Steve Leimberg's Employee Benefits and Retirement Planning Email Newsletter Archive Message #711

Date:07-Oct-19

Subject: Mary Vandenack on *Pizzella v. Vinoskey* - Department of Labor Gets Another Big Win in ESOP Fiduciary Duty Case

"The Department of Labor has been achieving success in litigating transactions related to ESOPs. In Pizzella v. Vinoskey,[i] the trial court ruled in favor of the Department of Labor against all defendants and on all claims made. The court determined that the sale of owner/seller stock to an ESOP was for an amount in excess of fair market value and resulted in a prohibited transaction. The court concluded that the independent trustee acted imprudently and in violation of its fiduciary duties in letting a transaction proceed based on an appraisal that contained assumptions and conclusions that should have been questioned. The court also found that the owner/seller was a knowing participant in a prohibited transaction and was liable as a co-fiduciary with the independent trustee."

Mary E. Vandenack provides readers with commentary on *Pizzella v. Vinoskey*.

Mary E. Vandenack is founding and managing member of **Vandenack Weaver LLC** in Omaha, Nebraska. Mary is a highly regarded practitioner in the areas of tax, benefits, private wealth planning, asset protection planning, executive compensation, equity fund development, business and business succession planning, tax dispute resolution, and tax-exempt entities. Mary's practice serves businesses and business owners, executives, real estate developers and investors, health care providers, companies in the financial industry, and tax-exempt organizations. Mary is a member of the American Bar Association Real Property Trust and Estate Section where she serves as Co-Chair of the Futures Task Force, Co-Chair of the Law Practice Group and on the Planning Committee. Mary is a member of the American Bar Association Law Practice Division where she currently serves as Editor-in-Chief of Law Practice Magazine. Mary is also active in the ABA RPTE section where she serves as co-chair of the Law Practice Group and as assistant secretary of the section. Mary was named to ABA LTRC 2018 Distinguished Women of Legal Tech, received the

James Keane Award for e-lawyering in 2015, and serves on ABA Standing Committee on Information and Technology Systems. Mary is a frequent writer and speaker on tax, benefits, asset protection planning, and estate planning topics as well as on practice management topics including improving the delivery of legal services, technology in the practice of law and process automation.

Here is her commentary:

EXECUTIVE SUMMARY:

The Department of Labor has been achieving success in litigating transactions related to ESOPs. In *Pizzella v. Vinoskey,*[ii] the trial court ruled in favor of the Department of Labor against all defendants and on all claims made. The court determined that the sale of owner/seller stock to an ESOP was for an amount in excess of fair market value and resulted in a prohibited transaction. The court concluded that the independent trustee acted imprudently and in violation of its fiduciary duties in letting a transaction proceed based on an appraisal that contained assumptions and conclusions that should have been questioned. The court also found that the owner/seller was a knowing participant in a prohibited transaction and was liable as a co-fiduciary with the independent trustee.

FACTS:

Sentry Equipment Erectors, Inc. (“Sentry”) was formed in 1980 by Adam and Carole Vinoskey. In 1993, Sentry adopted an Employee Stock Ownership Plan (“Sentry ESOP”).

The Sentry ESOP provided that the shares of stock held by the plan on behalf of participants were to be voted, with some exceptions, by the plan trustee. Adam Vinoskey served as a Trustee of the Sentry ESOP during the period 2006 through July 31, 2012.

Capital Analysts, Inc. (“CAI”) was engaged as the appraiser for the ESOP. Brian Napier, founder and president of CAI prepared appraisals for the Sentry ESOP from 2005 through 2015. Napier’s appraisals of Sentry stock ranged from $215 to $285 between 2005 and 2009. Such appraisals were relied on in repurchasing the Sentry ESOP shares of retiring employees of Sentry.

The Sentry ESOP purchased 48% of Sentry's stock in 2004 at $220.00 per share. The remaining 52% was owned by Adam Vinoskey's revocable trust.

In 2010, Adam Vinoskey announced retirement plans and his desire to sell his 52% ownership interest to the Sentry ESOP so that the Sentry ESOP would then own 100% of Sentry. At that time, Evolve Bank and Trust ("Evolve") was engaged to act as an independent fiduciary to represent the Sentry ESOP in the purchase of Vinoskey's shares. In the engagement letter, Sentry agreed to indemnify Evolve with respect to any breaches of fiduciary obligations.

Evolve engaged CAI to act as the independent appraiser and financial advisor for the transaction. Evolve also engaged the attorney who had previously represented Sentry in establishing and administering the ESOP.

In valuing Sentry, Napier (who completed the appraisal for CAI) used a capitalization of cash flows methodology. Napier rejected use of a discounted cash flows method. In the 2010 appraisal, Napier valued Sentry stock at $406.00 per share. Napier applied a "controlling interest" analysis in the appraisal on the basis that the Sentry ESOP would own the entirety of Sentry stock after the transaction. In the ruling in this case, the court noted that Sentry would not obtain complete control because, without changes in the structure of the company, Adam and Carole Vinoskey would continue to be trustees and have the right to vote shares.[iii] The plan would not, in this case, acquire control, by virtue of 100% ownership because the two of the three trustees (Adam and Carole Vinoskey) would have the ability to vote on most corporate matters, including electing the board of directors – and only the board of directors could remove and replace trustees.

In calculating the cash flows for purposes of the capitalization of cash flows, Napier added back various items. One add-back was for half of employee healthcare costs despite the fact that Adam Vinoskey opposed shifting healthcare costs to employees. Another add-back was for the Sentry contributions to the Sentry ESOP. The court ruled that these add-backs were not reasonable.[iv]

In appraising Sentry, Napier used capitalization rates. In 2005 through 2009, Napier concluded in favor of rates 16.2% or higher. For the 2010 transaction, Napier dropped the capitalization rate to 12.2%. In early 2011, Napier applied a capitalization rate of 18.2%.

Evolve raised various questions about Napier's draft appraisal (using a value of $405.73 per share) in an email on December 11, 2010 and phone conference on December 13, 2010. Evolve offered $406.00 for the shares owned by Adam Vinoskey without negotiation for a lower price and prior to receiving the updated appraisal from Napier. The transaction was closed on December 20, 2010, also before receipt of the updated appraisal. After closing, Evolve resigned as independent trustee.

In the *Vinoskey* case, the Department of Labor ("DOL") asserted that the independent trustee engaged in a prohibited transaction and the result of the same was the that Sentry ESOP overpaid for the stock purchased from the owner/seller. The DOL also asserted that the owner knowingly accepted a price that did not reflect fair value. The trial court ruled against all of the defendants and in favor of the DOL on all claims.

COMMENT:

Prohibited Transaction

The Employee Retirement Income Security Act of 1974 ("ERISA") prohibits plan fiduciaries from engaging in transactions that involve conflicts of interest.[v] Such transactions are referred to as prohibited transactions. Among transactions that fall in the prohibited transaction category are those with "parties in interest," transactions that involve "self-dealing" and transactions involving kickbacks to a fiduciary. A "party in interest" has a specific definition under ERISA[vi] and includes any plan fiduciary (administrator, officer, trustee or custodian), the employer or any affiliate, any employee of such employer, any service provider to the plan (attorney, auditor, etc.) whether paid by the plan or not, or an owner of 50 percent or more of the stock of the employer, among others.

There are various exemptions from the prohibited transaction rules. One exemption is any acquisition or sale of qualifying employer securities, for adequate consideration, to a plan qualified to own employer securities.[vii] Adequate consideration is defined as "the fair market value of the asset as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with the regulations…".[viii]

In the *Vinoskey* case, the court indicated that it was not the court's job to re-calculate fair market value and compare it to the fair market value determined by the trustee but rather to evaluate the conduct of the trustee in determining fair market value and to analyze whether such conduct was consistent with the trustee's fiduciary obligations.

In the court's analysis, the court noted that the focus of the inquiry as to whether an ESOP fiduciary has breached its fiduciary duties to the plan participants is based on an analysis as to whether the fiduciary acted "solely in the interest of the plan participants" and "engaged in a reasoned decision-making process, consistent with that of a prudent man in like capacity.[ix] The court concluded that Evolve failed to show that its reliance on the appraisal by Napier was reasonable. In making its conclusion, the court noted that while Evolve raised some issues concerning the appraisal, Evolve rushed through the transaction so that it could be effectuated by year end and failed to sufficiently probe Napier's rejection of using discounted cash flows, the add-back of one half the cost of health insurance, and the unusually low discount rate. Evolve failed to note or question Napier's use of a three-year look-back period as well as assumptions regarding working capital.

The court also concluded that Evolve should have realized that Napier's conclusion that the Sentry ESOP would acquire control was incorrect. Evolve had reviewed the Sentry corporate documents as well as the ESOP plan documents. The court noted that a prudent fiduciary would have "vigorously questioned" whether the Sentry ESOP was gaining control. At a minimum, Evolve should have insisted on provisions in the transactional documents that ensured that the Sentry ESOP gained control upon closing.

The court took issue with Evolve allowing the transaction to close prior to receipt and review of a final appraisal. The court noted: "ERISA demands more. A prudent fiduciary would not simply point out some flaws in a draft appraisal, leave others unaddressed, and settle on a price using an expert's range of value without ever reviewing that expert's final appraisal."[x]

The court concluded that Evolve had caused the Sentry ESOP to sustain a loss by purchasing Adam Vinoskey's shares at a price that exceeded fair market value. Evolve's actions were determined to result in causing the Sentry ESOP to engage in a prohibited transaction to which an exemption did not apply.

Duties of Prudence and Loyalty

The Court found that Evolve violated its duties of prudence and loyalty.[xi] The Court noted that Evolve failed to meet its duty of prudence for all the reasons cited in its analysis regarding a prohibited transaction.

A duty of loyalty is imposed on ESOP fiduciaries by ERISA. A fiduciary is required to discharge the fiduciary's duties in a manner that is solely in the interest of the participants and beneficiaries.[xii] At trial, one of the Evolve principals indicated he saw his duty as obtaining a fair deal for both the ESOP and Adam Vinoskey. The court determined that such a divided sense of loyalty, the failure to negotiate for a better price, and the rushed nature of the transaction, all reflected that Evolve had not complied with its duty of loyalty to participants and beneficiaries in consummating the transaction.

Owner Involvement In Prohibited Transaction

The Court ruled that Adam Vinoskey and his revocable trust were knowing participants in a prohibited transaction and that Vinoskey was liable with Evolve for its breaches as co-fiduciary.

In determining that Vinoskey was a knowing participant, the court noted that Vinoskey knew he was transacting with Evolve in its capacity as independent trustee and that Evolve knew of the facts that rendered the transaction a prohibited transaction. The Court noted that Vinoskey did not necessarily have knowledge of Evolve's imprudent process but did have knowledge that $406 per share exceeded the stock's fair market value.

A plan fiduciary is liable for a breach of fiduciary responsibility by another fiduciary of the same plan if the fiduciary knowingly participates in or undertakes to conceal an act or omission of such other fiduciary or if the fiduciary has knowledge of a breach by such other fiduciary.[xiii] Because Vinoskey knew that he was receiving a price for his shares in excess of fair market value, he knew that Evolve had breached its fiduciary duty. Because of that knowledge, Vinoskey was liable with Evolve as a co-fiduciary.

Practice Takeaways

- In considering a retirement plan transaction, consider and address all potential conflicts of interest in advance. A conflict waiver will not always be enough.
- Plan fiduciaries have an obligation to determine that appraisals are reasonable. Hire a fiduciary with the ability to review and determine the reasonableness of the appraisal.
- Plan year end transactions well in advance. Sometimes, decisions to proceed are simply not made until close to year end. If there is a short timeframe to accomplish a transaction, hire sufficient firepower who can dedicate the effort required to review and document the process.
- Avoid establishing the desired value of the transaction prior to an appraisal or valuation being accomplished.
- If you facilitate year end transactions for clients, clear your plate of non, year-end projects in advance.
- An appraisal that varies from appraisal history should be vetted. Variations, and the reasons therefore should be documented by the appraiser and reviewed in detail by the independent trustee.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Mary Vandenack

CITE AS:

CITATIONS:

[i] *Pizzella v. Vinoskey* (earlier *Acosta v. Vinoskey*), 2019 WL 3539813 (W.D. Va. 2019).

[ii] *Pizzella v. Vinoskey* (earlier *Acosta v. Vinoskey*), 2019 WL 3539813 (W.D. Va. 2019).

[iii] *Vinoskey,* 2019 WL 3539813 (W.D. Va. 2019.

[iv] *Vinoskey*, 2019 WL 3539813 (W.D. Va. 2019.

[v]ERISA §406 29 USC 1106.

[vi] ERISA §406(a)(1); 29 USC §1106(a)(1).

[vii] ERISA §408(e); 29 USC §1108(3).

[viii] ERISA §3; 29 USC §1002(18).

[ix] *Vinoskey*, 2019 WL 3539813 (W.D. Va. 2019 ((quoting *Brundle v. Wilmington Trust*, 919 F.3d at 773 (quoting DiFelice v. U.S. Airways, Inc., 497 F.3d 410, 420 (4th Cir. 2007))).

[x] *Vinoskey*, 2019 WL 3539813 (W.D. Va. 2019.

[xi] *Vinoskey*, 2019 WL 3539813 (W.D. Va. 2019.

[xii] 29 U.S.C. § 1104(a)(1)(A).

[xiii] 29 U.S.C. §1105(a).