

KROY DECISION: A REALITY CHECK FOR ERISA FIDUCIARIES

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INTRODUCTION

Nearly 19 years after the enactment of the Employee Retirement Income Security Act of 1974, as amended (ERISA), practitioners have received from the federal judicial system guidance about the meaning of the term “adequate consideration” within the meaning of §3(18) of ERISA.¹ This guidance is provided in the form of the holding in *Reich v. Valley National Bank of Arizona*, 1993 U.S. Dist. LEXIS 11837 (Aug. 19, 1993), in a lengthy opinion delivered by Judge Constance Baker Motley.

While the facts of this case concern a multi-investor leveraged ESOP buyout, the holding of the case provides broad and extensive guidance to ERISA fiduciaries and their legal and financial advisors concerning an investment by any retirement plan in any kind of nonpublicly traded security. In fact, because of the facts of the case and its procedural history, the holding arguably provides more guidance for investments by other retirement plans in nonpublicly traded securities than it does for leveraged stock ownership transactions. The opinion also provides a checklist as to the depth and breadth of investigation required of an ERISA fiduciary before making a decision concerning an investment in employer securities.

This article will explore the facts and procedural history of this case and analyze its holding and the limitations thereof, provide practical pointers for ERISA fiduciaries and their legal and financial advisors, review the issues addressed by the court in dicta, and finally, discuss issues that the holding does not answer and some interesting asides to the case.

PROCEDURAL BACKGROUND

Reich v. Valley National Bank of Arizona involves an action brought by the U.S. Department of Labor (the “DOL”) against Valley National Bank of Arizona (“Valley National”) in its capacity as trustee of the Kroy Inc. Employee Stock Ownership Plan (the “Kroy ESOP”). Both parties submitted cross-motions for summary judgment on the DOL’s breach of fiduciary duty claim against Valley National as well as its other claims against Valley National. Valley National also interposed counterclaims and affirmative defenses, which the DOL sought to dismiss. While a number of facts were stipulated pursuant to Federal Rules of Civil Procedure 12(b)(6) and 12(f), certain other facts were concluded by the court according to its review of depositions and other information available from discovery.²

In its judgment, the court granted the DOL motions for summary judgment, denied each of Valley National's numerous counterclaims and affirmative defenses and awarded damages in the amount of \$17.5 million to the DOL for the benefit of the ESOP participants and beneficiaries.

COURT FINDINGS OF FACT AND CONCLUSIONS OF LAW

The DOL alleged that Valley National breached its fiduciary duty while acting as trustee of the Kroy ESOP in connection with the management-led leveraged buyout transaction in which Kroy Inc. ("Kroy") was taken private. Specifically, the DOL alleged that Valley National breached its fiduciary duty by causing the ESOP to purchase stock in Kroy without obtaining adequate consideration for its purchase. Furthermore, the DOL alleged that Valley National failed to conduct a good faith independent investigation of the buyout in order to determine: (i) if the buyout was fair to the ESOP from a financial point of view, and (ii) if the price to be paid by the ESOP was not in excess of the fair market value of the underlying stock. By doing so, the DOL alleged, Valley National caused the ESOP to engage in various non-exempt prohibited transactions under ERISA.³

The DOL's motion for summary judgment alleged as a matter of law that Valley National failed to arrive at a good faith determination of fair market value of the Kroy stock it caused the ESOP to purchase. Accordingly, the DOL claimed that Valley National failed to make a prudent decision since it did not really understand the transaction or how the transaction affected the interests of the ESOP participants and beneficiaries. Valley National argued that there was no real economic loss to the ESOP and, therefore, that no money damages could be awarded to the DOL on behalf of the Kroy ESOP.

Upon a cursory examination of the court's findings of fact, one can quickly determine that Valley National was faced with a trail of troubling facts. Based on the speed at which Valley National was pressured to act and the numerous apparent procedural issues, it is quite evident why the DOL sought to litigate this matter in order to establish the points of law on its agenda and why this case was a very difficult one for the DOL to lose or for Valley National to win.

By way of background, Kroy was in the printing and typography business, which flourished in the 1970s and 1980s. The business prospects of Kroy Inc. began to decline in the mid-1980s (when it was a publicly traded company) because of competition from businesses established by former Kroy employees. As a result, in February 1986, Kroy's board of directors began exploring options to improve the financial performance of the company and concluded that a going private transaction using an ESOP was worth exploring. Subsequently, in July 1986, a management-led leveraged buyout was proposed by the Kroy management group with the assistance of Bankers Trust Company. A leveraged employee stock ownership plan was included in this proposal; in fact, the ESOP was central to the proposed leveraged buyout because of its inherent tax benefits in providing lower cost financing for the buyout.⁴ Thereafter, in August 1986, the work on the LBO transaction commenced with the creation of a new corporation, Kappa, which was created solely to facilitate the leveraged buyout. Thereafter, the ESOP was created, and Kappa and Kroy were merged.

Individual trustees for the ESOP were appointed in July 1986. These individuals served until December 1986, when they resigned because of purported difficulties in obtaining fiduciary liability insurance for themselves. Before resigning, the ESOP trustees did *not* negotiate the price to be paid by the ESOP for the shares or the terms thereof. Rather, Bankers Trust, working for management, determined the price the ESOP would pay for the shares before the trustees were appointed. The trustees first met during July 1986 and considered candidates to be their legal and financial advisors. The trustees rejected Houlihan, Lokey, Howard & Zukin (HLHZ) as a financial advisor because they feared that one of its principals, James Zukin, would cause “difficult” negotiations. The trustees chose Benchmark Associates because of its lower fee quotation, which the trustees considered indicative of Benchmark’s confidence that the task could be accomplished on a time-efficient basis. The lawyers representing the individual trustees did attempt to negotiate a lower price for the ESOP shares but were unsuccessful. The trustees relied completely on legal counsel for this purpose because of their inexperience with multi-investor leveraged ESOP transactions. The trustees resigned on December 17, effective as of December 5.

Management obtained its financing from a consortium of banks led by First Bank of Minneapolis. First Bank offered a participation to the Valley National’s commercial department but was rejected. The commercial department of Valley National declined participation in the buyout financing based upon its own thorough examination of relevant financial data and information which uncovered Kroy’s sales decline, pressure from new competition which weakened Kroy’s position in the market, inadequate cash flow to enable Kroy to meet projected repayment, and Kroy’s proposal to finance the deal with new and untested technology and increased sales. The commercial department of Valley National also concluded that Kroy’s declining sales and falling profitability rendered it unlikely that Kroy could service the debt it would incur in the proposed buyout. The credit review memorandum contained a notation: “I would be interested to see if First does this deal or how/why it makes sense??” Valley National’s commercial department notified its trust department that Kroy was seeking an institutional ESOP trustee and that the commercial department had declined the offer to participate in the financing; however, the trust department did not question the commercial department about its decision not to participate in the debt financing.

On December 10, 1986, Kroy contacted Valley National’s trust department about serving as successor trustee of the Kroy ESOP. The key contact at the Valley National trust department for Kroy was a sales person with little technical ERISA experience. In fact, when Valley National accepted its role as the Kroy ESOP trustee, it had never served as an ESOP trustee in a multi-investor ESOP-financed LBO.

Kappa’s lawyers were Patterson, Belknap, Webb & Tyler (“Patterson Belknap”) of New York. Before the closing of the transaction, Patterson Belknap sent certain information and documents relating to the Kroy transaction to the DOL’s national office for the DOL’s informal review, inasmuch as the DOL had no applicable opinion lever procedure for the ESOP transactions. However, the DOL gave no written approval at any time to the Kroy ESOP transaction and gave only minimal comments to Patterson Belknap concerning the transaction. The trustee’s lawyers were not involved in this informal process.⁵

SUCCESSOR TRUSTEE EFFORTS

The court found that Valley National conducted only minimal due diligence review beginning on December 11, 1986. The earliest discussions were largely about the fees to be paid to Valley National for its part in the Kroy buyout. On December 16, a Valley National trust department representative flew to New York and met with its legal and financial advisors at Patterson Belknap's offices with whom it reviewed the financial advisor's valuation report. While this report analyzed publicly available information, it did not include any independent assessment of whether Kroy could meet the sales projections upon which the LBO was predicated, and it did not reflect any investigation by the financial advisor of certain negative comments made by Kroy's distributors about Kroy and its products.⁶

The court also found that Valley National did not scrutinize the report and discussed it with its financial advisor only in general terms and made no independent analysis of the report; instead, it relied only upon assurances provided by its financial advisor. In fact, Valley National did not realize that the proposed purchase price to be paid by the ESOP included a control premium or that the opinion of its legal counsel did not address whether the ESOP would be able to exercise control in fact.

The court further noted that Valley National did not contact the predecessor individual trustees about the transaction or about any prior efforts to negotiate the price in terms of the ESOP's participation in the transaction. Valley National did not review the minutes of the meetings of the predecessor trustees. Thereafter, Valley National did not attempt to negotiate on behalf of the ESOP but concluded that further attempts to negotiate the price and its related terms were not apt to be fruitful. Valley National also did not visit the Kroy premises, interview management or review corporate governance documents.

According to the court, Valley National's understanding of its financial advisor's report was minimal at best, and the time spent with its legal counsel and financial advisor was insufficient. Although Valley National trust department personnel had a copy of its commercial department's analysis of the LBO, they did not furnish a copy thereof to either its legal counsel or the financial advisor. This analysis had been reviewed by the trust department, but it was disregarded because the trust department felt that it related only to a debt participation in the transaction and not to an equity investment.

While the legal counsel and financial advisor to Valley National were unaware that Valley National had declined to participate as a lender in the transaction, the financial advisor's representative admitted that, had he known the reason Valley National declined to participate, he would have felt that further investigation would have been required. This admission apparently was viewed by the court as further evidence of Valley National's lack of due diligence.

DEAL CONSUMMATED

On December 19, 1986, the initially scheduled closing of the Kroy transaction was postponed at the request of the non-ESOP investors. The deal was concluded on December 23, 1986, with the publicly held shares being purchased for \$78 million.

The ESOP purchased 6 million shares of Class A common stock at \$5.92 per share, for a total investment of \$35.5 million. In exchange for the shares, the ESOP gave to Kroy two separate promissory notes. The two promissory notes were to be repaid over the next six years with funds derived from the Company's promised future contributions. The shares of Class A common stock purchased by the ESOP with the leveraged proceeds initially represented 60% of the outstanding common stock of the corporation and were pledged to secure the ESOP loan.

The non-ESOP investors in the buyout obtained the following interests in Kroy:

1. The management group received, in exchange for its cash investment, 502,000 shares of Class B common stock of Kroy, which represented 5.02% of the shares of common stock of the new corporation, for which it paid \$1.125 per share.
2. A nonmanagement investor group, in exchange for \$3,935,000 of invested capital, received 3,498,000 shares of Class B, Class C and nonvoting Class C shares of Kroy, which represented just under 35% of the shares of common stock of Kroy, for which it paid \$1.125 per share.
3. Another non-ESOP investor received in exchange for a \$700,000 investment, 1,086,000 warrants to purchase the same number of Class C common shares of Kroy at an exercise price of \$1.125 per share, for which it paid \$0.66 per warrant.

In furtherance of the buyout, certain other equity incentive plans were adopted for issuance in the future of stock to the management group and other key employees.

Thus, immediately after the transaction, the ESOP owned 60% of the outstanding equity of Kroy, the nonmanagement investor group owned 35% and the management group owned 5%. On a fully diluted basis, the equity allocation was different: that is, the ESOP would have 50.1%, the nonmanagement group 38.3%, and the management group 11.6%.⁷

From 1987 to 1990, Kroy made \$17.5 million of principal contributions to the ESOP. On May 15, 1990, Kroy filed for protection from its creditors under Chapter 11 of the U.S. Bankruptcy Code. Thereafter, in August 1990, the ESOP sold its Kroy stock to Red Oak Investment Corporation for \$250,000 pursuant to a Bankruptcy Court order. The DOL had filed a lawsuit on December 18, 1989, against numerous defendants, including Valley National as ESOP trustee.

DEPARTMENT OF LABOR MOTIONS

Specifically, the DOL alleged that Valley National had caused the Kroy ESOP to engage in non-exempt prohibited transactions in violation of §§406(a)(1)(A), (B) and (D) by causing the Kroy ESOP to purchase Kroy shares for more than adequate consideration because:

1. it failed to conduct an independent good faith inquiry;
2. due to Valley National's nonfeasance, the ESOP did not get fair market value for its outlay; and
3. as a result, the Kroy ESOP suffered a \$17.5 million loss.

The DOL took the position that in order for the adequate consideration requirement to be met in a transaction, both the good faith inquiry *and* the fair market value requirement set forth in §3(18) must each be met separately. Conversely, Valley National contended that if the ESOP paid no more than fair market value for the Kroy stock, the good faith inquiry was unnecessary. While at one point in the decision, the court indicated that it did not decide this issue since it was clear that neither element was met, the court subsequently stated that the DOL position was, indeed, the correct position.⁸

ADEQUATE CONSIDERATION

Under ERISA, a defending fiduciary must prove by a fair preponderance of the credible evidence that the stock was purchased for no more than adequate consideration. That is, Valley National had to prove that it arrived at its determination of fair market value by way of a prudent investigation.⁹ The court determined that the evidence showed that Valley National failed to take independent steps; failed to understand the basis, evidence and analysis of its financial advisor's report; failed to take steps enumerated in the written opinion of its legal counsel; and failed to arrive at a determination of fair market value by way of a prudent investigation. Cited in support of these legal standards, the court noted the case law in *Donovan v. Cunningham*,¹⁰ *Whitfield v. Cohen*,¹¹ *Katsaros v. Cody*,¹² *Donovan v. Mazzola*,¹³ *Fink v. National Savings Bank*,¹⁴ *Central States Pension Fund v. Central Transport*,¹⁵ and *Eaves v. Penn.*¹⁶ It did not and could not cite to the DOL proposed adequate consideration regulations promulgated under §3(18) since these proposed regulations were not issued until after the Kroy transaction was closed.¹⁷

In an apparent reversal of its position in the voluntarily dismissed *Dole v. Farnum*¹⁸ action, the DOL took the position that it is irrelevant how the ESOP got its transaction funds in considering whether the ESOP paid more than adequate consideration for the stock. In *Farnum*, the DOL alleged that the ESOP trustee, ESOP administrative committee, and the employer's board of directors all caused or allowed the ESOP to pay an excessive price when it purchased 80% of the company's stock from the estate of its deceased owner by failing to take into account the cash drain on the employer represented by the employer's anticipated contributions to the leveraged ESOP and the requirement that the employer repay the obligation of the lender bank. This position generated immediate criticism in valuation circles, since post-transaction debt service is typically not taken into account in establishing a transaction price. Conversely, it arguably would be imprudent for an ESOP fiduciary to consider a purchaser's post-transaction debt service in negotiating the price at which the ESOP shares are sold. The DOL withdrew its complaint in *Farnum* in light of heavy criticism from the ESOP community.

GOOD FAITH INQUIRY

The DOL claimed that a fiduciary cannot excuse a poor investment by maintaining that the ESOP would not exist if not for the imprudent decision to make the investment. In this regard, the standard of review is to determine whether or not the trustees employed at the time of the transaction used appropriate methods to investigate the merits of the investment and to structure the investments. The court concluded that Valley National had not done so. Even though Valley National had access to an independent financial advisor,

the ESOP's advisors had been picked by Kroy's management and merely ratified by the predecessor trustees and Valley National. Further, the financial advisor's report was based solely on representations of Kroy management.¹⁹ In the eyes of the court, this amounted to dependent advice rather than independent advice. The court determined that a trustee cannot engage in passive acceptance of reports and opinions; *i.e.*, such behavior does not immunize an ERISA fiduciary from ERISA liability. Also harmful to Valley National's case was that its trust department had disregarded the memorandum of its commercial department prepared in connection with the latter's refusal to participate in the Kroy ESOP loan. The court reasoned that had Valley National's trust department considered that memorandum, it should have had substantial doubts about Kroy's ability to amortize the ESOP indebtedness and, consequently, would have concluded that the purchase of Kroy stock was imprudent.

Valley National was not the only participant in the transaction to be criticized by the court. Scrutiny was also focused on Valley National's financial advisor, primarily because the financial advisor failed to conduct an adequate independent investigation into Kroy, and thus, its opinions were of little value to Valley National. In this respect, the financial advisor's report was based almost completely on information provided by Kroy management with no independent exploration into the credibility of the representations and projections. The court criticized the financial advisor for failing to independently assess whether Kroy could realistically meet the sales projections, which were integral to Kroy's ability to meet its debt obligations. It is interesting to note that the report not only opined on fair market value and the fairness of the transaction but also included an opinion that the purchase of the Kroy shares by the Kroy ESOP was not imprudent.²⁰

FAIR MARKET VALUE

The court's key criticism regarding the financial advisor's conduct was that its report was inadequate because it discussed the "investment value" of the stock to the ESOP instead of determining fair market value of the stock according to a willing buyer and willing seller scenario. "Investment value" of the Kroy stock was determined merely by adding Kroy's total contribution obligation to the ESOP to the post-transaction value of the shares to obtain a "total indicated value." Thus, the "investment value" was \$6.61 per share (\$5.92, which was the contribution of principal needed to repay the debt on the purchase, plus a post-transaction value of \$0.69 per share). The logic of this valuation methodology for Kroy stock was rejected by the court because the logical conclusion is that an ESOP can pay any price it wants since the required contributions from the employer will always be equal to the price of the shares purchased by the ESOP. Therefore, any dollar price per share can always be justified under this approach. The court held that, as a matter of law, this was an incorrect valuation methodology, noting that Valley National's own expert even admitted that a cash purchaser would not pay the price per share that the Kroy ESOP did. The court also found that the financial advisor inappropriately analyzed the purchase price with specific reference to the ESOP as the buyer rather than any willing buyer as required.²¹

FINANCIAL ADVISOR ROLE

The court's criticism of the financial advisor's investigation is in part troubling. For example, much of the information management provides to an ESOP financial advisor cannot be independently verified absent a full audit, which is typically beyond the scope of a financial advisor. It seems unlikely that the courts would require financial advisors to entirely reconstruct historical financial statements or projections. On the other hand, a financial advisor should attempt to independently evaluate management's forecast in light of industry developments, expectations evidenced by stock prices for comparable public companies, and realistic assumptions regarding the company's competitive strengths and financial capabilities. The financial advisor may also engage in a "sensitivity analysis," whereby it changes one or more assumptions used for financial projections to see how these changes affect the company's projected financial performance.

The court's criticism of the trustee and financial advisor for not investigating negative comments made by Kroy's distributors concerning their opinions about Kroy and its products is also troubling. This is because, in the experience of the authors, making inquiries of customers, suppliers and distributors of a privately held company before a transaction is completed is likely to have a detrimental effect on the relationships with these parties at a time when confidentiality is key to the company's long-term success.

PREDECESSOR TRUSTEES

Valley National was not entitled to rely on the predecessor trustees' efforts because Valley National made no efforts to assure itself that the predecessors' work satisfied ERISA standards. In addition, the facts supported the conclusion that the predecessor trustees were totally passive in their representation of the ESOP. Unfortunately, the predecessor trustees' conduct evidenced a predisposition to close the deal when they decided not to hire HLHZ as financial advisor because they felt that Mr. Zukin's personality would lead to "difficult" negotiations, especially in light of his expressed reservations about the fairness of the transaction. Because Valley National never contacted the predecessor trustees or even reviewed their minutes or papers, Valley National could not legally attempt to rely on their efforts. In furtherance of this conclusion, the court noted that the price per share and proportional interest of the ESOP were paid solely because these were the amounts necessary to finance the Kroy leveraged buyout. To make matters worse, the predecessor trustees' inexperience forced them to rely solely on their legal counsel and financial advisor. This, together with the fact that the predecessor trustees resigned because of their inability to purchase fiduciary insurance, implied to the court that they were skittish about the propriety of the proposed transaction. This fact alone also should have put Valley National on notice that further investigation was required, the court concluded.

DUAL TEST

The court finally concluded that Valley National did not meet either the good faith inquiry or fair market value test because of its lack of investigation and because the fair market value was not determined on the basis of a willing buyer and willing seller scenario but, instead, on the basis of what a buyer would pay where it purchases the stock with no money

down, no cash at risk, and on the basis of a nonrecourse promissory note dependent upon payments by the company. Under this theory, as long as there is a guaranty by the employer to pay contributions to the ESOP and it is probable that the contribution guaranty would be honored, any price could be justified. Even this methodology would have failed in Kroy because the quality of the guaranty was questionable from the outset due to Kroy's declining performance.

It is noteworthy that the court relied upon the statement of Dr. Shannon Pratt in his textbook, *Valuing a Business* (2d ed. 1989), that the universally accepted definition of fair market value is the cash, or cash equivalent, price at which property will change hands between a willing buyer and a willing seller without compulsion. The court noted that, in his deposition testimony, Dr. Pratt opined that no third-party cash purchaser would pay the price that the Kroy ESOP paid.

CONTROL PREMIUM

There has been much discussion among ERISA practitioners as to what facts and circumstances can justify the use of a control premium in purchasing nonpublicly traded security. The Kroy decision sheds little additional light on this issue, indicating only that control is not an all or nothing matter and that the purported control of the Kroy ESOP was its ability to control the membership of the Kroy board of directors from the outset, based on its veto power, over the initial composition of the board. However, the evidence contained no assertion that the ESOP either exercised or considered exercising this power, and thus, the power appeared to be illusory. While the ability of an ESOP distributed to put his or her shares back to Kroy at "enterprise value" was considered, the court felt that the following additional factors needed to be included:

- the terms under which the company would satisfy its repurchase obligation;
- the company's short-term liquidity and long-term ability to satisfy its indebtedness; and
- the company's financial history of repayment.²²

There was no evidence before the court that these factors were considered by the Trustee at the time the transaction was closed, and there was no specific quantification of the level of the control premium contained in the financial advisor's report to Valley National. Moreover, the court concluded that the facts demonstrated that the put right of the Kroy ESOP participants was meaningless because Kroy was on the road to insolvency.

The only tangible guidance available to practitioners concerning control premiums is contained in the preamble to the DOL's adequate consideration proposed regulations (which had not been issued at the time of the Kroy closing), as set forth in Paragraph B.5. of the preamble thereto, which provides in pertinent part:

Specifically, the Department proposes that a plan may pay such a premium only to the extent a third party would pay a control premium. In this regard, the Department's position is that the payment of a control premium is unwarranted unless the plan obtains both voting control and control in fact. The Department will therefore carefully scrutinize situations to

ascertain whether the transaction involving payments of such a premium actually results in the passing of control to the plan. For example, it may be difficult to determine that a plan paying a control premium has received control in fact where it is reasonable to assume at the time of acquisition that distribution of shares to plan participants will cause the plan's control of the company to be dissipated within a short period of time subsequent to acquisition. *In the Department's view, however, a plan would not fail to receive control merely because individuals who were previously officers, directors or shareholders of the corporation continue as plan fiduciaries or corporate officials after the plan has acquired the securities. Nonetheless, the retention of management and the utilization of corporate officials as plan fiduciaries, when viewed in conjunction with other facts, may indicate that actual control has not passed to the plan within the meaning of paragraph (b)(4)(ii)(1) of the proposed regulation. Similarly, if the plan purchases employer securities in small increments pursuant to an understanding with the employer that the employer will eventually sell a controlling portion of shares to the plan, a control premium would be warranted only to the extent that the understanding with the employer was actually a binding agreement obligating the employer to pass control within a reasonable time. *See Donovan v. Commissioner, supra*, 716 F.2d at 1472-74 (mere intention to transfer control not sufficient).

*However, the Department notes that the mere pass-through of voting rights to participants would not in itself affect a determination that a plan has received control in fact, notwithstanding the existence of participant voting rights, if the plan fiduciaries having control over plan assets ordinarily may resell the shares to a third party and command a control premium, without the need to secure the approval of the plan participants.

Paragraph (b)(4)(ii)(1) of the proposed regulation includes as a factor in determining the fair market value of employer securities being acquired by a plan like an ESOP:

Whether or not the seller would be able to obtain a control premium from an unrelated third party with regard to the block of securities being valued, provided that in cases where control premium is taken into account:

1. Actual control (both in form and in substance) is passed to the purchaser with the sale, or will be passed to the purchaser within a reasonable time pursuant to a binding agreement in effect at the time of sale, and
2. It is reasonable to assume that the purchaser's control will not be dissipated within a short period of time subsequent to acquisition.

Note, however, that under the foregoing standard, an ESOP may have to acquire more than a mere majority if state law or the corporation's charter requires a super majority vote for certain shareholder issues, especially if those issues require a mandatory pass-through vote to participants under Code §409(c).

Accordingly, neither the Kroy decision nor the DOL proposed regulations provide much tangible guidance to ESOP practitioners about when or under what circumstances a control premium is appropriate. Such a consideration must take into account all surrounding facts and circumstances in order for practitioners to reach a comfort level with a "control premium" being paid by a plan for employer securities.

“NO LOSS” ARGUMENT

The court emphatically rejected the “no loss” argument of Valley National. Valley National had argued that, but for the leveraged buyout transaction, the ESOP would not have been created and that the ESOP had no alternative investment opportunity and, therefore, there could be no loss as a matter of law. This viewpoint did not prevail because the court found that an ERISA fiduciary must protect the primary purpose requirement of an ESOP, and the argument that the ESOP would not have been created without the tax benefits was flawed because the argument focuses on the secondary effects rather than the primary purpose. The court would not accept as a matter of law the argument that the ESOP contributions could be conditioned on a violation of the prohibited transaction rules of ERISA and related fiduciary duty provisions. Moreover, to argue that the ESOP would not have been created except to invest in the Kroy buyout and that, therefore, the ESOP could not have invested its loan proceeds otherwise, is illogical. The conclusion of this line of reasoning would be to excuse all breaches of fiduciary duty in a leveraged ESOP transaction and eliminate all damages, regardless of the breaches engaged in simply because if the ESOP transaction had not occurred, the participants would have received nothing in its place. This conclusion flies in the face of the basic philosophy of ERISA to protect the retirement interests of plan participants and their beneficiaries.

DAMAGES

Because the case involved an equitable relief action brought by the Department of Labor in an ERISA fiduciary breach action, the court focused its damages analysis on the fact that the Kroy ESOP’s assets were part of the overall benefits and compensation package offered to employees, that these benefits were not a mere gratuity, and accordingly, where the employer securities held by the ESOP become worthless, the plan participants have lost deferred wages. There does not appear in the court’s statement of facts any indication that the ESOP replaced a pre-existing retirement plan or that the Kroy employees made salary, bonus or other benefits concessions.²³

The court noted that there were two transactions: (1) the loan to the ESOP, and (2) the investment by the ESOP in employer securities. The court found the loss claimed by the DOL may be charged to either transaction. From this viewpoint, it was determined that the participants suffered a loss of \$17.5 million in the loan transaction or in the stock transaction. After carefully reviewing the language on the determination of damages, the authors believe that the most probable interpretation is that the measure of loss was the \$17.5 million in principal payments made before the company’s collapse, *reduced* by the \$250,000 received for the stock from Red Oak Investment, *plus* interest. It is also possible to read the decision to mean that the court measured damages as the remaining indebtedness, but this interpretation seems to fall apart since the remaining indebtedness was, in fact, \$18 million (\$35.5 million minus \$17.5 million of principal payments).²⁴

The damages portion of the decision is likely to be a real center of controversy upon appeal. While it is clear that the guiding principle in awarding equitable relief for breach of fiduciary duties imposed under ERISA is to enforce a remedy which best carries out the purposes of the plan and is most advantageous to plan participants and beneficiaries, it is debatable whether the damage measurement accomplishes this. Indeed, both parties have ample incentives to appeal as well as substantial risks.

A breaching fiduciary which has been held to have paid a price in excess of adequate consideration may argue that the actual damage measurement should be the excess of the price paid over its “true” fair market value. There appears to be no language in the decision which holds that Valley National’s investment decision was imprudent at any price, and thus, Valley National may argue that only the difference between the fair market value and the price actually paid by the ESOP should be used in measuring damages.²⁵

On the other hand, the appeal may prove quite risky for Valley National. For example, one possible measure of damages would be that the full \$35.5 million purchase price is the loss to the ESOP. Alternatively, one may argue that either the \$17.5 million of principal payments or the full \$35.5 million should receive an earnings increment based on some objective measure, such as the growth in the S&P 500 from the December 1986 closing to the date of the decision. Under such an approach, \$17.5 million invested in December 1986 would have been worth \$41.6 million in August 1993, when the case was decided, which is greatly in excess of the \$17.5 million (plus interest) awarded to the plan.²⁶

The fact of Kroy’s bankruptcy complicates the damage award inasmuch as the sale proceeds were paid to the public shareholders of Kroy and are thus impossible to retrieve for the ESOP. This is to be contrasted with the award in *Eaves v. Fenn*,²⁷ where the offending fiduciaries were also the sellers in the transaction and the amounts were restored to the trust by them, together with the disgorged profits under §409. This sort of rescission restores the plan’s original liquid assets and is an appropriate remedy that is most likely to protect plan participants and effectuate the purposes of the original plan. However, it was not possible to do so in Kroy. Thus, the court must look to other factors in selecting a remedy for breach of fiduciary duty, such as the purposes of the trust, the relative pecuniary advantages to the trust of various remedies, the nature and interest of each beneficiary, the practical availability of various remedies, and the extent of deviation from the terms of the trust required by adoption of the remedy.²⁸

VALLEY NATIONAL COUNTER CLAIMS AND DEFENSES

Valley National argued that although the DOL did not formally review the transaction before the closing and did not render an ERISA opinion letter, the DOL’s informal review of the transaction barred it from later challenging the transaction. It also alleged that the DOL violated a legal duty to Valley National by not promulgating ESOP leveraged buyout regulations. The court rejected these arguments and other arguments related to violation of due process, failure to adhere to informal review, “secret law,” lack of notice and comment, and the DOL’s failure to issue regulations. The court noted that nothing in §3(18) obligates the DOL to issue regulations on the issue.

The court rejected Valley National’s argument that the DOL was bound not to challenge the transaction after closing because it reviewed certain documents and did not inform either Kroy or Valley National that the proposed transaction would be subject to an enforcement action. It distinguished between the so-called “informal review procedure” in *Kroy* from that in *Raymond*,²⁹ *Scott & Fetzer*,³⁰ and *Blue Bell*³¹ matters because the latter cases involved *official* letters from the DOL to the parties, as opposed to the unofficial letters from the parties to the DOL reflected in *Kroy*.

REACTION TO HOLDING

One need not be an ERISA fiduciary aficionado in order to realize that the conclusion of facts by the court in this case were less than favorable from the viewpoint of the defending fiduciary. The purchase by Valley National of an equity investment when another department of the same bank had refused to participate in the debt side of the same transaction because it did not believe that the sponsoring employer had sufficient cash flow to repay the indebtedness is a nearly indefensible act. The consequences of failing to conduct even cursory due diligence into the entity selling the equity securities and accepting at face value the projections of management are high risk for a fiduciary. Using advisors handpicked by the seller and failing to independently negotiate the price and terms of the investment is also begging for trouble. In short, Valley National faced an uphill battle in this case. The holding of the case should be judged in this light.

While the case does much to organize, catalogue and articulate the specific actions that a fiduciary needs to take in order to meet the adequate consideration standard and how it should utilize and rely upon the work of its advisors, the holding of the case does leave many unanswered questions. For example, the DOL took the position that the proportional interest to be received by the ESOP on a fully diluted basis had to be equal to the proportion of the total investment in the transaction represented by the face amount of the ESOP's promissory notes, notwithstanding that the other investors invested their own cash. This DOL position, commonly referred to as the "dollar-for-dollar equity allocation theory," has generated much controversy in the ESOP community. However, the court did not address the dollar-for-dollar theory of the DOL in that it based its holding on the breach of fiduciary duty aspect of the case.³²

While the decision leaves open a wide range of issues concerning the proper determination of fair market value in multi-investor ESOP transactions, nothing the court states on the issues stands in the way of implementing leveraged ESOP transactions in the future. Fair transactional structures have been developed over the past several years, which have bridged the real economics of these transactions with the dollar-for-dollar views, advocated by the DOL. Most of these designs have used dividend-paying, noncallable, convertible, preferred stock for the ESOP in order to satisfy the concerns expressed by DOL.³³ Regardless of the outcome of the case on appeal, it seems likely that the ESOP community will have to pay even greater attention to all procedural aspects of a transaction in conjunction with evaluating the financial merits to satisfy their obligations and minimize risk associated with litigation. However, few ESOP practitioners believe that the decision will have a detrimental effect on ESOP formation or multi-investor ESOP transactions.

Lastly, some of the language in the decision could be construed as requiring a full solvency analysis in the financial advisor's report to the fiduciary.³⁴ While in some larger transaction this may be necessary, desirable and cost effective, it is probably unnecessary and financially burdensome for most transactions. The financial advisor and trustee should, however, analyze the financial data to assess the likelihood that the financial covenants contained in the ESOP in the loan agreements are likely to be met and that cash flow is reasonably expected to be sufficient to cover the timely amortization of the ESOP indebtedness.

PRACTICAL POINTERS FOR FIDUCIARIES

The holding in the Kroy case is rich with practical pointers for fiduciaries considering investments in privately held companies. While the following list is extensive, it is by no means exhaustive of the practical pointers, which may be derived from the holding:

- A fiduciary must engage in a diligent, independent investigation of the entity issuing the security;
- A fiduciary must visit the company premises, review relevant corporate governance documents and interview management;
- A fiduciary must engage its own advisors and not merely accept the handpicked advisors of the selling entity;
- A fiduciary must actively participate in the negotiation of the price and terms of the investment and cannot rely passively on its advisors to do so;
- A fiduciary must have the experience and knowledge which enables it to understand the nature of the investment;
- A fiduciary must undertake an independent analysis of the terms of the ESOP loan and other financing terms;
- A fiduciary must question its advisors about their conclusions, the bases of their conclusions and the underlying analysis; that is, the fiduciary must scrutinize the work of its advisors;
- Where a fiduciary accepts a successor fiduciary appointment, it must review the predecessor fiduciary's efforts and make a judgment on the effectiveness thereof;
- A fiduciary must furnish to its advisors any relevant data or information it may have at its own disposal that is otherwise not publicly available;
- Whether purchasing an equity security or debt security, a fiduciary must investigate the solvency of the corporation; and
- A financial advisory candidate should not be rejected by a fiduciary merely because it might engage in difficult negotiations while another candidate might "play ball," because such behavior evidences a predisposition to conclude a deal as presented.

PRACTICAL POINTERS FOR FINANCIAL ADVISORS

The following similarly expresses some practical pointers to financial advisors that may be derived from the Kroy decision:

- The financial advisor should not render a prudence opinion to a fiduciary, since only the fiduciary can and should make this decision, and rendering a prudence opinion risks being characterized as a person who renders investment advice for a fee, thereby making the financial advisor a fiduciary (or co-fiduciary);³⁵
- The financial advisor must conduct its own investigation of the financial projections of management and independently assess those projections and other publicly available

materials, probably by insisting on receiving all projections prepared (i.e., best case, worst case, base case, etc.) and the projections submitted to lenders and conduct a sensitivity analysis on the assumptions underlying the projections;

- While a financial advisor should seek as much information from as many sources as possible, confidentiality may make it inadvisable to contact the company's distributors, suppliers and/or customers as the opinion suggests it might do;
- An appraisal of a security must be based on what a willing buyer would pay in a cash or cash equivalent transaction to a willing seller, with neither under any compulsion and with full information available to both parties, and the appraiser cannot merely derive an ESOP specific value by summing together the value of the employer contribution guaranty plus the post transaction value of the security;
- Not only must the financial advisor opine that the purchase price does not exceed fair market value, but it also must provide to the fiduciary a range of fair market values of the security;
- In assessing whether a control premium is appropriate, a financial advisor should look at all relevant facts and circumstances, including the employer's ability to satisfy the put option obligations under an ESOP as well as the terms under which it will satisfy such obligations;
- The financial advisor should determine fair market value independent of the source of the ESOP funds;
- A financial advisor should be wary of being retained after a transaction has been negotiated and where its opinion is really sought solely to "bless" a transaction; and
- Financial advisors should carefully review their standard opinion letter language and decide whether many of the qualifying and limiting statements therein continue to be appropriate and how they might be modified.

PRACTICAL TIPS FOR LAWYERS

While the conduct of the lawyers in this case was not criticized by the court, it is still possible to derive some practical pointers for lawyers:

- An attorney should not issue written opinions on whether the ERISA fiduciary prudence standard has been met, since such an opinion is really a factual and circumstantial determination;
- An attorney advising an ERISA fiduciary should furnish to the fiduciary a due diligence checklist, legal memoranda concerning fiduciary standards, written procedures for fiduciaries and even sample minutes of fiduciary meetings;
- An attorney should encourage an ERISA fiduciary to appoint its own financial advisor and to carefully scrutinize the reports, work papers and analyses of its financial advisor; and
- An attorney advising an ERISA fiduciary should utilize informal DOL review of a transaction sparingly and even then with very little reliance thereon.

RELATED ISSUES

As mentioned earlier, the Kroy case does not decide whether the DOL dollar-for-dollar equity allocation position for multi-investor ESOP transactions is in fact a correct interpretation of the law. It is possible that the DOL will attempt to resolve this issue through other litigation or, now that the Kroy decision has been rendered, may provide guidance in the final regulations yet to be issued under §3(18). This, however, does not mean that ERISA fiduciaries and advisors can in the meantime ignore the DOL dollar-for-dollar approach. Thus, equity allocations should be carefully scrutinized and economically justified with meticulous care.

The court's discussion of the "investment value" approach, which placed a value on the employer's contribution stream, should not be confused with the value placed on convertible preferred stock described in Code §409(l)(3) which, in part, values the expected dividend stream. This is because the dividend is a right derived from the preferred stock, whereas the contribution stream exists independent of the preferred stock.³⁶

It is also uncertain what effect the decision may have on the final DOL regulations that are ultimately issued under §3(18). Upon review of the proposed regulations and the preamble thereto, one could conclude that the decision adds very little to the requirements and positions expressed therein, while others may argue that the decision may add a great deal of detail thereto while having little effect on the fundamental structure and requirements of the proposed regulation.

While the holding of the case does not and could not reflect the proposed regulations because they had not been issued at the time of the Kroy transaction closing, the authors believe that the existence of the regulations would not have changed the holding of the case. This is because the proposed regulations are substantially derived from pre-existing case law and administrative rulings.

The issue of control premiums, which is discussed in vague terms in the preamble to the proposed DOL regulations, receives little additional clarity in this case. It is still very unclear which circumstances and facts justify the control premium. No "laundry list" of facts and circumstances exists, and the number of possible combinations and permutations of corporate governance provisions makes it very difficult for financial or legal advisors to give clear-cut advice to an ERISA fiduciary.³⁷

Implicit in the case is the court's complete disregard of any "Chinese wall" theory concerning the separation of trust department and commercial department operations within a bank, especially where the commercial department makes available to the trust department its analysis of the transaction.

The reader should note that if this case arose today, Valley National (and possibly its financial advisor) could also have been assessed a civil penalty equal to 20% of the "applicable recovery amount" by the DOL under §502(l). However, §502(l) applies only to a breach of fiduciary responsibility or other violation occurring on or after December 19, 1989 and thus, was inapplicable to the case.³⁸ This penalty further behooves a fiduciary and its advisors to conform their conduct to the standards expressed in the decision.

CONCLUSION

The authors do not believe that the Kroy decision contains any real substantive surprises. However, the decision does contain a sobering reality check for ERISA fiduciaries and financial advisors and explores in story book form how a fiduciary should and should not conduct itself in deciding whether to purchase a nonpublicly traded security. While the holding applies directly to a multi-investor leveraged ESOP transaction, ERISA fiduciaries and their advisors should take a more expansive view of the decision since it clearly applies outside this arena.

On a broader basis, the DOL should reassess its view as to its role in monitoring ESOP transactions based upon a more realistic view of the operations of the business community and the financial marketplace. A glaring example is the position the DOL has taken as to the allocation of equity when a cash investor becomes partners with an ESOP in a buyout transaction. The DOL is blind to the realities of the business sector when it attempts to force a cash investor, who is at greater risk and has demonstrated an “up-front” financial commitment, to receive the same equity on a dollar-for-dollar basis as an ESOP that is at no risk on day one of the transaction and that has zero “up-front” financial commitment.

The DOL and the IRS must also find a way to present a unified position on ESOP issues and to resist the dilemma created for plan sponsors when opposite views are espoused, such as the issue of pass-through of votes to ESOP participants.³⁹

ENDNOTES

¹ See § 3(18). All section references are to ERISA and the regulations thereunder, unless otherwise stated.

² Thus, there was not a trial or hearing on this case.

³ Specifically, §§406(a)(1)(A), (B) and (D).

⁴ Code §§404(a)(9) and 404(k). Under these sections, a sponsoring employer may contribute to the ESOP and deduct all interest payments and principal payments equal to 25% of the aggregate compensation of eligible participants; dividends paid on stock purchased with ESOP loan proceeds that are used to repay related ESOP indebtedness may also be deducted. Code §133 enables a sponsoring employee to negotiate a lower interest rate on the ESOP portion of the buyout financing as a result of the exclusion of 50% of the interest income for the ESOP lender. The lender typically shares this tax benefit with the borrower in the form of a lower rate of interest.

⁵ Patterson, Belknap's customary practice was to send a description of the transaction to DOL. Patterson, Belknap alleged that DOL did not disapprove the transaction. The DOL contended that its policy was not to preapprove transactions, and therefore, it could not have preapproved Kroy.

⁶ See discussion under "Reaction to Holding," below.

⁷ See DOL Complaint. It is interesting to note that the court did not include in its recitation of the facts the 60% holding of equity by the ESOP on an undiluted basis which it apparently found not to be relevant.

⁸ Compare the statements at 1993 U.S. Dist. LEXIS, *37 with the later statements appearing at 1993 U.S. Dist. LEXIS *68.

⁹ See *Lowen v. Tower Asset Management Inc.*, 829 F.2d 1209 (2d Cir. 1987); *Donovan v. Cunningham*, 716 F.2d 1455, 1467-68 (5th Cir. 1987); *Marshall v. Snyder*, 572 F.2d 894 (2d Cir. 1978).

¹⁰ *Donovan v. Cunningham*, footnote 9, above.

¹¹ 682 F. Supp. 188, 194 (S.D. N.Y. 1978).

¹² 744 F.2d 279 (2d Cir.), cert. denied, 469 U.S. 1072, 83 L.Ed.2d 506 (1984).

¹³ 716 F.2d 1226, 1231 (9th Cir. 1983).

¹⁴ 772 F.2d 951 (D.C. Cir. 1985).

¹⁵ 472 U.S. 559, 86 L.Ed.2d 447 (1985).

¹⁶ 587 F.2d 453 (10th Cir. 1978).

¹⁷ The proposed regulations were published in the Federal Register on May 17, 1988.

¹⁸ No. 90-0371, (D. R.I.). For a discussion of this case, see Joel Chernoff, “Suit Threatens Leveraged ESOPs,” *Pensions & Investments*, Sept. 3, 1990, at 1.

¹⁹ See *Whitfield v. Cohen*, 682 F. Supp. 188, 194 (S.D.N.Y. 1988).

²⁰ The prudence decision as to making an investment in employer securities is typically the exclusive domain of the fiduciary. Indeed, the purpose of retaining a third party institutional fiduciary in a leveraged ESOP transaction is to ensure that the participants and beneficiaries are represented by an arm’s-length third party which has no conflicts of interest.

²¹ This statement that the expert for Valley National admitted that “no cash or cash equivalent, purchaser would have paid \$5.92 per share for Kroy stock” was one of the few statements in the court’s opinion to indicate that the Kroy stock was worth less than \$5.92 per share. It is curious to note that nowhere in this extensive opinion does the court address what the Purchase price per share should have been.

²² Again, the court relied on Valley National’s valuation expert for these factors to judge whether a control premium was justified.

²³ Had these facts been a part of the decision, they would serve to bolster the DOL’s argument on “lost deferred wages” which the court adopted.

²⁴ The DOL claimed that the loss incurred by the ESOP was “in the amount of \$17.5 million (the amount of the \$35.5 million that the ESOP still *owed* on its debt created out of the LBO) minus \$250,000 (emphasis added).” This appears to be an error either of the court or of the DOL in its court documents since the outstanding debt still owed by the ESOP had to be \$18 million and not \$17.5 million. Furthermore, this is an imperfect remedy since, if the damages are measured by the amount of principal paid, the fiduciary will be better off if the company fails sooner rather than later.

²⁵ This is the amount that it would take to “correct” the non-exempt prohibited transaction. *Treas. Regs. §§5141.4975-13 and 53.4941(e)-1*.

²⁶ Between December 1986 and August 1993, the S&P 500 Index increased by a multiple of 2.38.

²⁷ 587 F.2d 453 (10th Cir. 1978).

²⁸ See *Restatement of Trusts*, §§205 and 214.

²⁹ DOL Information Letter to Gareth

Cook (9/12/83), 11 Pens. Rep. 1494 (11/19/84).

³⁰ DOL Information Letter to Citizens and Southern Trust Company (7/30/85), 12 Pens. Rep. 1182 (8/26/85).

³¹ DOL Information Letter to Charles R. Smith (11/23/84 and 11/26/84). 12 Pens. Rep. 52 and 59 (1/7/85).

³² 1993 U.S. Dist. LEXIS 11837, n 7 at *103.

³³ Code §§409(l)(3) and 404(k).

³⁴ 1993 U.S. Dist. LEXIS 11837, *52 (Aug. 19, 1993).

³⁵ *See Martin v. Feilen*, 965 F.2d 660, 669 (3rd Cir. 1992), holding that an accountant may be a fiduciary in an ESOP transaction; 29 C.F.R. §2509.75-5, at D-1, stating similarly; and DOL ERISA Opinion Letter 7665 (1976), concluding that a company which valued employer securities for an ESOP was not a fiduciary.

³⁶ As contrasted with a contribution commitment, which merely may appear in the plan document, ESOP loan documents or other transactional documents.

³⁷ *See Curtis and Brown*, "Use of 'Enterprise Value' When An ESOP Purchases Less Than A 'Majority' of A Company's Outstanding Stock," 20 *Tax Mgmt. Comp. Plan. J.*, 126 (June 1992).

³⁸ P.L. 101-239, §2101(a).

³⁹ *See Irish*, "Twenty years of Employee Benefits," *J. Pension Plan. & Compliance* (Fall 1993).

This client memorandum is not intended as legal advice, which may often turn on specific facts. Readers should seek specific legal advice before acting with regard to the subjects mentioned here.