

# Pizzella v. Vinoskey: A Costly Lesson to Learn

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*In the 2019 Pizzella v. Vinoskey judicial decision, the United States District Court found that the employee stock ownership plan (“ESOP”) fiduciaries of Sentry Equipment Erectors, Inc., did not act with prudence and that they violated their fiduciary duties. The fiduciaries failed to further investigate the inconsistent assumptions applied in the valuation of the sponsor company stock that they relied on for the ESOP to purchase stock from the sponsor company owner. The District Court held that the ESOP fiduciaries were liable for \$6,502,500 in damages because they knowingly participated in a prohibited transaction that caused the ESOP to pay more than adequate consideration for the sponsor company stock.*

## INTRODUCTION

Congress implemented the Employees Retirement Income Security Act of 1974 (“ERISA”) to protect employees and the benefit plans employers created for them. One such plan is an employee stock ownership plan (“ESOP”).

To protect employees from employers completing stock transactions with the ESOP that benefit the employer-owners at the expense of the employees, ERISA imposes high standards of fiduciary duty on ESOP administrators.

In an ESOP, the employee participants can receive compensation in the form of company shares purchased by the ESOP for distribution to the employees. ERISA bans certain transactions between parties of interest (i.e., the ESOP and company owners) unless these transactions are transacted for “adequate consideration.”

Further, it is the responsibility of an ESOP fiduciary under ERISA to ensure that these types of transactions occur at a price that is no more than adequate consideration.

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 in accordance with regulations promulgated by the Secretary.”<sup>1</sup>

Private company stock that is held in an ESOP should be valued at least annually. The annual valuation is used for plan administration purposes, such as for providing distributions to departing plan participants.

Significant changes in sponsor company stock valuation conclusions from year to year may occur as market conditions and sponsor company operations change. It is important that any significant changes in the valuation methods and assumptions be discussed with the ESOP trustee(s) and company management.

In *Acosta v. Vinoskey*,<sup>2</sup> the ESOP trustees learned this costly lesson. This case went to trial in the United States District Court for the Western District of Virginia under *Patrick Pizzella v. Adam Vinoskey, et al.*<sup>3</sup>

In its case presented before Judge Norman K. Moon, the Secretary of Labor (“Secretary”) alleged that Sentry Equipment Erectors, Inc. (“Sentry”), its chief executive officer, Adam Vinoskey (“Vinoskey”), and other fiduciaries, Kenny Lenoir (“Lenoir”) and Michael New (“New”) of Evolve Bank and Trust (“Evolve”), hereafter referred to as “Defendants,”

breached their fiduciary duties and thus violated ERISA by approving the ESOP purchase of 52 percent of the Sentry stock at \$406.00 per share from Vinoskey.

The Secretary alleged that in paying more than fair market value, the ESOP overpaid by \$11,526,000.

The U.S. District Court (“District Court”) agreed and ruled that Vinoskey and Evolve were jointly liable for \$6,502,500 in damages because they knowingly participating in a prohibited transaction that caused the ESOP to pay more than adequate consideration for the Sentry stock.

For the valuation of stock for ESOP purposes, it is prudent for an ESOP fiduciary to hire a valuation analyst who is not only qualified to perform the valuation, but also understands that continuity in how the valuation is performed is important to the long-term success of the ESOP.

Therefore, any significant changes in valuation methodologies and values from year to year should be reconciled, documented in the report, and explained to the ESOP trustee(s) and ESOP sponsor company management.

This review of the District Court decision indicated that if the ESOP fiduciaries had invested more effort into understanding and resolving the issues identified in the valuation of the sponsor company stock, an audit by the Department of Labor could have been avoided.

## CASE BACKGROUND

Founded in 1980 by Adam and Carole Vinoskey (the “Vinoskeys”) and based in Virginia, Sentry designs and sells equipment such as conveyors and bottling machines for soft drink manufacturers.

The Vinoskeys created the ESOP, which included a 401(k) defined contribution plan and an employee stock ownership feature.

Because the skills required to operate a bottling plant are in high demand, Sentry retains its employees by providing generous health care (paying 100 percent of the premiums) and retirement benefits, including the ESOP.

Vinoskey was a trustee of the ESOP (and thus a fiduciary under ERISA), the Sentry chief executive officer, and chairman of the Sentry board of directors. Vinoskey was an ESOP trustee from 2006 to at least July 2012.



Sentry hired William Gust (“Gust”) of Gentry Locke to provide legal services to the ESOP. Capital Analysts, Inc. (“CAI”), a valuation firm owned by Brian Napier (“Napier”), CAI president, was hired to estimate the fair market value of the Sentry stock on an annual basis for ESOP administration purposes.

From 2005 to 2009, the values of the Sentry stock estimated by Napier ranged from \$215 per share (December 2005) to \$285 per share (December 2009). Vinoskey testified at trial that he reviewed and understood the valuations of the Sentry stock for ESOP purposes every year.

In 2004, the ESOP purchased 48 percent of the Vinoskeys Sentry stock for \$220 per share, or approximately \$9.0 million in total. The ESOP paid \$1.5 million to the Vinoskeys and the remainder of the price was borrowed from Sentry.

With contributions made by Sentry to the ESOP, the ESOP paid off its debt before 2010. Shares of Sentry stock were allocated to individual ESOP participants as the debt was paid off.

In December 2010, Vinoskey decided to retire and, through the Adam Vinoskey Trust, Vinoskey wanted to sell the remaining 52 percent interest in Sentry to the ESOP (“2010 Transaction”). Gust recommended hiring Evolve to serve as an independent transactional trustee for the 2010 Transaction.

In an email to Evolve on November 9, 2010, Gust invited Evolve to serve as a transactional trustee for the 2010 Transaction, which was estimated at approximately \$21 million by Napier. On November 12, 2010, Evolve sent an engagement letter to Sentry for its services as a transactional trustee.

On November 17, 2010, Michael Coffey who had assisted Gust on the ESOP transaction in 2004, emailed New (copying Gust and Napier in the email) an attachment with his price estimate of the 2010 Transaction at \$20,931,963.

On the same day, Lenoir and New presented to Evolve's ESOP Administration Committee and provided an attachment showing the size of the transaction was approximately \$21 million. Lenoir was one of Evolve's largest shareholders and headed the bank's trust practice. He supervised New, a lawyer employed at Evolve as a senior trust officer.

On November 18, 2010, Evolve accepted the engagement letter with Sentry. On the same day, Lenoir and New toured the Sentry plant on a site visit and interviewed the Vinoskeys and the incoming president, Mike Connor ("Connor").

On November 29, 2010, Evolve contracted with CAI to perform the appraisal of the Sentry stock for the 2010 Transaction. On December 9, 2010, CAI sent a draft to Evolve and Gust that estimated the fair market value of the Sentry shares at \$405.73 per share on a controlling basis, or \$20,697,330 for the 51,000 shares of Sentry stock owned by Vinoskey.

Upon review of the draft appraisal, Lenoir and New had a few major concerns and emailed Napier about them on December 11, 2010:

- The addback of half of the health care insurance cost paid by Sentry for its employees
- Unexplained and unusually low capitalization rate
- No explanation of how Sentry's industry and the overall economy would affect Sentry going forward. In the November 18, 2010, management interview, Connor had claimed that due to slower growth in the beverage industry, 2011 may be a challenging year for Sentry. Connor believed Sentry needed to diversify further into the food sector because the beverage industry was being affected by the slower economy in 2010.
- No explanation of how Napier adjusted his methodology to account for the valuation of the stock on a controlling basis
- No application of the discounted cash flow method
- No weighting on the asset-based approach which would lower the estimated per share value

On December 13, 2010, Lenoir and New discussed their concerns about the appraisal with Napier. On December 14, 2010, before Napier

resolved Lenoir and New's issues and finalized his valuation report, the Sentry board announced that the ESOP would purchase Vinoskey's 51,000 shares of Sentry stock at a price not to exceed \$406.00 per share.

On December 15, 2010, Evolve offered Vinoskey, and Vinoskey accepted, the per share price of \$406.00. On the same day, Evolve drafted a Resolution of the Special Independent Trustee of Sentry Equipment Erectors stating that the \$406.00 per share price did not exceed fair market value.

The transaction was completed on December 20, 2010, without any negotiation by Evolve with Vinoskey, for the ESOP to purchase the stock at a lower price.

The ESOP paid for the 51,000 Sentry shares with \$8.5 million in cash, \$1.9 million borrowed from Sentry, and a \$10.3 million note from Vinoskey at an interest rate of 4 percent. After the transaction closed, Evolve resigned its role as an ESOP trustee for Sentry.

## DISTRICT COURT FINDINGS

The District Court ruled in *Acosta v. Vinoskey* that the Secretary's expert witness, Dana Messina ("Messina"), was a qualified expert. Defendants had filed a *Daubert* motion and tried to exclude the testimony of Messina. The District Court held that Messina, who founded the valuation firm Kirkland Messina, was sufficiently qualified to testify about the value of Sentry.

The District Court noted that Messina had earned an MBA from the Harvard Business School and had more than 25 years of business valuation experience. The District Court accepted the Messina calculation of the amount the ESOP overpaid for the Sentry shares.

Messina calculated the damages estimate by determining the fair market value of the Sentry stock and how much more than fair market value the ESOP paid to purchase Vinoskey's shares. The District Court ruled that this approach is generally used by courts to compute overpayments.

In *Acosta v. Vinoskey*, the District Court found that New was not a fiduciary based on the definition set by ERISA. New did not have the authority to authorize the 2010 Transaction or set the stock price without Lenoir's approval. Thus, the claims against New were dropped.

The case went to trial to determine if Evolve and Vinoskey violated their fiduciary duties under *Pizzella v. Vinoskey*. In *Pizzella v. Vinoskey*, the District Court ruled that Evolve and Vinoskey caused

the ESOP to pay more than adequate consideration for the Sentry stock.

The District Court agreed with the Secretary that Evolve did not act prudently and thus violated its fiduciary duties because Evolve did not question or investigate the issues it had identified during its review of the November 2010 Napier appraisal of the Sentry stock.

In reviewing the evidence, the District Court found the following inconsistencies between the November 2010 valuation and prior valuations completed by Napier, which the District Court believed should have alerted the ESOP fiduciaries to investigate further into the November 2010 appraisal.

- Using the capitalization of earnings method, Napier estimated net cash flow using three years of historical earnings (2007 to 2009), thereby capturing Sentry's peak years of earnings and not the full business cycle.

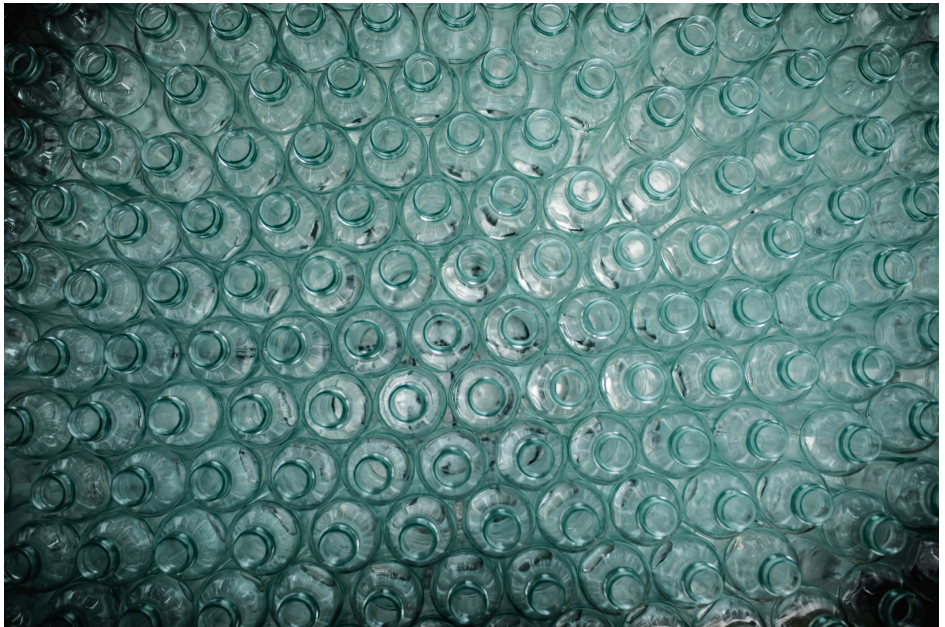
The Sentry earnings were typically cyclical depending on when large beverage companies made capital investments to their facilities. In his valuations of Sentry before 2008, Napier used five years of Sentry historical earnings in the capitalization of earnings method.

- Napier normalized earnings for the November 2010 appraisal by adding back half of Sentry's health care costs, which he did not do in his prior years' valuations. Napier admitted at trial that the health care cost add-back increased the per share price by \$50.00.

During the November 18, 2010, diligence meeting, New suggested to Vinoskey that Sentry could save money by requiring its employees to pay for some of their health insurance premiums. Vinoskey had adamantly refused because these benefits were important in retaining its skilled employees in a tight labor market.

- Napier used a capitalization rate of 16.2 percent in the 2009 appraisal but a capitalization rate of 12.2 percent in the November 2010 appraisal. Generally, the higher the capitalization rate, the lower the value.

The capitalization rate that Napier used in the November 2010 valuation was the lowest rate over the five-year period observed.



Just 11 days after the 2010 Transaction closed, Napier raised the capitalization rate to 18.2 percent in the December 31, 2010, valuation.

The lower capitalization rate in the November 2010 valuation was a result of applying a lower company-specific risk premium and a higher long-term growth rate, which Napier explained at trial (and not in his valuation report) was due to valuing a controlling interest in November 2010, instead of a noncontrolling interest in prior years.

- Napier added back excess cash and half the value of the land owned by Sentry for the 2010 Transaction, which increased the per share price of the Sentry stock by \$73.81. Napier did not add back these nonoperating assets in his prior years' valuations.
- In the November 2010 valuation, Napier used a 10 percent rate to calculate the Sentry working capital needs (10 percent cash to total assets or \$2.2 million), while in the post transaction appraisal as of December 31, 2010, Napier used a 20 percent rate.

The District Court concluded that appraisals of the Sentry completed after the 2010 Transaction were applicable because they allow the District Court to assess the reliability, creditability, and consistency of the expert witness' methodology in completing these appraisals.

Further, Napier even testified that he knew Sentry historically had maintained at

least 30 percent of its cash to cover working capital needs. In addition, Vinoskey had testified that Sentry would need at least \$10 million in cash to cover work-in-process and to withstand the cyclical nature of the Sentry business.

Messina argued that Napier intentionally caused the Sentry stock value to spike to meet the predetermined price of \$21 million for the 2010 Transaction. If Napier had been consistent in how he appraised the Sentry stock at November 2010, the per share value would be \$257.50, not \$405.73, indicating that the ESOP overpaid for the Sentry stock by \$7.5 million, according to Messina.

Napier testified that he was valuing the Sentry stock on a controlling basis for the 2010 Transaction because Vinoskey was selling a 52 percent interest, and after the transaction the ESOP would own 100 percent of the equity and have control over company operations.

Napier argued that the control considerations warranted a 40 percent increase in value and were the primary reason for the changes in assumptions made in his November 2010 valuation.

On the contrary, the Secretary argued that while the ESOP owned 100 percent of Sentry after the 2010 Transaction, it did not effectively control the Sentry operations.

The District Court agreed, and based on the evidence presented, found that the ESOP did not gain effective control of Sentry simply by purchasing 100 percent of the Sentry stock.

Pursuant to the ESOP and Sentry's bylaws, the board of directors have the power to appoint and remove ESOP trustees. Further, pursuant to the ESOP, the Sentry stock owned by the ESOP generally would be voted by the ESOP trustee(s), except in certain circumstances such as the sale of Sentry.

Before 2010, the Vinoskeys and another Sentry manager comprised the Sentry board. Before 2010, the Vinoskeys also served as two of Sentry's three ESOP trustees. Because of Sentry's corporate structure, the Vinoskeys had complete control over Sentry.

Vinoskey and his management team continued to manage Sentry after the 2010 Transaction. After 2010, Vinoskey and four other Sentry managers comprised the board. Sentry's board did not have an ESOP representative or outside directors and the Vinoskeys continued to serve as ESOP trustees, along with Connor.

The Vinoskeys' adamant refusal to cut health care premiums paid by Sentry for its employees was

evidence of their absolute control over the Sentry operations.

## SUMMARY AND CONCLUSION

While Evolve had concerns about the Napier appraisal of the Sentry stock for the 2010 Transaction, it did not ensure that its questions were addressed before finalizing the transaction. Instead, Evolve settled on the ESOP transaction price before Napier finalized his valuation report.

Additionally, the Evolve due diligence was rushed; its work on the 2010 Transaction began on November 9, 2010, and ended on December 20, 2010, in order for the transaction to close before year-end.

The District Court understood that Sentry would pay less income taxes for the year if the ESOP, a tax-exempt entity, owned 100 percent of the Sentry stock at year-end.

Ultimately, the District Court found that Evolve failed to act prudently as a fiduciary for the ESOP and was liable for damages suffered by the ESOP.

A careful review of the District Court decision indicates that when an ESOP trustee is fulfilling fiduciary duties imposed by ERISA when establishing the value of sponsor company stock, it is important that the ESOP fiduciary selects a valuation analyst who is both qualified to perform the valuation and understands that continuity in how the valuation is performed is important.

Any significant changes in the valuation methodologies and assumptions from year to year should be explained.

Errors or inconsistencies in the valuation that are not investigated and reconciled may draw the attention of regulating agencies, potentially leading to a costly legal dispute and significant financial consequences, as was the case in the 2019 *Pizzella v. Vinoskey* decision.

### Notes:

1. Regulation Relating to the Definition of Adequate Consideration; Notice of Proposed Rulemaking, 29 CFR Part 2510 (1988), p. 17,633.
2. *Acosta v. Vinoskey*, 310 F.Supp.3d 662 (W.D. Va. 2018).
3. *Pizzella v. Vinoskey*, 409 F.Supp.3d 473 (W.D. Va. 2019).

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