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ERISA Litigation

Fourth Circuit Affirms $30 Million in Trustee Liability for Overvalued ESOP

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The private plaintiff and governmental attack on employee stock ownership plans (ESOPs) was given energy recently, as the United States Court of Appeals for the Fourth Circuit affirmed a trustee's breach of ERISA fiduciary duties in causing the Constellis Group ESOP to overpay for the company stock purchased in a transaction by almost $30 million. In *Brundle on behalf of Constellis Employee Stock Ownership Plan v. Wilmington Tr., N.A.*, 919 F.3d 763 (4th Cir. 2019), *as amended* (Mar. 22, 2019), Constellis, a privately held company, retained CSG International (CSG), an investment banking firm, to explore the possibility of creating an ESOP to purchase Constellis. *Id*. at 771. CSG proposed a "unique" ESOP structure where Constellis' owners (the Sellers) would retain de facto control of Constellis by selling 90 percent of their shares to the ESOP and exchange the remaining 10 percent for "equity-like warrants" that would entitle the Sellers to buy back equity at a designated price and guarantee the Sellers a majority on Constellis' board of directors. *Id*. The proposed ESOP would maximize after-tax cash returns to the Sellers if completed by the end of the calendar year. *Id*.

On CSG's recommendation, Constellis engaged Wilmington Trust, N.A. (Wilmington) to serve as the ESOP's trustee, and Wilmington hired Stout Risius Ross (SRR) as its financial advisor for the ESOP transaction. *Id*. On November 12, 2013, SRR provided Wilmington with a draft valuation of Constellis stock (the SRR Report), which concluded that Constellis stock's fair market value was between $3,865 and $4,600 per share, resulting in the company's worth ranging from $275 to $330 million. Two days later, Wilmington met with SRR to discuss the report, and Wilmington decided on a negotiation range between $3,900 to $4,235 per share. *Id*. The next day, after about five hours of negotiation, Wilmington and CSG settled on a share price of $4,235. *Id*. at 772. Three days later, the ESOP issued a tender offer for the Constellis shares and the purchase closed for $4,235 per share—"the very top of Wilmington's authorized negotiation range." *Id*.

This action followed when an ESOP participant alleged that Wilmington caused the ESOP to enter into an ERISA prohibited transaction under ERISA Section 406. *Id*. The district court agreed, rejecting Wilmington's affirmative defense that the sale was for adequate consideration. *Id*. Concluding that Wilmington had violated its ERISA fiduciary duty by purchasing overvalued stock, the district court awarded almost $30 million as damages. *Id*.

On appeal, Wilmington challenged the court's liability and damages determination, as well as the $1.5 million award in non-statutory attorneys' fees. *Id*. Relying heavily on SRR's Constellis stock valuation, Wilmington mainly contended that the district court erred in concluding that it had violated ERISA. *Id*. at 773. The Fourth Circuit disagreed, focusing its inquiry on whether Wilmington acted solely in the ESOP participants' interests as a prudent fiduciary. *Id*.

Under this inquiry, the Fourth Circuit affirmed that Wilmington's decision-making process was inadequate in four major respects—Wilmington failed to investigate (1) omission of a prior valuation of Constellis stock just months before the SRR Report that produced a significantly lower stock value; (2) use of Constellis management's growth projections, which were specifically prepared for the SRR valuation and thus may have been less reliable given the risk that Constellis could have inflated the projections; (3) application of a 10 percent control premium to Constellis stock when there was evidence that the ESOP's unique ownership structure substantially limited the ESOP's rights; and (4) consistent rounding up by the SRR in the valuation of Constellis stock. *Id*. at 773-78.

Wilmington's conduct throughout the transaction provided further evidence of its failure to act as a prudent fiduciary solely on behalf of the ESOP participants. *Id*. at 778. Among other things, the Fourth Circuit noted Constellis' principal motivation for creating the ESOP—to further the Sellers' interests—and the resulting shortened transaction timeline and rushed due diligence process. *Id*.

Finally, the Fourth Circuit rejected Wilmington's argument that the subsequent sale of Constellis in July 2014 at an enterprise value of $288.3 million, of which $20 million was in cash to the ESOP, proved that the ESOP did not overpay for Constellis seven months earlier. *Id*. at 779. Though $288.3 million was in SRR's estimated range of $275 to $330 million, this subsequent sale did not constitute a meaningful comparator to the ESOP transaction when the buyer, a private security company like Constellis, would have been willing to pay significantly more because it stood to benefit from synergies as a result of the purchase. *Id*. at 780.

The Fourth Circuit's ruling provides yet another liability determination against ESOP trustees for overvaluing privately held stock when including control premiums and future stock warrants in the financing. In the past few years, these common aspects of ESOP transactions have been under repeated investigation by the US Department of Labor, as well as continued challenge by the ERISA plaintiff's bar. This Fourth Circuit decision will likely result in increased DOL scrutiny of ESOP transactions, especially those where control premiums and stock warrants are included, as many transactions in the past several years have been based on the same deal structure.

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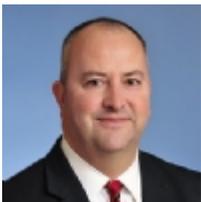**Craig C. Martin**

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