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A Reasonable Proposal: Treat ESOP Valuers as Fiduciaries Under ERISA



BY NINA WASOW

The Department of Labor's proposed regulation regarding the definition of "fiduciary" under the Employee Retirement Income Security Act (ERISA) has come under fire for reversing a long-standing rule

Nina Wasow (nwasow@lewisfeinberg.com) is an associate attorney at Lewis, Feinberg, Lee, Renaker & Jackson in Oakland, Calif., a national law firm that represents plaintiffs in employee benefit and pension litigation as well as civil rights and wage and hour litigation.

that performing valuations for the purposes of an employee stock ownership plan (ESOP) does not qualify as rendering investment advice within the meaning of ERISA's fiduciary definition. This article discusses whether the proposed regulation is a reasonable interpretation of ERISA and analyzes the common arguments made by the regulation's opponents.

Current Framework

ERISA Section 3(21)(A) defines "fiduciary" to include the provision of investment advice for a fee.¹ In 1975, the Department of Labor issued a regulation explaining the circumstances under which a person renders investment advice within the meaning of this statutory section. The regulation creates a five-part test.² To be treated as a fiduciary, an adviser who does not have discretionary authority or control over the property of the plan must:

- (1) render advice as to the value of securities or other property, or make recommendations as to the advisability of investing in, purchasing or selling securities or other property
- (2) on a regular basis
- (3) pursuant to a mutual agreement, arrangement or understanding, with the plan or a plan fiduciary, that
- (4) the advice will serve as a primary basis for investment decisions with respect to plan assets, and that

¹ 29 U.S.C. § 1002(21)(A)(ii).

² 75 Fed. Reg. 65,264, 10/22/10.

(5) the advice will be individualized based on the particular needs of the plan.

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Shortly after the regulation was issued, the department formally opined that valuation of closely held employer securities for an ESOP would not constitute investment advice under the regulation.³

This framework has remained in place for the past thirty-five years, despite major changes in the retirement plan industry and the financial marketplace. The current regulatory scheme allows fiduciaries to evade responsibility for imprudent decisions by claiming reliance on a service provider, and service providers can often evade responsibility via loopholes in the existing regulation, such as its requirement that the advice have been provided on a “regular basis” or that the advice served as the “primary basis” for plan investment decisions.

Proposed Regulation

Thus, in October 2010, the department proposed revisions to the regulation that would broaden the circumstances under which investment advisers will be treated as fiduciaries under ERISA. The proposed regulation includes many changes, but this article addresses one in particular: the treatment of appraisals and fairness opinions for ESOPs as fiduciary investment advice.⁴

The department explained its reason for the inclusion of ESOP valuers as fiduciaries as follows:

[A] common problem identified in the Department’s recent ESOP national enforcement project involves the incorrect valuation of employer securities. Among these are cases where plan fiduciaries have reasonably relied on faulty valuations prepared by professional appraisers. The Department believes that application of the proposal to appraisals and fairness opinions [will] . . . align the duties of persons who provide these opinions with those of fiduciaries who rely on them.

Since the proposed regulation was issued, the department has been barraged with comments, the vast majority of which are criticisms, and many of which are complaints by players in the ESOP business—valuers, plan sponsors, and ESOP advocacy groups—that the proposed regulation will bring about the end of employee ownership by making it too costly to obtain appraisals of closely held employer stock, among other dire consequences.⁵ Notwithstanding these concerns,

³ Advisory Opinion 76-65A (June 7, 1976).

⁴ 75 Fed. Reg. 65,265, 10/22/10.

⁵ Full text of all comments can be found at <http://www.dol.gov/ebsa/regs/cmt-1210-AB32.html>. See also Marcus Baram, Proposal to Protect Retirees’ Nest Eggs Becomes Latest Lobbying Flash Point (June 14, 2011) (available at http://www.huffingtonpost.com/2011/06/14/retirement-proposal_n_876343.html?id=1420).

treating ESOP valuers as fiduciaries is a reasonable interpretation of the statute, makes sense, and is unlikely to lead to the parade of horrors predicted by industry insiders.

Industry Opposition to Proposed Regulation

ESOPs are a big business. According to one ESOP advocacy organization, in 2010, there were more than 11,000 ESOPs nationwide with a total of more than 13 million participants, representing more than \$900 billion in plan assets (and another 800 tax code Section 401(k) plans invested primarily in employer stock with an additional 5 million participants, representing \$200 billion in assets).⁶

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Not surprisingly, the ESOP lobby is powerful, and ESOPs have been blessed with tax advantages, the wisdom of which has been questioned by some courts and commentators. See, e.g., *Summers v. State Street Bank & Trust Co.*, 453 F.3d 404, 410, 38 EBC 1065 (7th Cir. 2006) (125 PBD, 6/29/06; 33 BPR 1582, 7/4/06) (“Why Congress thought it appropriate to stimulate the adoption of this business form by giving companies tax breaks rather than allowing the free market to determine the merits of the form is a separate question . . . it is pertinent to note that one of the goals *not* sought to be achieved by the ESOP form is the funding of pension benefits. . . . It is a goal that the form is ill suited to attain because of its underdiversification.”) (internal citations omitted).

Approximately 95 percent of ESOPs own only closely held stock.⁷ These ESOPs need a professional valuation in order to purchase stock, in addition to annual valuations used for both reporting and disclosure purposes and to value participants’ “put” options. *Howard v. Shay*, 100 F.3d 1484, 1488-89, 20 EBC 2097 (9th Cir. 1996); *Montgomery v. Aetna Plywood, Inc.*, 39 F. Supp. 2d 915, 922 (N.D. Ill. 1998). Thus, the ESOP industry relies on the availability of valuers who are willing to provide opinions that suit the plan sponsor’s needs at a reasonable price.

However, ESOP valuations are vulnerable to abuse. The valuator is generally hired by the company or the ESOP trustee, who is frequently an officer and/or owner of the company, at least in closely held companies. In the case of a valuation for the purpose of a stock purchase by the ESOP, the owner has an interest in getting as much money as possible from the transaction and

⁶ National Center for Employee Ownership, A Statistical Profile of Employee Ownership (April 2011) (available at <http://www.nceo.org/main/article.php?id/2/>).

⁷ *Ibid.*

may have strong ideas about the value of the company. The valuator wants to get the job and be rehired for annual valuations. Thus, the valuator has an interest in giving the owner what he or she wants – in other words, it often is not a truly arms-length relationship.

Further, without being subject to a fiduciary standard, valuers have little reason to dig deeper than the company's representations regarding its future performance. And without regulatory guidance on proper valuation methodology, valuations are malleable, skewing in whatever direction the valuator is implicitly or explicitly told to go.

Treating ESOP Valuators as Fiduciaries

The plain language of ERISA Section 3(21) supports the treatment of ESOP valuers as fiduciaries. The statute simply states that a person who “renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of [a] plan, or has any authority or responsibility to do so” is a fiduciary.⁸

Valuers play a central role in determining the price that an ESOP pays for employer stock in a transaction and the price paid to a participant in exchange for the shares in his or her ESOP account. They give ESOP transaction prices the imprimatur of accuracy and fairness. This is appropriately characterized as investment advice. The fact that it may be given on a one-time basis makes no difference: the statute itself doesn't refer to ongoing or repeated advice, and the quality of a one-time valuation may make the difference between an ESOP that thrives and one that fails.

Treating ESOP valuers as fiduciaries makes sense. Under the current statutory and regulatory scheme, ESOP fiduciaries may evade responsibility for imprudent decisions by claiming reliance on a valuator, but the valuator is not a fiduciary subject to liability under ERISA, and thus the participants are left with the losses. Having the option to pursue claims against the appraiser will certainly benefit plan participants if the trustee is insolvent, undercapitalized, or underinsured.

Further, if the trustee took appropriate procedural steps to review and understand the valuation and generally acted in the participants' best interests, but the plan still paid more than adequate consideration, the valuator may be the only person who can make the plan whole.

Fiduciary Status of ESOP Valuators Withstands Criticism

Several themes emerge from the hundreds of comments submitted in opposition to the proposed regulation: (1) treating ESOP valuers as fiduciaries will undermine the traditional role of the trustee, (2) valuers will no longer be able to provide independent advice if they are treated as fiduciaries, (3) valuation is too subjective to be held to a fiduciary standard, (4) treating valuers as fiduciaries will make valuations prohibitively expensive and/or cause some valuers to exit the industry, and (5) there is no real problem with inaccurate ESOP valuations or unscrupulous valuers. These arguments are addressed in turn.

⁸ 29 U.S.C. § 1002(21)(A)(ii).

“Although valuers may demand higher fees and/or broader indemnification provisions based on the risk of ERISA fiduciary liability, it seems highly unlikely that this would cause businesses to stop using ESOPs as a tool of corporate finance, given their enormous tax advantages.”

Trustee Not Absolved. Conferring fiduciary status on valuers will not absolve the trustee of its traditional responsibility to review, understand, question, and ultimately approve the price of ESOP shares. As is the case now, if the proposed regulation is implemented, the valuator's job will be to provide accurate, reliable, and independent advice as to the value of employer securities.

Courts are certainly capable of finding that a valuator breached its fiduciary duty by using an improper methodology, failing to consider material information, failing to apply appropriate discounts, or using unsupported valuation multiples, and that the trustee also breached its fiduciary duty by failing to read, understand, or question the valuation, failing to obtain a better valuation, failing to negotiate on behalf of the ESOP participants, or committing any other procedural or substantive error that results in the ESOP paying too much for employer stock.

How the damages would be allocated between the two fiduciaries would depend upon the facts and circumstances of the case, but it is clear that ERISA imposes joint and several liability on breaching fiduciaries. *See, e.g., In re Worldcom, Inc. ERISA Litigation*, 339 F. Supp. 2d 561, 568, 33 EBC 2284 (S.D.N.Y. 2004).

Treating valuers as fiduciaries does not undermine the trustee's role any more than the long-standing treatment of other investment advisors as fiduciaries. *See, e.g., Lowen v. Tower Asset Management, Inc.*, 829 F.2d 1209, 1218-20, 8 EBC 2457 (2d Cir. 1987).

Expectation of Independence. Commenters insist that a fiduciary valuator cannot be independent,⁹ but the valuator's fiduciary duties would be owed to the plan, not to the company, and the Department of Labor's analysis of the proposed regulation makes it clear that these duties would include neutrality and objectivity: “[t]he Department would expect a fiduciary appraiser's determination of value to be unbiased, fair, and objective, and to be made in good faith and based on a prudent investigation under the prevailing circumstances then known to the appraiser.”¹⁰

There is no conflict between acting as a fiduciary and providing an unbiased valuation opinion: although valuers would be obligated to act in the best interests of

⁹ *See, e.g.,* Comments on Proposed Regulation by Dave Fitz-Gerald of Carris Financial Corp. (Feb. 3, 2011); Emily Girsch of Lincoln Savings Bank (Feb. 2, 2011); American Society of Appraisers (March 15, 2011).

¹⁰ 75 Fed. Reg. 65,265, 10/22/10.

plan participants, they would fulfill this obligation by providing accurate and fair valuation opinions.

Exercise of Judgment. Assuming, as some commenters assert, that valuation is an art, not a science, and that appraising a business involves the exercise of professional judgment, the same is true of many kinds of fiduciary decision-making. Courts have shown themselves to be capable of drawing the line between the reasonable exercise of judgment and discretion, on the one hand, and fiduciary misconduct, on the other.

Higher-Quality Appraisals. Many commenters worry that valuers will decide to get out of the ESOP business rather than accept the risk of fiduciary liability, which would make it more difficult for trustees to obtain competent appraisals, or that treating valuers as fiduciaries will increase the cost of implementing and maintaining ESOPs due to appraisers passing on the cost of fiduciary liability insurance, the need for additional legal advice, etc., which would in turn cause employers to abandon their ESOPs (or dissuade employers from establishing new ESOPs).

We are aware of no empirical support for the proposition that appraisers will exit the industry, and they are already exposed to potential liability for faulty valuations via state-law malpractice claims. *See, e.g., McDanold v. Star Bank N.A.*, 261 F.3d 478, 481, 26 EBC 1986 (6th Cir. 2001) (155 PBD, 8/16/01; 28 BPR 2127, 8/21/01).

Although valuers may demand higher fees and/or broader indemnification provisions based on the risk of ERISA fiduciary liability, it seems highly unlikely that this would cause businesses to stop using ESOPs as a tool of corporate finance, given their enormous tax advantages.

Further, these commenters ignore that they will get more value for their money: a valuator who is held to the fiduciary standard will presumably be extra-motivated to do a thorough, careful, competent job, and should flaws in the valuation give rise to litigation, the valuator will be on the hook.

Faulty Valuations. Some commenters suggest that the problem of faulty ESOP valuations is not serious and the department's intervention in this area is unwarranted.¹¹ But case law shows that bad ESOP valuations are a problem,¹² and although there is no known data

¹¹ For instance, the ESOP Association states that it has not "heard significant numbers of complaints from its corporate or fiduciary members about incorrect ESOP valuations." ESOP Association Comment on Proposed Regulation, Jan. 31, 2011, p. 4. This is not surprising: inaccurate valuations can lead to significant liability for plan fiduciaries, so they have an incentive not to publicize such errors.

¹² *See, e.g., Reich v. Valley Nat Bank of Arizona*, 837 F. Supp. 1259, 1275, 17 EBC 1257 (S.D.N.Y. 1993) (finding the valuation erroneous because it failed to analyze key aspects of the ESOP transaction); *Mohler v. Unger*, 1194 WL 1752237, at *5 (S.D. Ohio Aug. 26, 1994) (upholding a jury's finding that valuation of stock was erroneous and did not accurately reflect fair market value); *Howard v. Shay*, 100 F.3d 1484, 1489, 20

on the frequency of valuation errors, the Department of Labor is the agency charged with enforcing ERISA and dealing with participant complaints regarding potential ERISA violations, and is thus best-situated to know if erroneous valuations are widespread. And to the extent that they are occurring, the impact of such valuation errors on plan participants is severe.

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Because fiduciaries tend to lack knowledge and expertise about business valuation, they rely heavily on valuers to support the price of stock bought or sold by ESOPs. Any overstatement (or understatement) of value by the valuator translates directly to overpayment by (or underpayment to) the participants.

Conclusion

Despite the outpouring of negative commentary, the department's proposed treatment of ESOP valuers as fiduciaries is consistent with ERISA's purpose of protecting participants and beneficiaries of employee benefit plans, it is consistent with the statutory language, and it is a reasonable way to address the problem of flawed ESOP valuations.

EBC 2097 (9th Cir. 1996) (“Even a cursory review of the Arthur Young valuation and fairness opinion reveals the carelessness of this tack.”); *Montgomery v. Aetna Plywood, Inc.*, 39 F. Supp. 2d 915, 930 (N.D. Ill. 1998) (holding that “appraisal contained three valuation errors that seriously undermined [the appraiser’s] conclusions. . . [appraiser] reduced the Company valuation by \$6 million” based on a “fiction,” and rejecting valuator’s methods and discounts as “unsound”); *Chao v. Hall Holding Co., Inc.*, 285 F.3d 415, 430-32, 440, 27 EBC 2153 (6th Cir. 2002) (65 PBD, 4/4/02; 29 BPR 1150, 4/9/02) (holding that, as a result of the valuator appraising the wrong asset and other problems, the ESOP overpaid by more than \$1 million for employer stock); *Horn v. McQueen*, 215 F. Supp. 2d 867, 884, 28 EBC 1875 (W.D. Ky. 2002) (150 PBD, 8/5/02; 29 BPR 2141, 8/6/02) (calling into question whether the valuator “had begun meaningful valuation work. . . as of the week before the transaction was to close”); *Kloots v. American Express Tax & Business Servs., Inc.*, 2006 WL 1644373, at *2 (N.D. Ohio June, 12, 2006) (“the valuation method used. . . did not account for the complex set of factors approved by the US Department of Labor” and “was not a good faith fair market determination as required by ERISA”). In addition to reported cases, other litigation alleging overpayment for employer stock based on faulty valuations has settled favorably to plaintiffs in recent years. *See, e.g., Fernandez v. K-M Industries Holding Co., Inc. et al.*, Case No. C 06-7339 CW (N.D. Cal.) (settled for \$55 million); *Beam v. HSBC Bank USA, et al.*, Case No. 02-0682, 31 EBC 1257 (W.D.N.Y. Aug. 19, 2003) (187 PBD, 9/26/02; 29 BPR 2628, 10/1/02) (settled for \$9.35 million).