Rev Proc 2015-36 expanded the pre approved plan document process to include ESOPs
- IRS has now opened the program for ESOPs to be submitted for approval
- IRS LRMs (required boilerplate provisions) have now been issued for those plans

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Volume Submitter Or Custom?

- Need to balance the need for periodic amendments with the convenience of a "check the box" document
- The trick is in strategically checking the boxes
- Query – Will the IRS allow us to have every box we can dream of, so we can revisit the boxes to adopt any conceivable amendment

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EBLG Comments To IRS

- Are there any circumstances under which an interim DL could be requested on an individually designed plan before it is put on a pre-approved document or is the premise that if you want assurance, the plan must be restated onto a pre-approved plan?
- Does the pre-approved plan have to be in the form of a plan and adoption agreement (as per the examples in the ESOP LRM) or can it be in the form of a volume submitter?
- Item 20 appears to allow reshuffling provisions in all variations (i.e., value immediately preceding termination or value following termination) in the pre-approved plan document-is that correct? For example, transfers could be pro-rata among terminated participants or based on earliest severance date?
- Will pre-approved plans allow for one time "window period" distribution amendments periodically, or will that only be an option in an individually designed plan
- Pre-approved plan requires separate trust document, therefore, will an independent trustees document be sufficient or will there always need to be a separate trust agreement in addition to the independent trustees document?
- Can a 401(k) match or other contribution from another plan be deposited into the ESOP under a pre-approved plan format?
- In Item 18 of the ESOP LRM it appears that language to allocate suspense account dividends to participants based on compensation is not included. Is this provision unavailable under a pre-approved plan?