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From: John Menke [<mailto:JMenke@MENKE.com>]

Sent: Wednesday, January 19, 2011 11:28 PM

To: EBSA, E-ORI - EBSA

Subject: FW: Definition of Fiduciary Proposed Rule

Menke & Associates, Inc. is a consulting firm that specializes in the design and installation of ESOPs. Based upon our 35 years of experience in designing and installing ESOPs for privately held firms, we believe that the proposed rule is unworkable. We understand the need to clarify the respective duties and responsibilities that apply to ESOP fiduciaries and to ESOP appraisers. However, we believe that the proposed rule violates certain fundamental principles of trust law. That said, we do believe that the proposed rule can be modified to accomplish your objectives without violating long established principles of trust law.

The Department of Labor's proposed rules defining adequate consideration (29 C.F.R. §2510.3-18) make it clear that while a fiduciary may act pursuant to the report of an independent appraiser, the fiduciary bears the ultimate responsibility to make a prudent decision.

Similarly, the courts have uniformly held that the fiduciary bears the ultimate responsibility despite relying on the advice of outside experts. See *Howard v. Shay*, 100 F.3d 1484 (9th Cir. 1996), cert. denied, 520 U.S. 1227 (1997) (a fiduciary "is required to make an honest, objective effort to read the valuation, understand it, and question the methods and assumptions that do not make sense"); *Donovan v. Mazzola*, 716 F.2d 1226, 1234 (9th Cir. 1983) (counsel's asserted advice that expenditure was prudent does not immunize trustees); *Katsaros v. Cody*, 744 F.2d 270, 279 (2d Cir), cert denied, 469 U.S. 1072 (1984); *Donovan v. Cunningham*, 716 F.2d 1455, 1474 (5th Cir. 1983) (fiduciaries may rely on appraisal but it "is not a magic wand"; fiduciaries bear responsibility for assuring that appraisals are complete and up to date), cert. denied, 467 U.S. 12511 (1984); *Thompson v. Avondale Indus., Inc.*, 29 EBC 2865 (E.D. La. 2003); *Reich v. Valley Nat'l Bank of Arizona*, 837 F. supp. 1259 (S.D.N.Y. 1993); *Andrade v. Parsons Corp.*, 12 EBC 1954 (C.D. Cal. 1990), aff'd 1992 U.S. App. LEXIS 18220 (9th Cir. 1992); *Whitfield v. Cohen*, 682 F. Supp. 188, 194 (S.D.N.Y. 1988); *Donovan v. Walton*, 609 F. Supp. 1221, 1227 n.10 (S.D. Fla. 1985); *Donovan v. Tricario*, 5 EBC 2057,2064 (S.D. Fla. 1984); *Davidson v. Cook*, 567 F. Supp. 225, 236 (E.D. Va. 1983), aff'd mem., 734 F.2d 10 (4th Cir), cert. denied, 469 U.S. 899 (1984).

In the ESOP arena, many owners of privately-held firms have been able to avoid personal fiduciary liability by appointing an "independent fiduciary" who assumes complete fiduciary responsibility and liability for approving and executing specific transactions that involve the purchase of company stock by an ESOP or the sale of company stock by an ESOP. The independent fiduciary in these situations discharges his fiduciary responsibility by (1) conducting his or her own due diligence investigations, (2) obtaining an adequate consideration report (and in some cases a fairness opinion) from an independent appraiser, and (3)

by reviewing the adequate consideration report (and the fairness opinion, if any) to determine (a) the reasonableness of the assumptions, (b) the correctness of the methodology, and (c) the reasonableness of the final conclusion.

The proposed rule would obviate this procedure. The proposed rule would treat the independent appraiser as an ERISA fiduciary. Accordingly, the so called independent fiduciary would be entitled to rely upon the "expert" fiduciary, and the independent fiduciary would seldom if ever be held liable for a breach of fiduciary duties. The result would be the opposite of what is intended. The independent fiduciary would provide less due diligence and less oversight than exists under the current procedures.

Changing the existing rule in those cases where the ESOP has appointed an independent fiduciary would also overrule a long line of cases in which the courts have held that "a fiduciary is a person who exercise any power of control, management or disposition with respect to monies or other property of an employee benefit fund, or has the authority or responsibility to do so." *Farm King Supply v. Edward D. Jones & Co.*, 884 F.2d 288, 292 (7th Cir. 1989), citing *Forys v. United Food & Commercial Worker's International Union*, 829 F.2d 603, 607 (7th Cir. 1987). Under these cases, a showing of authority or control requires "actual decision-making power" rather than the type of influence that a professional advisor may have with respect to decisions to be made by the trustees or fiduciaries that it advises. *Id.*; *Pappas v. Buck Consultants, Inc.*, 923 F.2d at 535; *Laborers' Pension Fund v. Arnold*, 2001 WL 197634, at *3-5 (N.D.ILL Feb. 27, 2001). The application of the proposed rule in those cases where the ESOP has appointed an independent fiduciary would make the ESOP appraiser liable as an ERISA fiduciary even though the ESOP appraiser is not the person who exercises the power to negotiate and execute the transaction. The application of the proposed rule in these situations would be both unfair and unnecessary.

To the extent that there have been abuses of the valuation process, it occurs in those cases where the ESOP fiduciaries consists of individuals rather than institutional trustees or independent fiduciaries. Common law principles going back to the reign of Edward III (1327 -1377) allow any individual to act as a fiduciary, provided that the individual is competent and does not have a criminal record. In some cases, however, individual fiduciaries are not fully qualified to review an appraisal report to determine the reasonableness of the assumptions and the correctness of the methodology.

The solution is not to mandate that all fiduciaries must be institutional trustees or that all ESOP appraisers must be deemed to be ERISA fiduciaries. Rather, the solution may be to require that the appraisal report must be "audited" by an independent CPA firm in all cases where the ESOP fiduciary is neither an institutional trustee nor an independent fiduciary. This rule would be similar to the existing IRS requirement that all qualified plans must be audited by an independent CPA firm if the plan has more than 100 participants. Granted, implementation of this rule would add to the cost of maintaining an ESOP in those cases where the ESOP does not have an institutional trustee or an independent fiduciary. However, this cost would be relatively nominal, and would be far less than the costs that

would be incurred if all ESOPs were required to have an institutional trustee or if all ESOP appraisers were deemed to be ERISA fiduciaries. Further, requiring that the appraisal report be reviewed by an independent CPA firm is far more likely to prevent fraudulent valuations and erroneous valuations than would be the case if ESOP appraisers were merely put on notice that they may potentially be held liable as an ERISA fiduciary.

In summary, we believe that any rule that proposes to shift the primary fiduciary liability to the ESOP appraiser regardless of the appraiser's actual decision-making authority is unfair and unworkable. What is needed instead is a rule that follows existing case law in holding the person with the actual decision-making authority liable as an ERISA fiduciary, but adds the additional requirement that all individual fiduciaries must secure an outside CPA audit of the appraisal report before making their final decision. We believe that implementation of this requirement will eliminate almost all of the abuses and mistakes that the DOL has observed in reviewing ESOP appraisals, and it will do so without subjecting ESOP appraisers, most of whom are competent and conscientious, to undue risk and liability as ERISA fiduciaries.

Lastly, it should be noted that any question of divided loyalties on the part of an ESOP appraiser has already been addressed in the 1988 DOL proposed rules defining adequate consideration as follows:

"It should be noted that, under these proposed provisions, an appraiser will be considered independent of all parties to a transaction (other than the plan) only if a plan fiduciary has chosen the appraiser and has the right to terminate that appointment, and the plan is thereby established as the appraiser's client. Absent such circumstances, the appraiser may be unable to be completely neutral in the exercise of his function."

Under this provision, an ESOP appraiser is already charged with the fiduciary duty to provide his client, the ESOP fiduciary, with a professional valuation report that is the product of proper due diligence and the application of correct methodologies to the known facts and to reasonable assumptions. If the ESOP appraiser fails to discharge his duties to his client in a professional and competent manner, he can and should be held fully liable for professional negligence and/or professional malpractice in a state court action in the state where he resides or where he performs his services. An action for professional malpractice is not something, however, that should come under federal jurisdiction or under the jurisdiction of the DOL. Conversely, if the appraisal report is properly prepared and the appraiser also renders an opinion that the terms of the transaction are fair (but not necessarily ideal) to the participants, the ESOP appraiser should not be held liable as an ERISA fiduciary if the subject company later turns out to be a poor investment. Whether or not an investment subsequently turns out to be a good investment or a poor investment turns upon many factors other than price and terms. The ESOP fiduciary is responsible for making the actual investment decision on behalf of the ESOP. Since the ESOP appraiser has no say in the final investment making decision, the ESOP appraiser should not be held liable as an ERISA fiduciary. To say otherwise would be tantamount to saying that the ESOP appraiser is always the true fiduciary and that the plan fiduciary is nothing more than a directed

fiduciary who may have secondary liability but never the primary liability. Clearly such a rule would violate fundamental principles of trust law and would be unworkable.

Very truly yours,

John D. Menke
President & CEO
Menke & Associates, Inc.
(415) 362-5200 Phone
(415) 398-2260 Fax
jmenke@menke.com