LEWIS, FEINBERG, LEE, RENAKER & JACKSON, P.C.
ATTORNEYS AT LAW
476 9TH STREET
OAKLAND, CALIFORNIA 94607

PHONE: (510) 839-6824 • FAX: (510) 839-7839
SENDER'S E-MAIL: NWASOW@LEWISFEINBERG.COM

April 1, 2011

Employee Benefits Security Administration
Office of Regulations and Interpretations
Attn: Public Hearing on Definition of Fiduciary
United States Department of Labor
200 Constitution Ave., NW
Washington, D.C. 20210

RE: Proposed Regulation on the Definition of "Fiduciary"

Lewis, Feinberg, Lee, Renaker & Jackson, P.C. ("LFLRJ") submits the following comment on the Department of Labor's proposed regulation on the definition of "fiduciary."

Since 1976, LFLRJ has engaged in litigation and consulting work throughout the United States on all aspects of employee benefits, including benefit entitlement, fiduciary responsibility, plan design and administration, federal preemption, service-provider malpractice, prohibited transactions, and compliance with the requirements of the Department of Labor and other regulatory agencies. The firm has represented ESOP participants in class-action lawsuits alleging that ESOP fiduciaries breached their duties and engaged in prohibited transactions by causing the ESOP to pay more than fair market value for employer stock.[1]

We support the entire proposed regulation, but wish to comment specifically on the inclusion of valuators or appraisers of closely-held employer securities within the definition of "investment advisors" who are subject to ERISA's fiduciary rules. Some commenters suggest

[1] These cases include: *Neil v. Zell*, Case No. 08 C 6833 (N.D. Ill.) (representing a class of participants in the Tribune Co. ESOP against GreatBanc Trust Co., the ESOP trustee); *Clarke v. Lindeman*, Case No. 09-3467 JAM DAD (E.D. Cal.) (representing a putative class of participants in the Valley Aggregate Transport, Inc. ESOP); *Fernandez v. K-M Industries Holding Co., Inc.*, Case No. C 06-7339 CW (N.D. Cal.) (represented a class of participants in the K-M Industries Holding Co., Inc. Employee Stock Ownership Plan; class-wide settlements resulted in the payment of $55 million); *Horn v. McQueen*, 215 F. Supp. 2d 867 (W.D. Ky. 2002) (represented a group of employees of the U.S. Corrections Corp. of America; after trial, class-wide settlements resulted in the payment of over $13 million); *Udd v. Vidinsky, et al.*, Case No. CV 04-05080 JW (N.D. Cal.) (represented participants and beneficiaries of the Valin Corporation Amended ESOP; pursuant to a settlement, the plan received an addition 53,327 additional shares worth approximately $3.13 million including interest).

that the problem of faulty ESOP valuations is not serious and the Department's intervention in this area is unwarranted.[2] We disagree.

Case law shows that incorrect ESOP valuations are not unusual. *See, e.g., Reich v. Valley Nat Bank of Arizona*, 837 F. Supp. 1259, 1275 (S.D.N.Y. 1993) (finding the valuation erroneous because it failed to analyze key aspects of the ESOP transaction); *Mohler v. Unger*, 1194 WL 1752237, at *5 (S.D. Ohio Aug. 26, 1994) (upholding a jury's finding that valuation of stock was erroneous and did not accurately reflect fair market value); *Howard v. Shay*, 100 F.3d 1484, 1489 (9th Cir. 1996) ("Even a cursory review of the Arthur Young valuation and fairness opinion reveals the carelessness of this tack."); *Montgomery v. Aetna Plywood, Inc.*, 39 F. Supp. 2d 915, 930 (N.D. Ill. 1998) (holding that "appraisal contained three valuation errors that seriously undermined [the appraiser's] conclusions...[appraiser] reduced the Company valuation by $6 million" based on a "fiction," and rejecting valuator's methods and discounts as "unsound"); *Chao v. Hall Holding Co., Inc.*, 285 F.3d 415, 430-32, 440 (6th Cir. 2002) (holding that, as a result of the valuator appraising the wrong asset and other problems, the ESOP overpaid by more than $1 million for employer stock); *Horn v. McQueen*, 215 F. Supp. 2d 867, 884 (W.D. Ky. 2002) (calling into question whether the valuator "had begun meaningful valuation work. . . as of the week before the transaction was to close"); *Kloots v. American Express Tax & Business Servs., Inc.*, 2006 WL 1644373, at *2 (N.D. Ohio June, 12, 2006) ("the valuation method used...did not account for the complex set of factors approved by the US Department of Labor" and "was not a good faith fair market determination as required by ERISA"). In addition to reported cases, other litigation alleging overpayment for employer stock based on faulty valuations has settled favorably to plaintiffs in recent years. *See, e.g., Fernandez v. K-M Industries Holding Co., Inc. et al.*, Case No. C 06-7339 CW (N.D. Cal.) (settled for $55 million); *Beam v. HSBC Bank USA, et al.*, Case No. 02-0682 (W.D.N.Y.) (settled for $9.35 million).

The impact of such valuation errors on plan participants is severe. Because fiduciaries tend to lack knowledge and expertise about business valuation, they rely heavily on valuators to support the price of stock bought or sold by ESOPs. Any overstatement (or understatement) of value by the valuator translates directly to overpayment by (or underpayment to) the participants.

Treating ESOP valuators as fiduciaries makes sense. Under the current statutory and regulatory scheme, ESOP fiduciaries can sometimes evade responsibility for imprudent decisions by claiming reliance on a valuator, but the valuator is not a fiduciary, and thus the participants are left with the losses. Further, valuators certainly provide "investment advice" – they support (or not) the price that the ESOP pays in a transaction. They give the transaction price the imprimatur of accuracy and fairness. This is appropriately characterized as investment advice. The interpretation of ERISA § 3(21)(A)(ii) as excluding valuators from the definition of persons who "render[] investment advice for a fee" has arguably been incorrect all along, and we applaud the Department's efforts to correct this in the proposed regulation.

[2] For instance, the ESOP Association states that it has not "heard significant numbers of complaints from its corporate or fiduciary members about incorrect ESOP valuations." ESOP Association Comment on Proposed Regulation, January 31, 2011 ("Comment"), p. 4. This is not surprising: inaccurate valuations can lead to significant liability for plan fiduciaries, so they have an incentive not to publicize such errors.

Moreover, conferring fiduciary status on valuators will not absolve the trustee of its traditional responsibility to review, understand, question, and ultimately approve the price of ESOP shares. As is the case now, if the proposed regulation is implemented, the valuator's job will be to provide accurate, reliable, and independent advice as to the value of employer securities.[3] We see no reason that a court could not find that a valuator breached its fiduciary duty by using an improper methodology, failing to consider material information, failing to apply appropriate discounts, or using unsupportable valuation multiples, *and* that the trustee breached its fiduciary duty by failing to read, understand, or question the valuation, failing to obtain a better valuation, failing to negotiate on behalf of the ESOP participants, or committing any other procedural or substantive error that results in the ESOP paying too much for employer stock. How the damages would be allocated between the two fiduciaries would depend upon the facts and circumstances of the case, but it is clear that ERISA imposes joint and several liability on defendant fiduciaries. *See, e.g., In re Worldcom, Inc. ERISA Litigation*, 339 F. Supp. 2d 561, 568 (S.D.N.Y. 2004). Treating valuators as fiduciaries does not undermine the trustee's role any more than the long-standing treatment of other investment advisors as fiduciaries. *See, e.g., Lowen v. Tower Asset Management, Inc.*, 829 F.2d 1209, 1218-20 (2d Cir. 1987).

Having the option to pursue claims against the appraiser will certainly benefit plan participants if the trustee is insolvent, undercapitalized, or under-insured. Further, if the trustee took appropriate procedural steps to review and understand the valuation and generally acted in the participants' best interests, but the plan still paid more than adequate consideration, the valuator may be the only person who can make the plan whole.

The ESOP Association advances a "sky is falling" argument against the proposed regulation, namely, that valuators will decide to get out of the ESOP business rather than accept the risk of fiduciary liability, which will make it more difficult for trustees to obtain competent appraisals and increase the cost of implementing and maintaining ESOPs (due to appraisers passing on the cost of fiduciary liability insurance, the need for additional legal advice, etc.), and increase the odds that business owners will "pursue other means of ownership transition . . . which may result in less wealth in qualified plans." Comment, p. 5. We are aware of no empirical support for the proposition that appraisers will exit the industry, and they are already exposed to potential liability for faulty valuations via state-law malpractice claims. *See, e.g., McDannold v. Star Bank N.A.*, 261 F.3d 478, 481 (6th Cir. 2001). Although valuators may demand higher fees and/or broader indemnification provisions based on the risk of ERISA fiduciary liability, it seems highly unlikely that this would cause businesses to stop using ESOPs as a tool of corporate finance, given their enormous tax advantages.

Finally, the ESOP Association proposes that the Department provide guidance regarding valuation standards and valuator credentials rather than "punishing" valuators by treating them as

[3] The complaint by some commenters that valuation is an art, not a science, and that appraising a business involves the exercise of professional judgment, is neither here nor there. The same is true of fiduciary decisionmaking. Courts have shown themselves to be capable of drawing the line between the reasonable exercise of judgment and discretion, on the one hand, and fiduciary misconduct, on the other.

fiduciaries. Comment, p. 6-7. But the problem the Department is attempting to address is not with appraisers' inadequate credentials. The problem is that valuators serve their clients, and as the ESOP Association points out, most ESOP transactions are entered into by the owners of privately-held companies. Comment, p. 1. The valuator is generally hired by the company, and the company is controlled by its owner, who generally has an interest in getting as much money as possible in the transaction, and has a strong idea of the worth of the company that he or she grew. The valuator wants to get the job and be re-hired for annual valuations. Thus, the valuator has an interest in giving the owner what he or she wants. It is not a truly arms-length relationship. Adding the potential for fiduciary liability counter-balances this situation, making the appraiser's self-interest align more closely with the participants' interests.

In sum, the Department's proposed addition of ESOP valuators to the ranks of ERISA fiduciaries would be a change for the better. Thank you for your attention.

Sincerely,

LEWIS, FEINBERG,
RENAKER & JACKSON, P.C.

By Nina Wasow

Nina Wasow