UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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No. 19-2485

United States Court of Appeals
for the Fourth Circuit

SHARON LEE, ON BEHALF OF HERSELF INDIVIDUALLY, AND ON BEHALF OF ALL OTHERS SIMILARLY SITUATED,

v.

ARGENT TRUST COMPANY, CHOATE CONSTRUCTION COMPANY ESOP COMMITTEE, CHOATE CONSTRUCTION COMPANY BOARD OF DIRECTORS, WILLIAM MILLARD CHOATE, DAVE PRIESTER, COMMITTEE DEFENDANTS (JOHN AND JANE DOES 1-10), BOARD DEFENDANTS (JOHN AND JANE DOES 11-20), AND SELLING SHAREHOLDERS (JOHN AND JANE DOES 21 THROUGH 35),

APPEAL FROM DECISION OF THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF NORTH CAROLINA

NO. 5:19-CV-00156-BO

BRIEF OF *AMICUS CURIAE* PENSION RIGHTS CENTER SUPPORTING PLAINTIFF-APPELLANT FOR REVERSAL

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INTEREST OF THE AMICUS CURIAE[1]

The Pension Rights Center ("Center") is a Washington, D.C. nonprofit consumer organization. The Center was established in 1976, less than two years after the enactment of the Employee Retirement Income Security Act of 1974 ("ERISA"), with a mission to protect and promote the retirement security of American workers, retirees, and their families. For forty-four years, the Center has provided legal assistance to thousands of retirement plan participants and beneficiaries seeking to understand and enforce their rights under their plans, to recover benefits under the terms of their plans, and to ensure that their plans are adequately funded and prudently managed in their interests.

The issue presented by this case concerns the ability of participants and beneficiaries of employee stock ownership plans ("ESOPs") to file suit to enforce ERISA's fiduciary rules. Plaintiff alleges that the trustee of her ESOP purchased employer stock from company officers and board members for more than adequate consideration, thus breaching its fiduciary duties and diminishing the value of her individual account in the Plan. She contends that the improper valuation of the stock

[1] The parties have consented to the filing of this brief. No counsel for a party authored this brief in whole or in part, and no counsel or party made a monetary contribution intended to fund the preparation or submission of this brief. No person other than amicus curiae, its members, or its counsel made a monetary contribution to its preparation or submission.

purchased by the trustee on behalf of the ESOP constitutes an injury-in-fact, giving her Article III standing.

The Pension Rights Center has long been concerned about the risks to participants that are inherent in the structure of private company ESOPs and the consequent need for special vigilance by trustees who are charged with obtaining appropriate valuations of the employer stock purchased by these plans and negotiating transactions on behalf of participants. The Center has advised individuals concerned about the valuation of private company stock purchased by their ESOP trustees, and has published an ESOP fact sheet, blog entry, and white paper on its website.[2] The Center is filing this brief in order to share with this Court the background of private company ESOP transactions, the relevant provisions of federal law, and the principles applicable to the Article III standing issue decided by the District Court.

SUMMARY OF ARGUMENT

In adopting ERISA, Congress stated the purpose of the statute was "to protect . . . the interests of participants in employee benefit plans and their beneficiaries . . . by establishing standards of conduct, responsibility, and obligation for fiduciaries of

[2] *See* William K. Bortz, *Employee Stock Ownership Plans: Are They Worth the Risk?*, Pension Rights Center (2016), http://www.pensionrights.org/sites/default/files/docs/pdf/esops_-_are_they_worth_the_risks.pdf.

employee benefit plans, and by providing for appropriate remedies, sanctions, and *ready access to the Federal courts*." 29 U.S.C. § 1001(b) (emphasis added). These standards of conduct, responsibility and obligation are even more crucial in the case of private company ESOPs than for other retirement plans because of the unique structure of these plans. As the Seventh Circuit has noted, "If anything, [an ESOP] demands an even more watchful eye, diversification not being in the picture to buffer the risk to the beneficiaries should the company encounter adversity." *Armstrong v. LaSalle Bank Nat. Ass'n*, 446 F.3d 728, 732 (7th Cir. 2006). The Plaintiff in this case has plausibly alleged that the trustee of the Choate Construction Company ESOP breached these fiduciary duties and caused the Plan to enter into a prohibited transaction, causing her financial injury. The District Court therefore erred in dismissing her claims for lack of jurisdiction at the pleading stage.

The case law—both this Court's decision in *Brundle on behalf of Constellis Employee Stock Ownership Plan v. Wilmington Tr., N.A.*, 919 F.3d 763, 769 (4th Cir. 2019) and numerous other cases—shows that Plaintiff's allegations are plausible. Workers' retirement savings are lost when an ESOP pays an inflated price for employer stock. If the ESOP pays too much, some of the participants' potential retirement savings are transferred to the selling shareholders. This happens if the ESOP trustee did not conduct adequate due diligence before approving the purchase price or failed to engage in hard bargaining to get the best deal possible for the ESOP.

In addition, the District Court's ruling that Plaintiff has insufficiently pled Article III injury is contrary to well-established law. Because the sale of stock to an ESOP involves a transaction between the ESOP and a party in interest (here, the selling shareholders were also company directors and officers), it constitutes a "prohibited transaction" under 29 U.S.C. § 1106(a). A corporate insider's sale of stock to an ESOP is *per se* prohibited because such transactions are "likely to injure the [] plan," *see Harris Trust and Savings Bank v. Salomon Smith Barney, Inc.*, 530 U.S. 238, 242 (2000), and only become permissible if they meet one of the narrowly delineated exemptions in 29 U.S.C. § 1108. These exemptions are affirmative defenses that the transacting parties must demonstrate are satisfied. *Elmore v. Cone Mills Corp.*, 23 F.3d 855, 864 (4th Cir. 1994). This puts the burden of demonstrating that the ESOP did not pay more than "adequate consideration" on the trustee. 29 U.S.C. § 1108(e)(1). Since the Complaint plausibly alleges that the ESOP paid more than "adequate consideration," causing the Plaintiff's individual account to suffer a financial loss, she has sufficiently alleged an injury in fact.

The Court should reverse the decision below to permit Plaintiff to conduct discovery. If this case returns to this Court, it may very well be in the same posture as *Brundle*—an appeal following a trial in which the trial court ordered a substantial judgment based on a finding that the ESOP trustee violated its fiduciary obligations.

ARGUMENT

I. ESOPs POSE SPECIAL RISKS FOR PARTICIPANTS.

"The Employee Retirement Income Security Act of 1974 ("ERISA") allows an employer to create an ESOP, an employee pension plan that invests primarily in the employer's stock. The employer makes contributions to the plan that are used to purchase stock in the employer's company." *Brundle*, 919 F.3d at 769.

Although ESOPs are advertised as a way to enable rank-and-file employees to buy the company they work for, ESOPs are not always a good deal for workers. First, ESOPs, by definition, do not diversify their investments, subjecting employees to enormous, uncompensated risk. *See* Sean M. Anderson, *Risky Retirement Business: How ESOPs Harm the Workers They Are Supposed to Help*, 41 Loy. U. Chi. L. J. 1 (2009); John H. Langbein, Testimony to S. Comm. on Governmental Affairs, Jan. 24, 2002, *reprinted as* "What's Wrong with Employer Stock Pension Plans," in Enron and Other Corporate Fiascos: The Corporate Scandal Reader 487 (Nancy B. Rapoport & Bala G. Dharan eds., 2d ed. 2009). And ESOPs—because they often make large stock purchases from corporate insiders, as was the case here—create conflicts of interest between corporate insiders, who benefit from a high valuation, and rank-and-file participants, who benefit from a fair valuation. "[T]he actual record for ESOPs appears to be one in which it has been used more to the advantage of the firm than its employees." Aditi Bagchi, *Varieties of Employee*

Ownership: Some Unintended Consequences of Corporate Law and Labor Law, 10 U. Pa. J. Bus. & Emp. L. 305, 316 (2008) (quotation omitted). The case law on ESOPs demonstrates that this conflict between corporate insiders and rank-and-file participants is more than a theoretical concern. *See, e.g.*, *Brundle*, 919 F.3d at 771 (explaining how the prior owners of Constellis were "looking for an 'exit strategy' after having twice tried and failed to effectuate a sale of the company," and thus "began exploring the possibility of creating an ESOP to purchase Constellis.") (citation omitted).

ESOPs are not a gift to employees— "there are no free lunches; any [ESOP] benefit that an employer confers on an employee is reckoned by the employer as a cost and so affects the overall level of compensation that he is willing to pay." *Steinman v. Hicks*, 352 F.3d 1101, 1103 (7th Cir. 2003). "An employer's contributions to an ESOP thus constitute a valuable form of deferred compensation, rather than a gift to employees." *Brundle*, 919 F.3d at 769 n.1.

"Congress intended ESOPs to function as both an employee retirement benefit plan and a 'technique of corporate finance' that would encourage employee ownership." *Chao v. Hall Holding Co.*, 285 F.3d 415, 425 (6th Cir. 2002) (internal quotation and citation omitted). While ESOPs may provide an opportunity for employees to gain an ownership interest in their employer, a private company ESOP transaction is not lawful unless the trustee ensures that the price is fair and the

transaction terms account for material risks. In fact, the trustee's duty of undivided loyalty to the ESOP participants requires it to act like a real-world buyer who would negotiate with the sellers to try to get the best possible price for the ESOP.

As courts have recognized, ESOP transactions are vulnerable to abuse because the loyalty of ESOP fiduciaries can be compromised by conflicts of interest. *Howard v. Shay*, 100 F.3d 1484, 1489-90 (9th Cir. 1996) (senior executives of company who were also ESOP fiduciaries operated under a conflict of interest when involved in an ESOP transaction that affected their personal financial interest); *cf. Donovan v. Bierwirth*, 680 F.2d 263, 271 (2nd Cir. 1982) (ERISA "imposes a duty on the trustees to avoid placing themselves in a position where their acts as officers or directors of the corporation will prevent their functioning with the complete loyalty to participants demanded of them as trustees of a pension plan.").

Because of such conflicts, trustees of private company ESOPs sometimes fail to conduct adequate due diligence and do not fulfill their duty to obtain the lowest price possible for the ESOP, as alleged in this case. Such failures "improperly enrich [] the corporation's owners at the expense of its employees." *Brundle*, 919 F.3d at 769. Thorough and careful due diligence is necessary for private company ESOP transactions because there is no public market to establish the fair market value for the company's stock, and no public filings provide information about the company's financial condition and prospects.

A. Private Company ESOP Transactions Involve Inherent Risks Requiring the Utmost Vigilance on the Part of the Trustee.

No prudent financial professional would advise her clients to invest all of their retirement savings in a single stock, yet this is precisely what occurs in a private company ESOP. Under 29 U.S.C. § 1104(a)(2), ESOPs are not required to diversify their holdings. However, as courts have recognized, the absence of diversified investments requires a heightened duty of prudence by the trustee:

> The duty to diversify is an essential element of the ordinary trustee's duty of prudence, given the risk aversion of trust beneficiaries, but the absence of any general such duty from the ESOP setting does not eliminate the trustee's duty of prudence. If anything, it demands an even more watchful eye, diversification not being in the picture to buffer the risk to the beneficiaries should the company encounter adversity. There is a sense in which, because of risk aversion, an ESOP is imprudent per se, though legally authorized. This built-in "imprudence" (for which the trustee is of course not culpable) requires him to be especially careful to do nothing to increase the risk faced by the participants still further.

Armstrong, 446 F.3d at 732; *see also Chao*, 285 F.3d at 425 ("Even though ESOPs can be much riskier than a typical ERISA plan, the fiduciaries of [ESOP] plans are still held to their fiduciary responsibilities.").

The risk created by a retirement plan that invests in a single stock is not merely theoretical. For example, Appvion, a paper company based in Wisconsin and owned by its employees through an ESOP, filed for bankruptcy in 2017.[3] There are several

[3] *See* Kanishka Singh, *Paper maker Appvion files for bankruptcy*, Reuters (Oct. 2, 2017), https://www.reuters.com/article/legal-us-appvion-bankruptcy/paper-maker-appvion-files-for-bankruptcy-idUSKCN1C71DA. A list of other ESOP companies

pending lawsuits arising from alleged errors in the ESOP valuations of Appvion's stock, *e.g.*, *Great Am. Fid. Ins. Co. v. Stout Risius Ross, Inc.*, No. 19-CV-11294, 2020 WL 601784, at *1 (E.D. Mich. Feb. 7, 2020), and it appears unlikely that Appvion's workers will receive any value from their ESOP stock.

In 2007, the employees of the Tribune Company purchased the Company in a complex ESOP transaction, but the Tribune Company filed for bankruptcy within a year and the ESOP's stock became worthless. *Neil v. Zell*, 767 F. Supp. 2d 933, 936 (N.D. Ill. 2011). The District Court granted summary judgment to the plaintiffs on their claim that the ESOP trustee caused the ESOP to engage in a prohibited transaction by buying unregistered stock subject to a trading restriction. *Neil v. Zell*, 753 F. Supp. 2d 724, 731 (N.D. Ill. 2010).

The case law shows that when trustees fail to meet their fiduciary obligations of loyalty and prudence, these failures have had significant and sometimes devastating effects on the retirement savings of employees. As discussed below, the trustees acting on behalf of the employees in private company ESOP transactions

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that have filed for bankruptcy is found at *Bankrupt Companies and Failed Banks Which Offered ESOPs to Employees Prior to Bankruptcy or Receivership*, StockShield.com, https://stockshield.com/wp-content/uploads/2015/07/Bankrupt-Companies-and-Failed-Banks-Which-Offered-ESOPs-Prior-to-Bankruptcy-or-Receivership.pdf.

frequently do not conduct adequate due diligence or engage in hard bargaining on behalf of the participants.

B. ESOP Trustees May Fail to Conduct "Real World" Due Diligence or Seek the Best Price Possible for the ESOP, In Part Due to the Close Ties Between ESOP Service Providers Who Are Nominally Representing Adversarial Interests.

This Court recently identified the most common problems with ESOP stock purchases. In *Brundle*, the trustee admitted that he did not do the same level of due diligence for the ESOP transaction as a "real world buyer is going to do." *Brundle on behalf of Constellis Employee Stock Ownership Plan v. Wilmington Tr. N.A.*, 241 F. Supp. 3d 610, 637 (E.D. Va. 2017), *aff'd*, 919 F.3d 763 (4th Cir. 2019). The District Court described the trustee's due diligence as "comparatively lackluster" and criticized the trustee for ignoring several red flags that should have warned the trustee that the proposed transaction was not prudent. *Id*. at 636-648. This Court affirmed a $29.7 million judgment against the trustee to compensate the ESOP. *Brundle*, 919 F.3d at 783.

Other cases also demonstrate the consequences of an ESOP trustee's failure to perform "real world" due diligence. In *Perez v. Bruister*, the Fifth Circuit held that the trustee's due diligence was inadequate and defendants' "conduct was lacking in the care necessary to enable them to rely reasonably" on valuations of the subject company. 823 F.3d 250, 264 (5th Cir. 2016). Likewise, in *Pizzella v. Vinoskey*, the court criticized the ESOP trustee's "lackluster due diligence and unreasonable

reliance on [its financial advisor's] appraisal." 409 F. Supp. 3d 473, 516 (W.D. Va. 2019). Following trial, the court identified multiple due diligence shortcomings by the trustee, including the trustee's agreement for the ESOP to pay a controlling-interest price for company stock, even though the selling shareholders would retain a "firm grip" over the company following the ESOP transaction. *Id*. at 514-516. Plaintiff in the present case has alleged that the Defendant trustee, here Argent Trust, likewise permitted the Choate Construction ESOP to pay for a controlling interest in the Company, despite the Selling Shareholders' ability to retain a significant amount of control over the Company through warrants they received from the transaction. Joint Appendix ("JA") 010-011, 019.

In *Perez v. First Bankers Trust Services, Inc.*, No. CV124450MASDEA, 2017 WL 1232527, at *20 (D.N.J. Mar. 31, 2017), the ESOP trustee failed to review the financial information provided by the selling shareholders "to ensure that it was accurate or complete." The trustee also blindly accepted the selling shareholder's representation that the company was evolving away from reliance on its primary customer even though the trustee received documents showing the opposite was true. *Id*. at *24. And in *Kindle v. Dejana*, the defendant trustee failed to spot an error in the transaction valuation report, resulting in a substantial overpayment by the ESOP. 238 F. Supp. 3d 353, 370 (E.D.N.Y. 2017).

As shown by these examples, the ESOP trustee's due diligence shortcomings have often resulted in the ESOP paying more than fair market value in private company ESOP transactions.

C. ESOP Trustees May Fail to Engage in Hard Bargaining to Get the Best Price Possible for ESOP Participants.

Some ESOP trustees do not understand that they have a statutory duty to negotiate the best price possible for the ESOP. Rather, they see their role as crafting a transaction that satisfies the goals of the selling shareholders. For example, in *Perez v. Bruister*, one of the ESOP trustees testified that "as a trustee for the [ESOP], she tried to determine what was best for everyone, including [the selling shareholder]." 54 F. Supp. 3d 629, 659 (S.D. Miss. 2014), *aff'd as modified*, 823 F.3d 250 (5th Cir. 2016). The Fifth Circuit noted that "[t]he trustees did not separate the [sellers'] personal interests from [the] valuation process so as to avoid a conflict of interest," and affirmed the District Court's finding that the defendants breached their duty of loyalty. 823 F.3d at 261-62. In *Horn v. McQueen*, "[t]he price paid by the ESOP for the [CEO's] shares was not reached through negotiations between the ESOP and [CEO]." 215 F. Supp. 2d 867, 881 (W.D. Ky. 2002). The ESOP trustee testified that the "price simply reflected the amount he already knew that [the CEO] wanted for his interest in the company." *Id*. Likewise, in *Howard*, the Ninth Circuit reversed the District Court's judgment for the defendant fiduciaries because, among other things,

the ESOP "fiduciaries completed the transaction without negotiation." 100 F.3d at 1489.

The failure of ESOP trustees to vigorously represent the interests of plan participants may arise in part from the close connections between the trustees and the tight-knit community of ESOP advisors. As noted by this Court in *Brundle*, "CSG, Wilmington, and SRR maintained significant long-term business relationships, having worked together on more than twenty ESOP deals . . . the ESOP world . . . [is] a very incestuous community." *Brundle*, 919 F.3d at 771 (4th Cir. 2019) (citation and quotation omitted). And three of the advisors involved in the *Brundle* transaction—CSG Partners, Stout Risius & Ross ("SRR") and Greenberg Taurig—were also involved in the Choate Construction ESOP transaction. JA 016 – 017.

As the District Court in *Brundle* noted, CSG Partners, SRR, and Greenberg Taurig "worked with one another regularly[,]"; CSG Partners had previously referred 23 ESOP deals to the ESOP trustee in the *Brundle* transaction; and the trustee could not recall "ever asking SRR to revise any of its valuation reports." *Brundle*, 241 F. Supp. 3d at 617 (citations omitted). Indeed, the District Court in *Brundle* concluded that the ESOP trustee's "lack of engagement and willingness to negotiate so favorably with CSG may have been motivated by its significant business relationship with CSG. . . . These long-term business relationships support the

conclusion that [the ESOP trustee] had become complacent in relying upon SRR's evaluation, and may have had an incentive to maintain its lucrative relationship with CSG." *Id*. at 643.

II. PLAINTIFF PLAUSIBLY ALLEGES THAT HER ESOP PAID MORE THAN ADEQUATE CONSIDERATION FOR CHOATE STOCK AND THUS HAS SUFFICIENTLY ALLEGED ARTICLE III INJURY-IN-FACT.

In this case, Plaintiff has alleged both breach of the fiduciary duty of prudence and prohibited transaction claims against the Defendant ESOP trustee. JA 024-033. ERISA's prohibited transaction rules bar "the fiduciary of any ERISA plan from causing a 'sale or exchange . . . of any property between the plan and a party in interest.'" *Brundle*, 919 F.3d at 769 (citing 29 U.S.C. § 1106(a)(1)(A)). "Absent a statutory exception, this provision would ban ESOPs because their creation necessarily requires the ESOP to purchase stock from its sponsoring employer, which is a party in interest. Congress, however, has carved out an exception to this prohibition to permit the creation of an ESOP if the stock purchase meets certain conditions. *See* 29 U.S.C. § 1108(e)." *Id*. at 769-770. The primary requirement of the prohibited transaction exception is that "an ESOP pay no more than 'adequate consideration' for the employer's stock. [29 U.S.C.] § 1108(e)(1)." *Id*. at 770. "Because an ESOP fiduciary that raises an affirmative defense under the § 1108(e) exception seeks to avoid ERISA liability for an otherwise prohibited transaction, the fiduciary bears the burden of proving by a preponderance of the evidence that the

sale was for adequate consideration. This burden is a heavy one." *Id*. (citation and quotation omitted).

The elements of the breach of fiduciary duty and prohibited transaction claims overlap because an ESOP trustee's procedural prudence in investigating the disputed transaction is a key element of a prohibited transaction claim: "Like the inquiry into whether a fiduciary acted with loyalty and care, the inquiry into whether the ESOP received adequate consideration focuses on the thoroughness of the fiduciary's investigation." *Howard*, 100 F.3d at 1488 (citation omitted); *see also Fish v. GreatBanc Tr. Co.*, 749 F.3d 671, 681 (7th Cir. 2014) ("Whether [the defendant trustee] properly approved the buy-out transaction despite the prohibition in [29 U.S.C.] § 1106 depends on whether its process was sufficient to fulfill the procedural requirement of adequate consideration"); *Brundle*, 919 F. 3d at 770 (court's inquiry into whether defendants caused ESOP to engage in a prohibited transaction by paying more than "adequate consideration" for company stock "rests on the *conduct* of a fiduciary, as judged by ERISA's 'prudent man' standard of care." (emphasis in original)); *Henry v. Champlain Enters., Inc*., 445 F.3d 610, 619 (2d Cir. 2006) (same).

Here, the Complaint includes plausible allegations that the ESOP paid more than adequate consideration for Choate Construction stock in the 2016 transaction because, *inter alia*, the transaction price did not account for the fact that the selling

shareholders would retain substantial control over the Company following the ESOP transaction and the selling shareholders received warrants that diluted the ESOP's ownership interest. JA 010-011, 019. At the pleading stage, these allegations are sufficient for Article III standing. "If an employer's stock was not worth what the ESOP paid for it, then the ESOP paid more than adequate consideration *and the ESOP and its participants suffered a loss under ERISA.*" *Brundle*, 919 F.3d at 770 (emphasis added; quotations omitted)

CONCLUSION

This Court and other courts have found that trustees breached their fiduciary obligations under ERISA in numerous private company ESOP transactions when they caused ESOP participants to pay too high a price for private company stock. In the numerous cases cited above, courts have found that fiduciary defendants caused financial losses to the ESOP and awarded a monetary judgment for the benefit of the ESOP participants. Plaintiff is entitled to discovery to prove the similar allegations in her Complaint—this is not a case that can be decided on the pleadings. Therefore, the judgment of the District Court should be reversed.

CERTIFICATE OF COMPLIANCE

The undersigned attorney certifies that this brief complies with the applicable type-volume limitations set forth in Fed. R. App. P. 32(a)(7)(B). The brief contains 3,832 words, excluding the parts of the document exempted by Fed. R. App. P. 32(f), as determined by the word-count feature of Microsoft Office Word 2019 in 14-point, proportionally spaced Times New Roman font.

Dated: March 30, 2020

/s/ Catha Worthman
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CERTIFICATE OF SERVICE

I hereby certify that on March 23, 2020, I electronically filed the foregoing with the Clerk of Court for the United States Court of Appeals for the Fourth Circuit by using the CM/ECF system. I certify that all participants in the case are registered CM/ECF users and that service will be accomplished by the CM/ECF system on the registered counsel.

Dated: March 30, 2020

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