No. 22-15378

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

MARTIN J. WALSH, Secretary of Labor,
United States Department of Labor,

Plaintiff-Appellee,

v.

BRIAN J. BOWERS, *et al.*,

Defendants-Appellants.

Appeal from the United States District Court
For the District of Hawai'i
Case No. 1:18-cv-00155-SOM-WRP
The Honorable SUSAN OKI MOLLWAY, Presiding

BRIEF OF *AMICUS CURIAE* THE ESOP ASSOCIATION IN SUPPORT OF APPELLANTS

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CORPORATE DISCLOSURE STATEMENT

In accordance with Federal Rule of Appellate Procedure 26.1, The ESOP Association states that it has no parent corporation, and no publicly held company has 10 percent or greater ownership in The ESOP Association.

INTEREST OF *AMICUS CURIAE*[1]

The ESOP Association ("TEA") is a national nonprofit organization that supports the creation and maintenance of employee stock ownership plans ("ESOPs"), which are regulated by the Employee Retirement Income Security Act of 1974 ("ERISA"). Since its inception in 1978, TEA has served companies with ESOPs, professionals with a commitment to ESOPs, and companies considering an ESOP. TEA works to promote and enhance laws and regulations that govern ESOPs and provide its membership with expert educational programming and information.

TEA's members include sponsors of ESOPs, ESOP trustees, appraisers of ESOP companies, and other professionals who work with ESOPs. Particularly given the Department of Labor's record of suing ESOP stakeholders based on a valuation methodology not permitted by ERISA, TEA's members have an interest in the ability of defendants in such suits to recover attorneys' fees and costs in instances where the Department of Labor advocates a position that was not substantially justified.

[1] All parties consented to TEA filing this brief. No party's counsel authored this brief either in whole or in part. No one other than TEA, its members, and counsel, made a financial contribution intended to fund the preparation of this brief.

INTRODUCTION

TEA supports an award of fees and costs in Appellants' favor and against the Department of Labor ("DOL"), because the DOL's position was not substantially justified. *See* 28 U.S.C. § 2412(d)(1)(A). The District Court's denial of such an award rested on a fundamental misunderstanding about the nature and extent of the deficiencies in the DOL's position. In particular, the DOL's case hinged on the interpretation of a statutory exemption to ERISA's prohibited-transaction provisions that allows a fiduciary to cause an employee stock ownership plan to purchase (or sell) employer stock if for "adequate consideration" (the "Adequate Consideration Exemption"). 29 U.S.C. § 1108(e). Congress intended for the DOL to promulgate final regulations—subject to public comment and *judicial review*—on the Adequate Consideration Exemption's requirements, but for nearly 50 years, the DOL has neglected to do so. Nevertheless, the DOL has been aggressively suing ESOP trustees (and other parties involved in ESOP stock transactions) for failing to comply with the DOL's idiosyncratic interpretation of the Adequate Consideration Exemption.

The DOL's litigation position on the Adequate Consideration Exemption is not only non-binding, but it also conflicts with ERISA's express statutory definition of adequate consideration, which, for private-company stock, is the "***fair market value***" ("FMV") of the asset "as ***determined in good faith***" by the ESOP's

trustee. 29 U.S.C. §§ 1002(18) (emphasis added), 1104(a)(1)(B), 1108(e). This Court, and many others, have held that the Adequate Consideration Exemption focuses not on the price an ESOP paid, but the *conduct* of the ESOP trustee in determining the price. *Howard v. Shay*, 100 F.3d 1484, 1488 (9th Cir. 1996) ("the inquiry into whether the ESOP received adequate consideration focuses on the thoroughness of the fiduciary's investigation"). But the DOL routinely sues ESOP trustees[2] if the DOL disagrees with valuation determinations made by third-party, expert, independent valuation advisors.

Making matters worse, the DOL regularly fails to assess FMV, but invokes a different standard of value best described as "investment value," resulting in unrealistically low valuations that the DOL relies on to accuse ESOP trustees, and others, of violating the Adequate Consideration Exemption. The DOL also misinterprets the "good faith" standard, which must be determined with due consideration of the particular type of benefit plan and decision involved. 29 U.S.C. §§ 1002(18), 1104(a)(1)(B). The DOL commonly misstates the nature of an ESOP and attempts to hold ESOP fiduciaries liable for failing to act like private-party, private-equity buyers ("PE Buyers"), or fiduciaries of non-ESOP plans.

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[2] The DOL's claims against Appellants were derivative of its claims against the Trustee. Although this brief primarily addresses the duties of an ESOP trustee, the DOL's claims against Appellants were premised on the DOL's position regarding the duties of the Trustee.

Even if the DOL's position on FMV and good faith were reasonable, the DOL has failed for almost 50 years to promulgate a regulation, subject to public comment and *judicial review*. The DOL was not substantially justified in *suing* to impose on the defendants the DOL's incorrect position on the Adequate Consideration Exemption. This Court should reverse the District Court and remand this case for an appropriate award of the Appellants' fees and costs.

ARGUMENT

I. Legal Framework.

A. The Adequate Consideration Exemption Generally.

ERISA regulates benefit plans in large part by imposing fiduciary standards of prudence and loyalty and the fiduciary obligation not to cause a prohibited transaction unless an exemption applies. *See* 29 U.S.C. §§ 1001(b), 1104(a), 1106 (prohibiting fiduciaries from causing or engaging in transactions "[e]xcept as provided in Section 1108"); § 1108 ("Exemptions from prohibited transactions"); *see also Carpenters Loc. Union No. 26 v. U.S. Fid. & Guar. Co.,* 215 F.3d 136, 140 (1st Cir. 2000) (ERISA regulates plans in part by establishing standards of conduct for fiduciaries); *see also Harris Tr. & Sav. Bank v. Salomon Smith Barney, Inc.*, 530 U.S. 238, 250-53 (2000) ("Section 406's prohibitions are subject to both statutory and regulatory exemptions").

The Adequate Consideration Exemption allows an ESOP trustee to cause an ESOP to transact in employer stock "if such acquisition, sale, or lease is for adequate consideration . . ." 29 U.S.C. § 1108(e)(1); *see also Howard*, 100 F.3d at 1488. ERISA defines "adequate consideration" for private-company stock is as follows:

> . . . 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 regulations promulgated by the Secretary***.

29 U.S.C. § 1002(18)(B) (emphasis added).

The "good faith" required by the Adequate Consideration Exemption incorporates ERISA's general standard of fiduciary prudence in ERISA § 404(a)(1)(B). *See Donovan v. Cunningham*, 716 F.2d 1455, 1468 (5th Cir. 1983) (good faith in § 408(e) is subject to the standard in § 404(a)(1)(B)); *Henry v. Champlain Enterprises, Inc.*, 445 F.3d 610, 620 (2d Cir. 2006) (noting that Adequate Consideration Exemption depends on "prudence required of a fiduciary" under § 404(a)(1)(B)); *Perez v. Bruister*, 823 F.3d 250, 263 (5th Cir. 2016) (same). ERISA § 404(a)(1)(B) requires a fiduciary to act:

> (B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent [person] ***acting in a like capacity*** and ***familiar with such matters*** would use in the ***conduct of an enterprise of a like character and with like aims***.

29 U.S.C. § 1104(a)(1)(B)(emphasis added).

Absent the Adequate Consideration Exemption, an ESOP trustee and other parties are subject to personal liability and various equitable remedies. 29 U.S.C. §§ 1109(a), 1132(a)(2), (a)(3), (a)(5). An ESOP stock transaction can involve purchases for hundreds of millions of dollars. Needless to say, the Adequate Consideration Exemption is *exceptionally important* to an ESOP stock transaction.

B. For Nearly 50 Years, the DOL Has Neglected to Promulgate Regulations on the Adequate Consideration Exemption.

ERISA provides little guidance on precisely how a determination of adequate consideration should be made because Congress "wanted the Secretary [of Labor] to flesh out the standards for fiduciaries to follow" when an ESOP purchases stock. *Cunningham*, 716 F.2d at 1466. Yet after ERISA's passage in 1974, the DOL did not promulgate regulations. Instead, it began suing ESOP trustees for not assessing specific valuation issues using particular approaches, methods, and assumptions that the DOL preferred.

In *Cunningham*, for example, the DOL alleged that an ESOP trustee caused an ESOP to pay more than adequate consideration in transactions that occurred in 1976 and 1977. In interpreting the Adequate Consideration Exemption, the court particularly was concerned with striking a balance between Congress' intent to "encourage the formation of ESOPs" while also "safeguarding the interests of participants in employee benefit plans by vigorously enforcing standards of fiduciary responsibility." *Id.* The court rejected the DOL's position that the FMV

and good-faith requirements were independent, which would impose upon ESOP trustees a "set of highly specific estate and gift tax regulations promulgated by the Internal Revenue Service to guide valuation of closely-held stock for tax purposes." *Id.* at 1472. The court rested that rejection, in part, on the fact that the DOL failed to promulgate regulations setting forth the valuation standards it proposed. *Id.* at 1473 (opining that if the DOL believed that "more specific rules are needed," then "the better—and fairer—approach is to inform fiduciaries of them beforehand by regulation."). "Judicial adoption" of highly specific estate and gift tax valuation regulations "is no substitute for the regulations the Secretary has never promulgated," and the court would not "require fiduciaries to follow a specific valuation approach as a matter of law under [the adequate consideration definition]." *Id.*

Instead, the standard for the Adequate Consideration Exemption is "one of prudence." *Id.* at 1473. Put another way, the court's duty is to determine if the price paid is "the fair market value of the asset *as determined in good faith by the ... fiduciary;* it is not to redetermine the appropriate amount for itself *de novo*." *Id.* at 1467 (emphasis original). "ESOP fiduciaries will carry their burden to prove that adequate consideration was paid by showing that they arrived at their

determination of fair market value by way of a prudent investigation in the circumstances then prevailing." *Id.* at 1467-68.[3]

C. The 1988 Proposed Regulation on Adequate Consideration.

In 1988, the DOL issued a Proposed Regulation Relating to the Definition of Adequate Consideration ("Proposed Regulation"). 53 Fed. Reg. 17632-01 (May 17, 1988); *Bruister*, 823 F.3d at 263 n.14 ("It appears [*Cunningham*] was the Labor Department's impetus for proposing the regulation."). It acknowledges that "[g]uidance is especially important" to the determination of adequate consideration, and that "[t]he definition of the term 'adequate consideration' under ERISA *is of particular importance to the establishment and maintenance of ESOPs*." 53 Fed. Reg. 17632, 17632, 17632 n.6 (emphasis added). The Proposed Regulation was never finalized and was of little, if any, help; in fact, "[n]one of the courts" that have relied on it "actually apply its specifically enumerated substantive requirements." *Bruister*, 823 F.3d at 262 n.13. The DOL has not promulgated a final regulation on the Adequate Consideration Exemption.

For many years, TEA, and others, have implored the DOL to issue regulations on the Adequate Consideration Exemption. And Congress has taken

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[3] As one court explained, a fiduciary does not violate the Adequate Consideration Exemption "even if the consideration paid differs somewhat from what the court determines to be adequate consideration." *Montgomery v. Aetna Plywood, Inc.*, 39 F. Supp. 2d 915, 936 (N.D. Ill. 1998) (citations omitted).

notice: on June 14, 2022, bipartisan legislation requiring the DOL to promulgate regulations on the determination of FMV for purposes of an ESOP stock purchase cleared the Senate Committee on Health, Education, Labor, and Pension. 2021 CONG US S 4353, Sec. 702(d)(4)(B), 117th CONGRESS, 2nd Session (June 21, 2022).

II. The Adequate Consideration Exemption's Statutory Requirements for FMV and Good Faith Require Application of Principles for a FMV Appraisal, Determined in View of the Character and Aims of an ESOP.

In the absence of final regulations, the Adequate Consideration Exemption has two express requirements that provide important statutory guidance on the exemption's meaning: "fair market value" and "as determine[] in good faith." 29 U.S.C. §§ 1002(18), 1108(e).

A. Standards for a FMV Appraisal.

In the valuation field, FMV is what is known as a "standard of value" or "basis of value."[4] A standard of value "describe[s] the fundamental premises on which the reported values will be based"[5] and is "critical," because it "may influence or dictate a valuer's selection of methods, inputs and assumptions, and the ultimate opinion of value."[6] There are other standards of value, such as fair

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4 INTERNATIONAL VALUATION STANDARDS (2017), at IVS 104, § 10.1.

5 *Id.*

6 *Id.*

value, intrinsic or fundamental value, going-concern value, liquidation value, book value, and investment value (the most relevant in this appeal).[7]

The generally accepted definition of FMV is:

> . . .the price at which an asset would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, and both parties are able, as well as willing, to trade and are well-informed about the asset and the market for that asset.[8]

Importantly, FMV is not the lowest possible price a buyer might prefer to pay.[9] It is an objective assessment of market forces[10] designed to result in an even-handed assessment of value.[11] By definition, FMV must consider not just a

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[7] Shannon P. Pratt, THE OPINION OF THE COLLEGE ON DEFINING STANDARDS OF VALUE, 34 Valuation 2, at 6-11 (1989), *available at* http://www.appraisers.org/docs/default-source/college-offellows-articles/defining-standards-of-value.pdf.

[8] The Proposed Regulation quotes this definition. 29 C.F.R. Part 2510, 1988 WL 269847. Courts, and the DOL, have acknowledged that FMV in the Adequate Consideration Exemption incorporates the well-accepted meaning in the field of valuation. *See* Plaintiff's Opposition to the Vinoskey Defendants' Motion to Exclude the Expert Reports and Testimony of Dana Messina, *Acosta v. Vinoskey*, 2017 WL 11432209 (W.D.Va. Dec. 1, 2017) (DOL acknowledging that "fair market value" "is part of the definition of 'adequate consideration' set forth in ERISA itself.").

[9] *Supra*, n. 4, at § 30.2(e) (FMV also considers a hypothetical seller who is motivated to obtain "the best price").

[10] *Supra*, n. 7, at p. 6 § IV(A) (FMV considers the general "market" that "can be thought of as all the potential buyers and sellers of like businesses, business interests, or property").

[11] *Supra*, n. 4, at § 30.2(a), (d), (e); *supra*, n. 7, p. 6.

hypothetical buyer, but also a hypothetical *seller*, who exerts contrary pressure on the price: the "two amounts together constitute[] the fair market value." *Judge v. Comm'r*, 35 T.C.M. (CCH) 1264 (T.C. 1976). It violates the FMV standard to assess value only from the perspective of a buyer. *Chapman Glen Ltd. v. Comm'r*, 140 T.C. 294, 325 (2013) (value only from reference of buyer is not FMV); *Buckley v. Comm'r*, 68 T.C.M. (CCH) 754 (T.C. 1994) (same); *Black v. Comm'r,* 36 T.C.M. (CCH) 1347 (T.C. 1977) (same); *Hans v. Tharaldson*, No. 05-CV-115, 2011 WL 6937598, at *1 (D.N.D. Dec. 23, 2011) (similar).

FMV is the same standard ERISA and the Tax Code demand for required annual ESOP valuations, reporting, and distributions. 29 U.S.C. §§ 1023(b)(3), 1002(27); 26 U.S.C. § 401(a)(28)(C). It is the same standard used throughout the Tax Code and regulations,[12] the Bankruptcy Code, and many other statutes. *See, e.g.*, 26 C.F.R. § 20.2031-1; Rev. Rul. 59-60, 1959-1 C.B. 237 (1959). FMV often is expressed as a range of figures: "[T]here is no universally infallible index of fair market value." *Slatky v. Amoco Oil Co.*, 830 F.2d 476, 482 (3d Cir.1987) (en banc). "There may be a range of prices with reasonable claims to being fair market value. Were we to mandate that courts determine whether [a price] was at fair

[12] *See, e.g.,* 26 C.F.R. § 54.4975-11(d)(5) (requiring that the value of ESOP stock for various purposes must be made at "fair market value"); *see also* § 54.4975-7(b)(12)(iii).

market value, [parties] could rarely rest comfortably that their offer would eventually be determined by the court to be fair market value." *Id.*

B. Congress Was Aware of FMV's Meaning When ERISA Was Passed in 1974.

Congress intentionally selected FMV as the standard for a permissible ESOP stock transaction. Early bills proposed different standards, including: "a price not less favorable to the fund than the offering price for a security as established by current bid and asked prices quoted by persons independent of the issuer";[13] deal terms "determined in an arm's-length transaction, or [that] provide for receipt by the trust of no less than fair market value";[14] and the "*fair value* of the security."[15] Relatively shortly before ERISA's passage, proposed bills defined adequate consideration with the expectation that the Secretary of Labor would promulgate regulations.[16]

Congress knew that the standard of value could significantly impact value. During one hearing on pension reform, Congress was reminded that "there are a

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[13] ERISA-LH 69, 1968 WL 98953 (A.&P.L.H.), 19; ERISA-LH 68, 1970 WL 123047 (A.&P.L.H.), 17-18; ERISA-LH 100, 1974 WL 186670 (A.&P.L.H.), 49, 84, 203.

[14] ERISA-LH 90, 1973 WL 173127 (A.&P.L.H.), 108.

[15] ERISA-LH 47, 1974 WL 186653 (A.&P.L.H.), 73 (emphasis added).

[16] *See, e.g.,* ERISA-LH 71, * 117 (1974) ("determined pursuant to rule or regulation.").

substantial number of accepted methods of valuing assets of pension plans,"[17] and FMV may not always "level out short-run market swings" as well as alternatives like "cost or book value" or "the use of a moving average (over, e.g., five years)."[18] Congress had been requiring FMV as a standard for many other federal statutes, and FMV had been interpreted consistently by courts for many decades, including in a Supreme Court decision the year before ERISA's passage.[19] *See Almota Farmers Elevator & Warehouse Co. v. United States*, 409 U.S. 470, 474 (1973) (FMV generally is "what willing buyer would pay in cash to a willing seller").

There is no discretion to apply another standard of value. *See, e.g., Reich v. Valley Nat'l Bank of Arizona*, 837 F. Supp. 1259, 1275 (S.D.N.Y. 1993), *rev'd on other grounds*, 569 F.3d 96 (2d Cir. 2009) (an ESOP fiduciary must not consider a standard of value other than FMV); *Sec. & Exch. Comm'n v. Nutmeg Grp., LLC*,

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[17] ERISA-LH 92, 1973 WL 173012 (A.&P.L.H.), 85-86 (discussing valuation standards for funding purposes).

[18] *Id.*

[19] *See, e.g.*, 16 U.S.C. §§ 459d-1 (1962), 79d (1968), 160c (1971); 26 U.S.C. § 1053 (1954); 30 U.S.C. § 705 (1962); *Ruehlmann v. C. I. R.*, 418 F.2d 1302, 1304 (6th Cir. 1969) ("The hypothetical 'willing buyer' and 'willing seller' are presumed to act objectively based upon their knowledge of the relevant facts"); *Baetjer v. United States*, 143 F.2d 391, 396 (1st Cir. 1944) ("what a [hypothetical] willing buyer would pay in cash to a willing seller"); *Davis v Commr.*, B.T.A.M. (P-H) P 40599 (B.T.A. 1940) (requires hypothetical "willing buyer and a willing seller, each with full knowledge of all the pertinent facts, and neither being under any compulsion, would deal").

No. 09-CV-1775, 2017 WL 1545721, at *9 (N.D. Ill. Apr. 28, 2017) (recognizing that applying wrong standard of value requires "exclusion under Daubert"); *Chavez v. Arancedo*, No. 17-20003-CIV, 2018 WL 4610567, at *7 (S.D. Fla. Sept. 24, 2018) (excluding expert who assessed "fair value" instead of "actual cost" standard); *Inventio AG v. Otis Elevator Co.*, No. 06 CIV. 5377, 2011 WL 3359705, at *6 (S.D.N.Y. June 23, 2011) (excluding expert who used incorrect "entire market value rule" standard); s*ee also Rivera v. Mendez & Compania*, 988 F. Supp. 2d 174, 179 (D.P.R. 2013) (excluding expert who calculated "sale price" and not correct "license fee" measure).

C. The Good Faith Required by the Adequate Consideration Exemption Is Determined in View of the Character and Aims of an ESOP and the Purpose of an ESOP Stock Purchase.

The good faith required by the Adequate Consideration Exemption is governed by the prudence standard in § 404(a)(1)(B), which requires a fiduciary to act with care, skill, prudence, and diligence, "***under the circumstances then prevailing***," that a prudent person "***acting in a like capacity***" and "***familiar with such matters***" would employ in "the ***conduct of an enterprise of a like character and with like aims***." 29 U.S.C. § 1104(a)(1)(B)(emphasis added). This "flexible" standard requires conduct to be assessed in the context of the "type of plan" and particular "decision" involved. *Cunningham*, 716 F.2d at 1467 n. 26 ("the emphasis of Section 404 is on flexibility"); *DeFelice v. U.S. Airways, Inc.*, 497

F.3d 410, 420 (4th Cir. 2007) (prudence depends on the "the particular plan and decision at issue"); *In re Computer Scis. Corp. Erisa Litig.*, 635 F. Supp. 2d 1128, 1134 (C.D. Cal. 2009), *aff'd sub nom. Quan v. Computer Scis. Corp.*, 623 F.3d 870 (9th Cir. 2010) (same); *Bussian v. RJR Nabisco, Inc.*, 223 F.3d 286, 299 (5th Cir. 2000) (same); *Tatum v. RJR Pension Inv. Comm.*, 761 F.3d 346, 358 (4th Cir. 2014) (same).

Because of this, it is vital to understand precisely what a private-company ESOP is, and what it is not.[20] An ESOP is not, as the DOL regularly argues, a traditional, passive retirement plan, like a 401(k), designed to maximize participants' retirement savings.[21] The "ESOP's primary purpose, however, is not to serve as a retirement vehicle but, rather, to serve as an incentive for corporations to structure their financing in such a way that employees can gain an ownership stake in the company for which they work." 129 Cong. Rec. S16629, 16637. The ESOP was designed to provide corporate financing and make employees

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[20] The extra-statutory materials cited in brief have not been considered by other courts. These materials are of exceptional importance in view of widespread misstatements about ESOPs that drive the current wave of litigation against ESOP trustees.

[21] *See* Brief of Appellee, *Scalia v. Vinsokey*, et al., No. 20-1252, Fourth Circuit Court of Appeals, Doc. 37, p. 11 ("the purpose of the [ESOP] is to 'maximize retirement savings for participants.'"). Although an ESOP can be used as a retirement plan, its primary character and aims are not like a traditional retirement plan.

"beneficial" owners of stock, thus "linking the day-to-day performance of work by employees and the day-to-day growth and operation of business enterprise." ERISA-LH 30-C, 1972 WL 136948 (A.&P.L.H.), 104, 105. ESOPs are a corporate investment in workers who, through their "labor power," might grow the company and participate in that growth. *Id*. at 106; *see also* 132 Cong. Rec. S7934-01, 1986 WL 776250 (discussing Senator Long, the "father of the ESOP," and the ESOP's purpose).

Two manuals about ESOPs produced by the U.S. Senate provide additional information. *See* ESOPs: An Explanation for Employees[22] (1978) ("Employee Handbook"); see also Employee Stock Ownership Plans: An Employer Handbook[23] (1980) ("Employer Handbook"). An ESOP is not a traditional retirement plan,[24] because the principal goal is to "give the employee-participants an interest in the ownership and growth of the employer's business."[25] The "special purpose" of the ESOP "requires" that fiduciary standards "must be based upon the ESOP objective of providing stock ownership for employees."[26] Moreover, ESOP

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[22] https://www.finance.senate.gov/imo/media/doc/sprt95-31.pdf.

[23] https://www.finance.senate.gov/imo/media/doc/prt96-25.pdf.

[24] *Supra*, n. 24, at 23 (ESOP does not principally "[p]rovid[e] retirement benefits."); *id.* at 60 (distinguishing ESOP from "benefits such as the retirement plan").

[25] *Id.* at 23, 24.

[26] *Id.* at 24.

fiduciaries ***are exempt from the requirement that they must seek a fair rate of return.***[27] "ESOPs, unlike pension plans, ***are not intended to guarantee retirement benefits*** . . ." *Moench v. Robertson*, 62 F.3d 553, 568 (3d Cir. 1995) (emphasis added), *abrogated on other grounds by Fifth Third Bancorp v. Dudenhoeffer*, 573 U.S. 409 (2014).

The ESOP trustee's principal obligation in an ESOP stock purchase is to facilitate employee ownership of the stock. The benefit to participants comes over the long-term, if employees remain with and contribute to the company.

D. The Standard for Good Faith Reliance on a Third-Party Valuation Advisor.

There are different considerations where, as in this case, a trustee retains a third-party, qualified valuation advisor to advise on the FMV of the stock. Although the trustee has the statutory obligation to determine FMV, obtaining an independent assessment[28] is "evidence of a thorough investigation"[29] and of good

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[27] *Id.* at 26, 27; *see also* 32 Cong. Rec. S7934-01, 1986 WL 776250; Treas. Reg. §1.401-1(a)(2); Rev. Rul. 69-65, 1969-1 C.B. 114, modifying Rev. Rul. 57-372, 1957-2 C.B. 256.

[28] *Donovan v. Mazzola*, 716 F.2d 1226, 1234 (9th Cir. 1983).

[29] *Howard*, 100 F.3d at 1489; *see also Cosgrove v. Circle K Corp*., 871 F. Supp. 1248, 1251 (D. Ariz. 1994) (citing *Donovan*, 716 F.2d at 1474) ("Proper reliance on an independent appraisal is strong evidence of a prudent investigation").

faith.[30] If the ESOP trustee retains an independent valuation expert, then the Adequate Consideration Exemption focuses even more sharply on conduct rather than the valuation itself. A trustee who retains a qualified, independent advisor satisfies the Adequate Consideration Exemption if the trustee makes a good-faith effort to: (1) "investigate the expert's qualifications," (2) "provide the expert with complete and accurate information" and (3) "make certain that reliance on the expert's advice is reasonably justified under the circumstances."[31] This is the prevailing, general standard for good-faith reliance on an appraisal in other contexts, like tax disputes.[32]

It is axiomatic that reasonable reliance on a valuation advisor does not require a principal to become an expert herself. As this Court explained, "[t]o justifiably rely on an independent appraisal," even "a conflicted" fiduciary "need not become an expert in the valuation of closely held corporations" *Howard*, 100 F.3d at 1490; *United States v. Boyle*, 469 U.S. 241, 251 (1985) (rejecting argument that a party relying on an attorney must challenge specialized issues within the

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[30] *Martin v. Feilen*, 965 F.2d 660 (8th Cir. 1992)

[31] *Keach v. U.S. Trust Co.*, 419 F.3d 626, 637 (7th Cir. 2005) *see also Bruister*, 823 F.3d at 264.

[32] *Neonatology Assocs., P.A. v. Comm'r*, 115 T.C. 43, 98 (2000), *aff'd*, 299 F.3d 221 (3d Cir. 2002).

expert's bailiwick or seek a "second opinion," because that "would nullify the very purpose of seeking the advice of a presumed expert in the first place.").

Cementing that the Adequate Consideration Exemption does not invite a valuation dispute, courts have held that a trustee who relies reasonably on an advisor does not violate ERISA "even if the consideration paid differs somewhat from what the court determines to be adequate consideration." *Montgomery*, 39 F. Supp. 2d at 936; *see also Bruce v. Comm'r*, 108 T.C.M. (CCH) 230 (T.C. 2014), *aff'd*, 608 F. App'x 268 (5th Cir. 2015) ("We conclude that it was objectively reasonable for Mr. Bruce to rely on Mr. Lobrano's advice, even though we conclude that the advice was wrong.").

III. The DOL's Case Against Appellants Was Unreasonable.

A. The DOL's Entire Approach Was Unreasonable.

This case began when the DOL flagged the ESOP for investigation and its retained expert identified issues "relating to the valuation"[33] (use of projections and the "control premium"). ER-001969. Years later, in a post-trial brief, the DOL argued that the court should assess FMV as an independent requirement, separate

[33] In a 2015 interview, Timothy Hauser, the Deputy Assistant Secretary for Program Operations of the Employee Benefits Security Administration, discussed purported problem areas in ESOP transactions on which EBSA was focused. Hauser identified valuation issues. *See* Q&A with Tim Hauser of the U.S. Dep't of Labor, Insights (Spring 2015), at 74-75, *available at* https://willamette.com/insights_journal/15/spring_2015_8.pdf.

from the element of good faith, and that the failure to show FMV, alone, constitutes a breach of ERISA. ER-000640, ¶ 52.[34] The Fifth Circuit rejected that argument nearly 40 years ago;[35] the Adequate Consideration Exemption is not a test of the valuation, it is a test of the trustee's conduct, namely the reasonable reliance on a valuation advisor. ESOP trustees are not required to be valuation experts to rely on valuation experts, and the DOL should not be suing to impose its idiosyncratic opinions on valuation issues.

B. The DOL's Position on Aggressive Negotiation and the Lowest Possible Price Was Unreasonable.

The DOL's position on the assessment of FMV and the good faith required of an ESOP trustee is, at its core, that ESOP trustees must act like PE Buyer of companies.[36] Not only is this not the standard set forth in ERISA or any

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[34] The DOL relied on *Chao v. Hall Holding Co., Inc.*, 285 F.3d 415, 423 (6th Cir. 2002), in which the Sixth Circuit suggested that FMV is a separate requirement. This Court has not adopted this interpretation of the Adequate Consideration Exemption. Nor should it, because it makes no sense. If FMV is a separate element, then the good-faith requirement is meaningless; the Adequate Consideration Exemption becomes a test of valuation. In other words, if an ESOP trustee exercises good faith and prudence, the DOL still could bring a valuation dispute challenging FMV. That it not consistent with Congress' intent or the fiduciary obligations imposed by ERISA.

[35] *Supra*, at 8-10.

[36] The DOL openly admits. *See, e.g.,* Puntillo Report, *Solis v. First Bankers Trust Services, Inc. et al.*, No. 12-cv-4450, 2014 WL 11770110 (D.N.J. Aug. 14, 2014) (opining that ESOP trustee has duty to act as "a sophisticated investor, such as a private equity firm, performing diligence that met the standard of care and custom and practice of such investors in a similar transaction"); Messina

regulations, but it also violates both the FMV standard and the standard of good faith required by the Adequate Consideration Exemption.

One of the DOL's core arguments was that the Trustee was obligated to ensure that the ESOP paid the lowest possible price, through aggressive negotiations designed to maximize the retirement benefits of employees. The DOL argued that Trustee was required to "start the negotiations *below* the fair market value" estimated by an appraiser because that would be "in the best interest of the ESOP participants." ER-000994, 2-18 (emphasis added). Its expert opined that aggressive "negotiations" *had* to occur in order to indicate "a fair market value determination between a willing buyer and a willing seller." ER-000693, 8-16. The DOL argued that the ESOP did not act like a PE Buyer, who would have "vigorously negotiated the price to meet their goal of purchasing the company at the lowest price possible."[37]

The DOL regularly pushes this meritless argument through proffered experts with no experience with ESOPs. Johnson, for example, never acted as an

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Report, *Acosta v. Bat Masonry Company, Inc. et al*., 2017 WL 2633697 (W.D.Va.) ("it is inconceivable that a private equity firm or typical buyer of businesses would agree to such a deal").

[37] ER-000826, 9-12. This, too, is a common argument the DOL makes. *See* Report of Mark Johnson, *Scalia v. Reliance Trust Co.*, No. 017CV04540, 2020 WL 7669982 (D. Minn. March 16, 2020) (opining that trustee did not act prudently because it did not "negotiat[e] for the best deal for the ESOP").

independent fiduciary for an ESOP, never advised an ESOP sponsor in implementing an ESOP, never served as an advisor to an ESOP transaction, and never participated or advised on an ESOP transaction on what constitutes prudence. 467-1, 20:21-23; 22:6-8; 23:4-9; Dkt. No. 466, at 12-13. In his deposition, Johnson did not know—and *initially contested the notion*—that ERISA's standard of prudence "depends upon the care, skill, prudence, and diligence under the circumstances then prevailing." Dkt. 467-1, 22:19-22.

The DOL's position violates the FMV standard, because FMV is not, by definition, the lowest possible price that a buyer might obtain through aggressive negotiation. Whether they know it or not, [38] the DOL and its experts assessed the lowest price that a private party[39] might prefer to pay for an asset, which is closest to an "investment value" assessment. Using "investment value as a proxy for fair market value" is as "irrational as using forced liquidation value of a similar company to establish fair market value for a healthy one." MISUSING FAIR MARKET VALUE, 11 Value. Strateg. 12, 16, 2008 WL 761920, 4.

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[38] The label on an appraisal does not determine which standard of value the valuator addressed. *Reri Holdings I, LLC v. Comm. of Internal Rev*, 143 T.C. 41, 76 (U.S. Tax Ct. 2014).

[39] This is the position the DOL routinely takes on the Adequate Consideration Exemption's requirements. *See, e.g.*, *Acosta v. Vinoskey*, Plaintiff's Opposition to Defendant Evolve Bank and Trust's Motion to Exclude the Rebuttal Expert Report and Testimony of Dana Messina, 2017 WL 11432215 (W.D.Va. Dec. 1, 2017); *see* Messina Report, *Acosta v. Vinoskey*, 2017 WL 9857222.

More to the present point, inadvertently (or surreptitiously) substituting investment value for FMV can result in absurdly low assessments of value,[40] in part because investment value does not consider the contrary, upward pressure from a hypothetical seller.[41] The DOL's extensive focus on a "non-binding indication of interest letter" ("IOI") that the Company received from URS Corporation ("URS") proves this point.[42] ER-000069. An IOI is a classic example of *investment value* from the perspective of a particular buyer making a lowball offer. *See, e.g., Hans*, 2011 WL 6937598, at *4 (perspective of a "hypothetical prudent hotel investor" is not FMV).

As a practical matter, FMV cannot possibly mean the lowest price obtained through actual negotiations of a potential transaction, because a FMV appraisal is required in situations where there is no transaction and no negotiations, like annual

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[40] "Key differences exist between investment and fair value standards and fair market value that an analyst cannot ignore." *See* MISUSING FAIR MARKET VALUE, 11 Value. Strateg. 12, 15, 2008 WL 761920, 2.

[41] *See* INTERNATIONAL VALUATION STANDARDS, at § 60.2.

[42] The DOL argued that URS's due diligence and initial indication amount of $15 million represented the fair market value of the Company. "The fact that the Company was valued substantially lower by URS, a competitor and a buyer representing only itself and with no conflicting interests shows that Defendants were only able to obtain their desired $40 million price tag because those acting on behalf of the ESOP were not committed to the best interests of the Plan participants and beneficiaries." D. Ct. Dkt. No. 509, p. 46.

reporting.[43] What is more, the DOL's position that the Trustee had to seek the lowest price—even lower than the range of FMV[44]—in order to maximize returns conflicts with the character and aims of an ESOP. An ESOP is not a traditional, passive retirement plan, and an ESOP fiduciary is exempt from any requirement that it seek a fair return on the ESOP's initial purchase of stock.[45]

C. The DOL's Position on the Control Premium Was Unreasonable.

Focusing again on the valuation, the DOL and its experts argued that the ESOP overpaid because the valuation advisor applied a "control premium" that increased the estimate of FMV. D. Ct. Dkt. 31, p. 19. The DOL's view, which it routinely argues,[46] is that a control premium cannot be applied unless an ESOP obtains "***complete control over the Company***," including control of "day-to-day

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[43] *Supra*, n. 4, at IVS 104, § 30.2 (FMV is "impersonal and detached" and excludes "special terms or circumstances such as atypical financing, sale, leaseback arrangements, special considerations or concessions granted by anyone associated with the sale, or any element of value available only to a specific owner or purchaser.").

[44] *Supra*, at 22-23.

[45] *Supra*, at 18.

[46] *Scalia v. Heritage*, No. 18-0155, 2020 WL 12719512 (D. Haw. Oct. 19, 2020) (opining that ESOP would only obtain control if, among other things, the ESOP were amended to eliminate any power of board to direct the trustee).

operations." D. Ct. Dkt. 509, p. 68 (emphasis added).[47] The DOL's position violates 'Valuation 101' principles for a FMV appraisal.

In a FMV assessment, the theory behind the control adjustment is that a hypothetical buyer and hypothetical seller might agree that a block of stock is worth more if the block of stock gives the buyer certain elements of control beyond the rights a true minority shareholder would have.[48] To a PE Buyer, the only elements of control that might have value are those that entitle the PE Buyer to fully control the board and day-to-day operations of the target company. But for a FMV appraisal, control is "not a black and white concept with a bright dividing line," but a "broad spectrum."[49] In fact, there are ***at least 20 elements of control*** that can support a control premium in a FMV assessment.[50]

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[47] The DOL's expert argued that "full stockholder voting rights, the elimination of the power of the B+K Board of Directors to the trustees on the voting of any shares and likely changing the trustee selection process" were required for a control premium.[47] D. Ct. Dkt. No. 604, ¶ 34(d). He opined that "the plan participants only had the mandatory, minimal voting rights which an ESOP must provide. Voting rights for which no premium was required." *Id.* ¶ 33(d). After removing the control premium that the Trustee's valuation advisor applied, the DOL's valuation expert further reduced his estimated value by 10% for so-called "limited control." ER-00608, ¶ 111.

[48] Shannon P. Pratt, VALUING A BUSINESS: THE ANALYSIS AND APPRAISAL OF CLOSELY HELD COMPANIES 385 (5th ed.) (2008); Fishman and Pratt, PPC'S GUIDE TO BUSINESS VALUATIONS (15th ed.) (2005).

[49] Pratt, VALUING A BUSINESS (5th ed.) p. 385.

[50] *Id.*

These include the right to cause, or "block," an entity's ability to "acquire, lease, or liquidate business assets" or "liquidate, dissolve, sell out, or recapitalize the company," or "appoint or change members of the board of directors."[51] The ESOP gave participants these rights. Participants who are allocated stock have statutory pass-through voting rights, allowing them to vote in favor of, or block, recapitalizations, liquidations, dissolutions, sales of substantially all the assets, and other transactions.[52] The Trustee also was a "directed" trustee, meaning the company would direct the Trustee on whom to vote for as company directors. But a directed trustee does not *have* to comply with a direction. *See* 29 U.S.C. § 1103(a)(1). ERISA's fiduciary obligations require a directed trustee to consider whether the direction is consistent with the trustee's fiduciary duties to the ESOP. *Id.* The right of ESOP participants to be represented by a trustee, who can veto a direction from the company, is without question a right that a true minority shareholder does not have.

This was not a minority transaction. The DOL's position that the control premium could not have been applied, and a further discount for lack of control should have been applied, was unequivocally wrong under the FMV standard.

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[51] *Id.*

[52] *Id.*

D. The DOL's Attacks on the Sellers Were Unreasonable.

The DOL attacked Bowers and Kubota, as selling shareholders, on the basis that they may have wanted to use an ESOP as an exit strategy or that their advisor provided the Trustee with an initial asking price. *See, e.g.,* D. Ct. No. 509 at 10; *id.* at 48 ("Defendants Bowers and Kubota had set upon the $40 million purchase price long before [Trustee] became involved with the ESOP."). This is an argument the DOL routinely makes. *See* Brief for the Secretary of Labor as Amicus Curiae Supporting Plaintiff-Appellee, *Brundle, et al. v. Wilmington Trust, N.A.*, No. 17-1873(L), 17-2224, 17-2323, 17-2324, 18-1029 (4th Cir.) at 3. ("As part of their 'exit strategy' from the business, [sellers] decided . . .to form an ESOP to purchase all of their [] stock.").

These attacks are not well-taken. As Congress explained, the use of an ESOP by selling shareholders to create a market, even in the absence of another buyer, ***is a feature of an ESOP***. ESOPs were designed to provide shareholders with a "limited market for their stock," and "in many cases it is the only market for such stock."[53] A "benefit to the employer is that the ESOP provides its shareholders with a buyer for their stock if they wish to sell," and this is a "tremendous advantage" because it could assist in "attracting additional

[53] *Supra*, n. 24, at 1, 4, § I(F).

investors."[54] The sellers were *counterparties* in the transaction, and there is nothing wrong with their asking for a particular price for their stock. The Trustee, in turn, had the obligation to make a good-faith determination of FMV on behalf of the ESOP.

E. The DOL's Position on the Independence of a Valuation Advisor Was Unreasonable.

The DOL argued[55] that the Trustee's valuation advisor was not independent, because the advisor performed one, preliminary opinion on value for the Company shortly before the Trustee was retained.[56] The independence of a valuation advisor is not affected by one, preliminary opinion. The IRS's "Independent Appraiser Rules" for ESOPs, for example, explain that an appraiser is not independent if s/he is "[r]egularly used by" the sponsor ***and*** "does not perform a majority of his/her appraisals for entities other than" the sponsor. IRM pt. 4 § 4.72.8.8.1 (08-29-2016); 26 U.S.C. § 401(a)(28)(C) (requiring ESOP valuations by an "independent appraiser"). Courts also have held that to lack independence, an advisor must have a stake in the asset, such as where the advisor also is a promoter of the investment that the principal is considering. *Stobie Creek Investments, LLC v. United States*,

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[54] *Id.* at 9.

[55] Johnson Declaration, 2021 563744 ¶ 33(g) (D. Haw. June 18, 2021).

[56] Johnson opined that "[t]o be independent, the appraiser cannot have been employed by the seller of the property involved with the transaction." *Id.* ¶ 20.

82 Fed. Cl. 636, 715 (2008), *aff'd*, 608 F.3d 1366 (Fed. Cir. 2010); *see also Illes v. Comm'r*, 982 F.2d 163 (6th Cir. 1992). If the DOL wants more stringent requirements for independence, it must promulgate a regulation.

IV. Even if the DOL's Interpretation of the Adequate Consideration Exemption Were Reasonable, It Was Unreasonable for the DOL to Sue Appellants.

There are, *at best*, differing interpretations on FMV determined in good-faith. The DOL sought to hold Appellants liable for failing to comply with the DOL's particular views. If it wants ESOP parties to follow specific approaches, the DOL must issue regulations. This is especially true because the DOL's interpretation violates basic principles for a FMV appraisal and conflicts with the character and aims of an ESOP. The DOL was not substantially justified in suing Appellants for failing to comply with the DOL's specific interpretation of the Adequate Consideration Exemption. An award of fees and costs is appropriate.

CONCLUSION

For the foregoing reasons and those set forth in the Brief of Appellants, the District Court's order denying Appellants' eligibility for attorneys' fees and costs should be reversed, and this case should be remanded to the District Court for a determination of the amount of attorneys' fees and nontaxable costs to be awarded to Appellants.

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Respectfully submitted,

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UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

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9th Cir. Case Number(s) 22-15378

The undersigned attorney or self-represented party states the following:

[X] I am unaware of any related cases currently pending in this court.

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Signature s/Mark D. Taticchi **Date** July 27, 2022

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

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