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Fiduciary Responsibility

View From McDermott: Fifth Circuit Focuses on Process in ESOP Valuations

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Though the Supreme Court's 2014 unanimous ruling in *Fifth Third Bank v. Dudenhoeffer* announced the Employee Retirement Income Security Act (ERISA) standards for stock valuation in the context of a large public employee stock ownership plan (ESOP), the vast majority of ESOPs are still grappling with valuation issues. ESOPs that hold stock of closely-held corporations—approximately 90% of all ESOPs—remain almost unaffected by *Dudenhoeffer's* valuation discussions, and face continued scrutiny by the Department of Labor (DOL). Appraisal of closely-held stock is an inexact science that involves an inherent level of un-

certainty in assessing a variety of potential fact patterns.

This article summarizes valuation issues in acquisitions of closely-held corporation stock by ESOPs in the context of *Perez v. Bruister*, a recently decided Fifth Circuit case. The case stressed the importance of “process” in valuation determinations being utilized for acquisitions of a corporation's stock by an ESOP. In reviewing the case, this article provides a detail of the process that should be followed to ensure consideration of the appropriate factors by fiduciaries in reviewing valuations for ESOP transactions. The article concludes with a discussion of guidance provided by the court in *Bruister* that may be instructive as to best practices for ESOP fiduciaries charged with establishing the value to be used by an ESOP holding shares of stock of a private company.

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What Exactly Is an ESOP?

In order to understand why the valuation of stock being purchased by an ESOP matters, it's first necessary to review how an ESOP typically purchases a corporation's stock.

An ESOP is a type of tax qualified retirement plan designed to invest an employee's retirement savings primarily in the stock of his employer—tying at least a portion of the employee's retirement nest egg to the value, really the success or failure, of the corporation for which he works.

There are countless ways in which an ESOP may buy stock, though the most common transactional structure results in a “leveraged ESOP.” This leveraged ESOP structure is often used because it provides a means for employers to fund ESOP stock acquisitions with tax-favored capital. While there are many permutations of this transaction, the basic structure requires that:

■ **Step 1:** Corporation establishes an ESOP. As part of this process, the corporation must identify one or more named ERISA fiduciaries to control and manage the operation and administration of the ESOP and its assets.

■ **Step 2:** Corporation acquires the necessary cash to allow the ESOP to purchase shares of corporation stock. Such cash is generally provided by outside financing (e.g., a bank loan to the corporation) or by using extra cash on the balance sheet of the corporation.

■ **Step 3:** Corporation lends the cash from above to the ESOP pursuant to the terms of an “exempt loan” which is governed by certain requirements set forth in the Internal Revenue Code (IRC) and ERISA. This loan is commonly referred to as the “inside loan” which simply refers to the fact that it is between the corporation and the ESOP versus involving an outside lender.

■ **Step 4:** ESOP uses the cash proceeds of the inside loan to purchase shares of corporation stock held by the owner(s) of the corporation.

As a result of the leveraged ESOP transaction, the ESOP will now hold shares of corporation stock that have been purchased with the proceeds of the inside loan. These shares are placed into a holding or “suspense” account and are released and allocated to participants’ accounts as the inside loan is repaid by the ESOP. The ESOP will repay the loan using tax-deductible annual contributions from the corporation. If used properly, a strong, profitable company can use a leveraged ESOP to simultaneously provide significant tax savings for itself, and substantial benefits for its employees. As a result, more and more owners of closely-held corporations are investigating whether an ownership transition utilizing an ESOP might provide advantages to the owner, the corporation, and its employees.

What Exactly Is a Fiduciary?

ERISA requires that all ESOPs have one or more fiduciaries who are responsible for controlling and managing the operation and administration of the ESOP and its assets and it imposes certain responsibilities upon those fiduciaries including the following:

■ **Duty of Loyalty:** A fiduciary must act solely in the interest of plan participants and their beneficiaries (i.e., also known as the “Exclusive Benefit Rule”).

■ **Duty to Diversify Plan Investments:** A fiduciary must invest plan assets in a range of investment alternatives designed to minimize the risk of large losses. (Note, an ESOP is designed to invest primarily in corporation stock and, therefore, is generally not diversified with respect to its plan assets. This is permitted under both the IRC and ERISA to the extent that it is prudent to retain this investment structure. *Fifth Third Bancorp et al v. Dudenhoeffer et al.* (June 25, 2014) makes it clear that there is no presumption that an ESOP does not have to diversify investments to the extent that it would be prudent to do so.)

■ **Duty to Follow Plan Documents:** A fiduciary must follow the requirements of the plan documents with respect to administration and operation unless it is not prudent to do so.

■ **Duty to Monitor Expenses:** A fiduciary must ensure that a plan pay only reasonable and necessary plan expenses.

■ **Duty Not to Participate in a Prohibited Transaction:** Both the IRC and ERISA identify transactions among certain parties as being at-risk for abuse based on actual or apparent conflicts of interest and provide a general prohibition on a plan entering into such transactions.

Certain of the prohibited transaction rules (and the associated exemptions) are fundamental to the holding in *Bruister*. Specifically, under both the IRC and ERISA, there is a general prohibition on sales of property between a plan (such as an ESOP) and a party-in-interest (referred to as a “disqualified person” under the IRC). A shareholder of the corporation sponsoring the ESOP is a party-in-interest. Therefore, transactions by and between the ESOP and the shareholder are largely prohibited - absent specific rules to the contrary. Both the IRC and ERISA provide a general exemption to the prohibited transaction rules that allows an ESOP to purchase stock from a party-in-interest if certain protections are in place to ensure that the ESOP is able to protect its participants. One such protection is that the ESOP is prohibited from paying more than “adequate consideration” for the purchased stock. Therefore, a fiduciary must not engage in a transaction if he knows, or should know, that the transaction constitutes a direct or indirect sale or exchange of any property between the plan and a party in interest unless the transaction is made for adequate consideration.

For purposes of complying with the appropriate regulatory exemptions that allow an ESOP to purchase shares of the sponsoring employer’s stock, it is the ESOP trustee’s responsibility to oversee the valuation process to determine that the ESOP pays no more than adequate consideration for the corporation stock. Adequate consideration is considered to be equal to the “fair market value” of the securities being purchased. Fair market value is generally defined by Proposed Labor Regulation Section 2510.3-18 as “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 the asset.”

The determination of what constitutes “adequate consideration,” and the process undertaken in connection with such analysis, is at the heart of the *Bruister* case. For closely-held corporations, ESOP fiduciaries often rely on the work of independent financial appraisers to determine fair market value of the corporation’s stock. It is this selection and supervision of financial appraisers that has come under significant DOL scrutiny in the past decade. The DOL appears to view private company valuation work with a high degree of skepticism as to its accuracy. After the DOL filed a number of lawsuits relating to ESOP acquisitions of corporation ownership, with most alleging poor valuation work, Timothy Hauser (deputy assistant secretary at the DOL’s Employee Benefits Security Administration) noted that “[v]aluation is the first, second, third, and fourth problem” with respect to ESOP transactions.

Case Study: Sputnik Co.

The blessing and curse that an ESOP can provide for employers and employees can be best illustrated through example. (The described facts relate to a fictional entity and individuals that have been created for illustration purposes.) Take Sputnik Co. Sputnik Co. was a Mississippi-based company that installed and serviced satellite television for one large client. Sputnik was a small company, with 100% of its stock owned by its CEO, Mr. Smith. From his personal lawyer, Mr. Green, Mr. Smith learned that he could save millions of dollars in taxes if he liquidated his ownership in Sputnik by selling the entirety of his ownership to an ESOP. Such sale would also provide Sputnik with significant tax savings and planning opportunities as the to-be-established inside loan was repaid following the acquisition.

Mr. Smith had Mr. Green hurriedly draw up a governing document for the ESOP. The document named three ESOP trustees: (1) Mr. Smith, (2) Mr. Smith's favorite Sputnik employee Ms. Lemon, and (3) Sputnik's accountant Ms. Pear. Noteworthy was the fact that there was no independent fiduciary appointed or engaged for purposes of the transaction. Mr. Smith (in his role as a trustee) retained a valuation appraiser for the ESOP, Mr. Sunshine. Mr. Smith also retained a lawyer for the ESOP, Ms. Diligent. Sputnik obtained a loan from a bank and loaned that money to the newly-established ESOP to purchase the shares held by Mr. Smith.

Several weeks before the transaction, Ms. Diligent and Mr. Sunshine began their analysis and advisory work. Mr. Sunshine appraised Mr. Smith's shares by factoring in market trends, Sputnik's financial reliance on one major client, and climate issues. Recognizing that not one of the newly-minted ESOP trustees had any experience in reviewing the valuation work-product to be produced by Mr. Sunshine, Ms. Diligent planned out fiduciary training for Mr. Smith, Ms. Lemon, and Ms. Pear. As the education process commenced, Mr. Smith quickly realized Mr. Sunshine's price for the shares would not be quite enough to fully deduct the contribution payments Sputnik intended to make to the ESOP and would not provide the liquidation value Mr. Smith had imagined. Seeing legal bills rising, and his potential profits falling, Mr. Smith decided to take action.

Mr. Smith held an emergency trustees meeting, telling Ms. Lemon and Ms. Pear that the Sputnik ESOP would be in better hands if it removed Mr. Sunshine, and reduced its reliance on the expensive work of Ms. Diligent. Mr. Smith recommended that the trustees retain the appraisal services of Mr. Shadow, and volunteered the services of his own personal lawyer Mr. Green. Recognizing that ERISA rules regarding interested party transactions would prevent him from formally voting on the decision to retain Mr. Shadow, Mr. Smith stayed silent during the formal vote. Both knowing Mr. Smith as an honest businessman from the many years they have worked with him, and fearing for their jobs, Ms. Lemon and Ms. Pear voted in favor of firing Mr. Sunshine and appointed Mr. Shadow. What Ms. Lemon and Ms. Pear did not realize, however, was that Mr. Shadow was not who Mr. Smith claimed him to be. Mr. Shadow had recently been convicted of embezzling from one of his clients, and Mr. Shadow did not have a college degree. At no point did Ms. Lemon and Ms. Pear

question Mr. Shadow's credentials beyond what was presented to them by Mr. Smith, the very interested owner of Sputnik who would reap significant benefit from an inflated stock price.

Shortly thereafter, Mr. Shadow began the process of valuing Sputnik stock, sending several drafts of each valuation to Mr. Smith and Mr. Green before sending them to Ms. Lemon and Ms. Pear. This was not merely poor process on the part of Mr. Shadow but an action demanded by Mr. Smith and Mr. Green to allow them to review and comment upon the work product prior to its delivery to the voting members of the trustee group. Ms. Diligent was cut off from most of these communications. In fact, Mr. Green pushed to increase the value of the shares at every opportunity. Several communications between Mr. Green and Mr. Shadow show Mr. Green clearly advocating for an increased valuation with respect to Sputnik and at every turn Mr. Shadow responded by providing additional analysis that supported a rising valuation.

Once Ms. Lemon and Ms. Pear received Mr. Shadow's valuation, which, as noted above, had already been revised on a number of occasions based upon the input of Mr. Smith and Mr. Green, Ms. Lemon and Ms. Pear approved the valuation without further inquiry or diligence. Each overlooked and ignored the various communications between Mr. Smith and Mr. Green with respect to the valuation and the demand for an increased stock price. As a result of either lack of knowledge or undue influence exerted by Mr. Smith, neither Ms. Lemon nor Ms. Pear corrected assumptions in the valuation report regarding Sputnik's fortunes or the lack of analysis relating to Sputnik's financial reliance on a single customer. Despite these flaws in both analysis and process, the valuation work was approved and accepted.

The transaction closed in late July and Mr. Smith was over the moon.

Sputnik Gets Sued. Two years later, a hurricane destroyed the Mississippi coast, and Sputnik's business crumbled. The value of the shares in the ESOP dropped to zero, and participants in the Sputnik ESOP brought a lawsuit in federal district court. These participants argued that Mr. Smith, Ms. Lemon, and Ms. Pear breached their fiduciary responsibilities to the ESOP.

The Secretary of Labor also sued Mr. Smith, Ms. Lemon, and Ms. Pear in federal court for breaches of fiduciary duty, engaging in prohibited transactions, failure to monitor (against Mr. Smith in his capacity as corporate director of Sputnik), and co-fiduciary liability. The case was soon consolidated with the suit brought by the ESOP participants that raised substantially the same claims. The district court found in favor of the plaintiffs on all claims and awarded significant equitable restitution damages. The appropriate circuit court largely affirmed the appealed verdict.

What Went Wrong?

Fiduciary Independence. In many instances, a finding of liability under the requirements of ERISA turns on whether there was a conflict of interest and whether it was avoided because a fiduciary's decisions were made with an eye single to the interests of the participants and beneficiaries (i.e., can the fiduciary satisfy the Exclusive Benefit Rule despite his other loyalties and interests?) It is important to note that independent

or professional fiduciaries are not required under ERISA and “insiders” (e.g., the president of the company) may serve as officers, trustees, and/or members of the board of directors. When one individual serves in multiple capacities he is generally said to be wearing “two hats” and must clearly distinguish between his various roles when taking action. Actions taken as an ERISA fiduciary are sacrosanct and must be carefully entered into to ensure that the fiduciary is acting only with respect to his plan responsibilities. Ancillary benefits may accrete to the corporation or the corporation’s individual owner but such benefits may not be a driving force in any decisions made.

ERISA’s “two hats” doctrine is applied to the potentially “conflicting loyalties” of a non-independent fiduciary. If there is no plan language to the contrary, a named fiduciary does not have to remove himself completely from all fiduciary decision-making. However, the fiduciary must have a process in place that isolates his decisions with respect to those that present certain conflicts. It is vital that the fiduciary be able to identify when he is acting as an ERISA fiduciary and show that he is acting solely in the interests of plan participants with respect to the conflicted decision. If the conflict is such that a fiduciary cannot act solely in the interest of participants, he must be recused from the process. It is incumbent upon the ESOP fiduciary to recognize these situations and take the appropriate actions.

A fiduciary is subject to fiduciary duties under ERISA only to the extent that he performs fiduciary functions, so by abstaining from voting, Mr. Smith believed that he was not a fiduciary in regard to the ESOP transactions. However, ERISA does not look only to actions a fiduciary says are being taken. ERISA creates fiduciary status and responsibility when someone acts as a fiduciary, regardless of supposed authority. This means that ERISA dictates that Mr. Smith performed fiduciary functions to the extent he exercised any discretionary authority or discretionary control in the management of the ESOP or exercised any authority or control in the management or disposition of the ESOP’s assets. Mr. Smith exercised authority or control respecting management or disposition of the ESOP’s assets when he fired Mr. Sunshine, hired a second appraiser, influenced the outcome of the second appraiser’s valuations, made his personal preferences known to the other ESOP trustees, actively participated in all of the meetings relating to the subject transactions, and had his personal lawyer write emails to the second appraiser. So, despite not participating in the formality of the fiduciary decision (e.g., Mr. Smith did not vote on the transaction), he functionally participated in the ESOP’s acquisition of stock. This means that Mr. Smith influenced or controlled the investment of the ESOP’s assets and, therefore, is deemed to be a fiduciary, regardless of his assertions and title at that time.

Valuation. As previously discussed, the prohibited transaction rules set forth under the IRC and ERISA generally prohibit sales of property between a plan and a party-in-interest/disqualified person. Mr. Smith, as the owner of all of the issued and outstanding stock of Sputnik, was both a party-in-interest and a disqualified person with respect to the Sputnik ESOP. Therefore, transactions by and between the Sputnik ESOP and Mr. Smith were largely prohibited unless it is demonstrated

that the ESOP paid no more than adequate consideration.

For a security with no recognized market, ERISA defines adequate consideration as the fair market value of the security as determined in good faith by the trustee or named fiduciary (e.g., willing buyer/willing seller analysis). The courts have made it clear that adequate consideration is a conduct test; it is not sufficient to merely arrive at the right number. Whether the determination of adequate consideration is appropriate and correct requires an inquiry into whether fiduciaries arrived at their determination of fair market value by way of a prudent investigation into the circumstances then prevailing. The plan fiduciaries carry the burden to prove that the ESOP has paid no more than adequate consideration and that the process to determine such value was prudent and appropriate.

Here, Sputnik Co.’s share valuation shows no prudent investigation. Though Mr. Smith—the named fiduciary—arguably determined the price of the Sputnik shares, he did not use good faith. Ms. Lemon and Ms. Pear did not investigate the qualifications of the second appraiser, and overlooked communications in which Mr. Green and Mr. Shadow were obviously working together to increase value. Ms. Lemon and Ms. Pear did not provide any information to Mr. Shadow regarding the Sputnik business and its associated risk factors, factors that should have influenced his valuations. Ms. Lemon and Ms. Pear also failed to double-check or significantly review Mr. Shadow’s valuations. There was no indication or record showing any prudent process was undertaken or followed. As payment of only adequate consideration is an affirmative defense to be proven by the defendants, Mr. Smith, Ms. Lemon and Ms. Pear were woefully underprepared to show their actions followed the customary and required process to protect the ESOP.

Duty to Monitor. Most courts recognize a duty to monitor under ERISA, meaning that a fiduciary is responsible for monitoring the work of any fiduciary he appoints. The situation facing Sputnik adds an interesting wrinkle insofar as the duty to monitor would imply that Mr. Smith was liable for not stopping Ms. Lemon and Ms. Pear (both appointed by Mr. Smith in his capacity as a member of the board of directors) from condoning his manipulation of the ESOP transaction. Mr. Smith fired the ESOP’s independent counsel, caused his lawyer to influence the second appraiser to get the highest selling price he could for himself, caused the second appraiser to send him preliminary drafts before sending the valuations to the ESOP trustees, cut the ESOP counsel out of all communications regarding valuation, adjusted assumptions and figures used by the second appraiser to obtain a higher valuation, and generally did not say anything, let alone speak up for the ESOP participants. Ms. Lemon and Ms. Pear did not stop him, and he did not stop them from not stopping him.

Perez v. Bruister

While the facts of Sputnik seem like a law school exam, created to provide issues to be examined as one investigates the rules and requirements surrounding ERISA fiduciary law, in *Bruister* the Fifth Circuit affirmed a judgment holding trustees liable for plan

losses in a situation reflecting the quandary of Sputnik Co. In *Bruister*, the Fifth Circuit found both a trustee-owned LLC as well as the two insider trustees liable for plan losses in relation to three transactions in which the Bruister & Associates Inc. (“BAI”) ESOP allegedly paid too much for its acquisition of BAI stock. Between 2002 and 2005, Herbert Bruister, owner of BAI, sold 100% of his stock in BAI to the company’s ESOP. At the time of the three transactions at issue, Bruister’s personal stock was held by the Bruister Family, LLC (“BFLLC”), an LLC of which he was a 50% owner. Bruister served as an ESOP trustee at the time of each of the transactions, along-side, two other employee trustees who were appointed by Bruister to that position.

In April 2010, the Secretary of Labor brought a civil action against Bruister and the trustees for a breach of fiduciary duty, engaging in prohibited transactions, failure to monitor (against Bruister in his capacity as corporate director of BAI), and co-fiduciary liability. The case was later consolidated with a suit brought by ESOP participants that raised substantially the same claims. After a 19-day bench trial, a district court in Mississippi awarded plaintiffs \$4,504,605.30 in equitable restitution.

This equitable restitution, affirmed by the Fifth Circuit, reflected the amount that Bruister and the ESOP trustees allegedly caused the ESOP to overpay for the BAI stock. The court’s basic methodology for calculating this amount of overpayment involved estimating the fair market value of BAI stock at the time the ESOP entered into each transaction, then deducting that estimated fair market value from the higher amount the ESOP actually paid. The court took into consideration expert testimony offered by the Secretary, Bruister and the ESOP trustees, and plan participants. Each expert used different valuation methods, different assumptions, and different estimates. The Secretary’s expert used actual revenue numbers reported on BAI’s financial statements, but used industry average numbers for comparable companies to estimate BAI’s expenses and profits. Bruister’s expert used a guideline public company valuation method to calculate the value of the stock, arriving at a price very close to what the ESOP actually paid at the time of the challenged transactions. The court disregarded any outstanding loan repayment, and averaged all the expert’s valuations to mitigate the impact of any differing assumptions.

Fiduciary Independence. Herbert Bruister challenged his fiduciary status with respect to the ESOP transactions because, like Mr. Smith, he abstained from all votes related to the transactions themselves. The Fifth Circuit explained that the two hats doctrine determines whether, notwithstanding his abstention from the vote, Bruister served as a functional fiduciary. Like Mr. Smith, the court found that Bruister exercised authority or control respecting management or disposition of the ESOP’s assets in the following ways:

1. Firing the first appraiser for being too thorough
2. Hiring a second appraiser to replace the first appraiser
3. Influencing the outcome of the second appraiser’s valuations
4. Making his personal preferences known to the other two ESOP trustees

5. Actively participating in all of the meetings leading up to the transactions;

6. Allowing his personal lawyer to review draft valuations before the draft valuations without providing them to the ESOP lawyer; and

7. Allowing his personal lawyer send emails to the second appraiser, without copying ESOP lawyer, indicating that the second appraiser needed to “tweak” his findings in order to get a higher price for Bruister. Bruister also challenged whether, as a fiduciary, he actually breached the duty of loyalty because the price that the ESOP ultimately paid was not inflated compared to the fair market value Bruister’s expert calculated at trial. The Fifth Circuit rejected the idea that an “all’s well that ends well” argument can prevent liability under ERISA, and stressed that Bruister breached the duty of loyalty when he failed to place the interests of participants and beneficiaries first and foremost. The trustees breached the duty of loyalty when they did not separate Bruister’s personal interests from the second appraiser’s valuation process so as to prevent a conflict of interest.

Valuation. Bruister similarly argued that the ESOP transaction was for “adequate consideration” because the price that the ESOP ultimately paid was not inflated compared to the fair market value that his expert calculated at trial. While proper valuation cannot excuse a breach of loyalty, it can prevent prohibited transaction liability.

Disagreeing with Bruister, the Fifth Circuit panel explained that the adequate consideration exemption is an affirmative defense that is expressly focused on the conduct of fiduciaries. In the context of a closely-held corporation, ERISA defines adequate consideration as the fair market value of the asset as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary of Labor. There is no regulation that defines adequate consideration, though the Secretary proposed regulations that the value assigned must reflect the stock’s fair market value and the value must be the product of a determination made by a fiduciary in good faith. The Fifth Circuit has interpreted this to mean that ESOP fiduciaries must 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. Reliance on experts alone does not indicate that a fiduciary has satisfied this open ended duty of care. The court found that Bruister’s conduct was lacking in the care necessary to enable them to reasonably rely on the appraiser’s valuations because of the following:

1. The second appraiser was not given complete information, and was not informed of risk factors for the company that should have influenced his valuation;
2. The defendants used insufficient due diligence in reviewing the second appraiser’s valuations;
3. The trustees conducted insufficient investigation into the second appraiser’s background and qualifications;
4. The trustees overlooked communications in which the second appraiser and Bruister’s personal lawyer

were obviously working together to increase the value; and

5. The trustees failed to double check or significantly review the appraiser's ultimate conclusions. Valuation also dictates damages. It is hornbook law that damages should be awarded to put the injured party in the situation it would have occupied had the wrong not been committed. The wrong in *Bruister* was that the ESOP overpaid for BAI stock. The Secretary of Labor urged that the appropriate remedy in a case like *Bruister*, and a case like *Sputnik*, is rescinding the transaction to the extent that the fair market value of stock at the time of sales cannot be determined with certainty. Rescission would restore the parties to the pre-transaction status quo by returning the entire purchase price paid by the ESOP. Disagreeing with the Secretary, the court ruled that rescission was not an appropriate remedy even where the acquired stock had fallen to \$0 because the fair market value of stock of a closely-held corporation includes a discount for future risks, including the risk that the stock will later become worthless. Participants in the ESOP had a reasonable expectation of purchasing BAI stock at a fair price, so the correct measure of damages is the amount they overpaid at the time of the transaction, not the difference in purchase price and current price (i.e. \$0). The court arrived at its fair market valuation by averaging the testimony of three experts, and concluded that the ESOP overpaid by \$4,504,605.30.

Post-Bruister

Though *Bruister* established the preeminence of prudent process in ESOP valuation, there is no uniform checklist for procedural prudence, and the question of what exactly constitutes "objective prudence" remains a contentious debate in federal courts. *Bruister's* emphasis on process conflicts with other court decisions that focus on results. The court in *Bruister* noted that, "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." This means that the determination of adequate consideration is "expressly focused on the conduct of fiduciaries. . . [and] in focusing on conduct, the reviewing court does not redetermine fair market value." This thought process is important as it emphasizes the court's reliance on process versus results.

The defendants in *Bruister* attempted to justify their actions by noting that the district court accepted certain aspects of the valuation prepared for the Bruister ESOP. In other words, the defendants relied heavily on the argument that the process may have been insufficient but the results were appropriate. As noted above, this does not sway the Fifth Circuit Court which provides:

The flawed valuation process, in other words, led to an insupportable fair market value calculation, notwithstanding that it coincidentally fell within a range later estimated by reliable methodology during the damages portion of the case. Second, the existence of this coincidence does not satisfy the Defendants' burden to prove the adequate consideration affirmative defense under the test we have just laid out. Third, the very premise of this argument is questionable, because the district court

did not fully accept the Defendants' trial expert's fair market value calculation that overlapped [the price the ESOP paid] but merged it with those of the plaintiffs' experts.

This dicta is instructive for ESOP fiduciaries. In the Fifth Circuit, at least, it appears that the fact that a fiduciary-accepted valuation may be instructive (or even correct) as to the proper valuation of a corporation's stock is insufficient to provide an affirmative defense to a prohibited transaction allegation if that valuation was conducted improperly. The courts continue to focus on ERISA as a process based standard and provide important information for fiduciaries who wish to create a record supporting their actions.

This holding is somewhat in curious contrast to case law investigating claims of a fiduciary breach in a non-ESOP context. In 2014, the Fourth Circuit recognized that a fiduciary could avoid liability for his flawed process if a prudent fiduciary "would have" made the same decision. *Tatum v. RJR Pension Inv. Comm.* involved the elimination of company stock funds as 401(k) investment options when Nabisco spun off R.J. Reynolds. Though the committee failed to thoroughly investigate the alternatives and risks to eliminating the stock funds and quickly made the decision, the district court ruled that prudent fiduciary "could have" made the same decision to eliminate company stock funds. The Fourth Circuit reversed, saying that the "could have" standard was too lenient. The court explained that "could have" describes what is merely a possibility, while "would have" describes what is probable. It is important to note, however, that while the Fourth Circuit disagreed with the standard articulated by the district court, it did agree that defendants may be free of liability to the extent they can, despite their breach and lack of process, show that their ultimate decision was objectively prudent and appropriate. While it is questionable as to what damages would have arisen in *Bruister* had the valuation been proven to be objectively proper, the Fifth Circuit certainly appeared to indicate that there would still be liability in connection with the fiduciaries breach of duty and poor process.

Best Practices

Bruister provides an instructive framework for individuals acting as ESOP fiduciaries and suggests that the ability of a fiduciary to prove his process will be determinative in instances of litigation and DOL review of valuation issues.

1. Actions Can Make a Fiduciary. The lesson here is that it is not enough not to be labeled as a fiduciary. If your actions involve discretion or management over plan assets, you will be considered to be an ERISA fiduciary and subject to the strict standards applicable to such status. This is an important consideration for individuals serving a corporation or plan in multiple capacities. In these instances an affected individual should carefully document the action(s) he has taken and carefully identify instances when such individual is specifically acting (or not acting) in an ERISA fiduciary capacity. It is important that subsequent actions also comport with such assertions and documentation.

2. Process Is Key in Determining Stock Value. In connection with a fiduciary's analysis of the valuation process, the Fifth Circuit makes it clear that this involves more than simply arriving at the right number.

The process undertaken in connection with the valuation must be clear and evident. Actions that can (and in some instances must) be taken, and documented, by the ESOP trustee(s) include:

- Reviewing the financial advisors qualifications. The Fifth Circuit explained that whether a fiduciary's reliance on an expert is justified can depend on that expert's reputation and experience.

- Reviewing and understanding the process undertaken by the financial advisor. To justify its reliance on an expert's conclusions, a fiduciary must be able to articulate the reasoning and process underlying the expert's investigation, whether the expert's opinion is supported by relevant material, and whether the expert's methods and assumptions were appropriate to the decision at hand.

- Understanding the financials of the company and the economic environment in which the valuation is performed and ensuring that such metrics are consid-

ered in connection with the valuation. A fiduciary cannot reasonably rely on an expert's valuation if the fiduciary does not understand all of the factors at work in valuation.

- Identifying conflicts of interest and recognizing undue influence being exerted upon the financial appraiser (if any).

- Determining that the valuation analysis performed was appropriate and creditable given the circumstances. A creditable valuation cannot result from a poor process.

3. Documentation Is Key in Determining Process. Case law surrounding ESOP fiduciary actions regarding the determination of "adequate consideration" indicates that such determination is the result of a set and appropriate process. The means to prove such process is appropriate documentation by ESOP fiduciaries that are not subject to significant conflicts of interest. ERISA continues to be largely a process-oriented statute in these instances.