Judicial Opinions regarding the Constellis Group, Inc., and the SJP Group, Inc., ESOP Transactions

Chip Brown and Kyle Wishing

This discussion provides an overview of two recent judicial opinions related to employee stock ownership plan ("ESOP") installation transactions. While the judicial opinions are specific to the circumstances of the Constellis Group, Inc. ("Constellis"), ESOP transaction and the SJP Group, Inc. ("SJP"), ESOP transaction, these opinions may provide useful insights for prospective ESOP companies and professional ESOP advisers. The following discussion (1) introduces the two lawsuits, (2) provides context for the subject ESOP transactions, (3) lists the arguments that were presented in court, and (4) summarizes the judicial opinions.

The Constellis Litigation

On March 13, 2017, the judicial opinion was released for *Brundle, on behalf of Constellis Employee Stock Own*ership Plan v. Wilmington Trust N.A. (the "Constellis litigation").[1]

The Constellis litigation was petitioned by Tim P. Brundle, a former employee of Constellis and a former participant in the ESOP sponsored by Constellis. The Constellis ESOP was established in December 2013, when the ESOP acquired 100 percent of the outstanding Class A common stock of Constellis (the "ESOP transaction").

The Constellis lawsuit was filed against Wilmington Trust N.A. in connection with its role as trustee (the "trustee") of the Constellis ESOP.

The plaintiff alleged that the ESOP transaction was a prohibited transaction under the Employee Retirement Income Security Act of 1974 ("ERISA") Section 1106. The plaintiff alleged that the price of $4,235 per share paid by the ESOP in the ESOP transaction was greater than the fair market value of the stock, which caused the ESOP to overpay for the interest by $103,862,000.

The matter was tried in the United States District Court for the Eastern District of Virginia by Judge Leonie M. Brinkema. The court ultimately awarded damages of $29,773,250. The court estimated the damages amount by considering nine contested inputs into the valuation analysis for which the court concluded the fair market value of Constellis as of the transaction date.

Background of Constellis

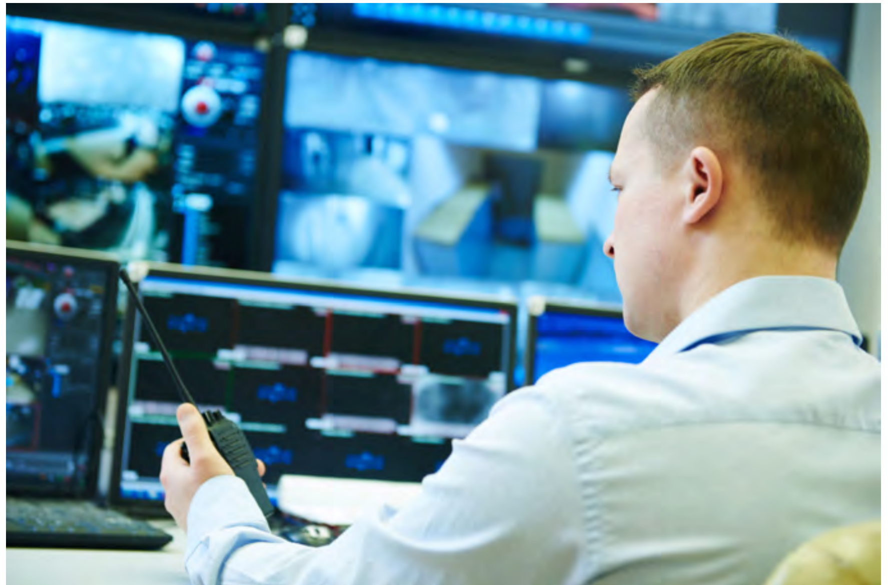
The predecessor of Constellis, Triple Canopy, Inc. ("Triple Canopy"), was formed by Thomas Katis and Matthew Mann in the fall of 2003. Triple Canopy was a private security firm that primarily served the U.S. Department of State and the U.S. Department of Defense ("DoD"). The company experienced steady growth as it was awarded several large contracts to provide fixed site security services.

Along the way, Triple Canopy acquired several other security companies and reorganized the companies as subsidiaries operating under Constellis. Triple Canopy was the largest subsidiary of Constellis.

Constellis entertained buyout talks from private equity firms in 2007 and again in 2012. However, neither transaction discussion ended in success. In 2012, Vestar Capital Partners was the potential acquirer. In the Vestar Capital Partners proposal,

the initial offer price was between $340 million and $350 million.

After due diligence was performed, Vestar decreased its offer price to $275 million prior to closing. The decrease in the offering price caused the deal to crater.



Background of the ESOP Transaction

In June 2013, a Constellis board member proposed the idea of forming an ESOP to the Constellis general counsel, Juliet Protas. Protas retained CSG Partners, LLC ("CSG"), to advise Constellis on the prospective formation of an ESOP.

Prior to the ESOP transaction, the Constellis equity ownership was as follows: Katis owned 31.1 percent, Mann owned 29.2 percent, Howard Acheson owned 11.1 percent, John Peters owned 5.6 percent, and other noncontrolling shareholders held the remaining equity (collectively, the "sellers").

CSG prepared a series of presentations to advise the sellers and Constellis management on ESOP structured transactions. These presentations highlighted the ESOP as a liquidation strategy and promoted the tax benefits for the sellers. CSG did not recommend a traditional 100 percent ESOP.

Instead, CSG recommended an alternative strategy that consisted of a 90 percent equity interest held by the ESOP and warrants for 10 percent of the equity held by the sellers.

The warrants allowed the sellers to appoint a majority of board members until the warrants were exercised. On September 26, 2013, immediately after the CSG presentation, Constellis management and the sellers decided to move forward with the ESOP transaction.

Constellis hired the trustee to serve as the ESOP trustee at the recommendation of CSG. The trustee then hired a financial adviser and legal counsel for the proposed transaction. The trustee was officially retained on October 25, 2013.

The ESOP Transaction

The ESOP transaction was structured in the same way it was proposed by CSG. The ESOP was to acquire all of the outstanding voting shares and the sellers were to receive warrants redeemable for 10 percent of the equity. The trustee's financial adviser prepared a valuation analysis and a fairness opinion, which it presented to the trustee on November 14, 2013.

The financial adviser concluded that the fair market value per share of Constellis stock was between $3,865 and $4,600 with a median fair market value of $4,235.

At the meeting, the trustee committee authorized the trustee team to negotiate a deal price between $3,900 and $4,235 per share with the stipulation that the sellers indemnify the full amount of a pending liability from the Defense Contracting Auditing Agency ("DCAA").

The sellers communicated that there was urgency to accept the offer in order to close the transaction prior to year-end for Constellis to obtain favorable tax treatment. Noncontrolling shareholders needed to receive a tender offer at least 20 days prior to closing.

On November 13, 2013, CSG and the sellers proposed a sale price of $4,525 per share. The trustee responded on November 15, 2013, with an offer price of $3,900 per share. After a few more rounds of negotiating, the parties agreed to $4,235 per share.

It was agreed that the Series A warrants (the warrant class that could elect members to the board) would expire 10 years from the transaction date.

Also, as part of the transaction, Constellis adopted a management retention plan, which provided a cash bonus to key managers if they agreed to stay with the company after the closing of the ESOP transaction. The cash bonus was set at 5 percent of the total transaction value. Stock appreciation rights ("SARs") for key members of management were also approved but not issued as part of the transaction.

Further, the sellers and Constellis[2] agreed to "reasonable commercially acceptable representations and warranties,"[3] for an amount up to 30 percent of the transaction price. Losses due to a breach of representations and warranties would, first, be offset by the seller notes and, second, be paid in cash.

On November 18, 2013, the tender offer to noncontrolling shareholders was issued. On December 20, 2013, the transaction was scheduled to close. The financial adviser updated its report prior to the closing date and maintained a similar range of value.

This analysis was presented to the trustee committee on December 18, 2013, and the transaction closed on December 20, 2013. In the transaction, the ESOP purchased 47,586.55 shares at $4,235 per share, or a total purchase price of $201,529,032.77. The transaction was funded with cash from Constellis (approximately 24 percent), a loan from Constellis (approximately 7 percent), and seller notes (approximately 69 percent).

Post-ESOP-Transaction Developments

In early 2014, there were a number of items that negatively affected the Constellis business operations.

One of the largest contracts of Constellis was contested by a competitor and subsequently rebid. Constellis was awarded a smaller portion of the contract, which resulted in:

1. a $100 million decrease to revenue for the project and
2. a delay on the receipt of project revenue.

Also in 2014, several other project developments negatively affected the Constellis business pipeline. A fixed-site security project in Kuwait on which Constellis was serving as a subcontractor was rebid. Constellis lost "tens of millions of dollars" due to the project rebid.

Constellis lost a bid on a $338 million project for security services in Germany, and the DoD informed Constellis that a contract for security services at Camp Leatherneck, Afghanistan, would be terminating four months earlier than expected.[4]

Also, it became apparent that Constellis was at fault for the full amount ($62.2 million) of the liability related to the DCAA audit.

In February 2014, Jason DeYonker of Forte Capital Partners ("Forte") contacted Mr. Katis as a prospective buyer. Forte owned ACADEMI, which was one of Constellis's primary competitors. Mr. DeYonker had become interested in acquiring Constellis after hearing of the 2013 ESOP transaction.

After some initial skepticism, Mr. Katis and the board decided that a sale to Forte was in the best interest of the company. Both sides expected to gain synergies through the transaction. The newly formed entity had an opportunity to become the leader in the industry.

Forte's initial offer was $230 million with none of the proceeds going to the ESOP. After some negotiation, Forte revised its offer to $283.3 million with $10 million in proceeds to the ESOP, as set forth in the March 24, 2014, letter of intent.

At the request of Forte, the sellers included the ESOP in the sales procedure. On March 25, Constellis again retained Wilmington to serve as the ESOP's transactional trustee. The trustee retained the same parties to serve as its financial adviser and legal counsel.

In the coming weeks, the trustee concluded that the $10 million offer was not sufficient consideration to provide to the ESOP. The offer from Forte was revised on May 5, 2014, to a total purchase price of $288.3 million with $20 million of those proceeds due to the ESOP.

The trustee's financial adviser performed a fairness analysis for the proposed Forte sale transaction. The adviser's analysis included certain adjustments to consider a controlling sale to a third-party analysis.

These changes included adjustments for:

1. the exclusion of the discount for lack of marketability,
2. the exclusion of the company-specific risk premium, and
3. the inclusion of tax benefits due to the ESOP structure.

The analysis included four scenarios based on (1) the amount of work performed under a customer contract and (2) the inclusion of ESOP tax benefits.

Based on this analysis, the trustee's financial adviser stated that:

1. the total ESOP consideration is not less than fair market value of the equity interest held by the ESOP and
2. the terms and conditions of the transaction, taken as a whole, are fair to the ESOP from a financial point of view.

The trustee's financial adviser provided its opinion on July 25, 2014.

Wilmington subsequently approved the transaction. The transaction resulted in the termination

of the ESOP just seven months after the ESOP was installed.

Court Proceeding—The Constellis Litigation

The subject of the trial was whether the trustee satisfied an affirmative defense of Section 1108(e). According to the Constellis litigation opinion, "Wilmington has not demonstrated that its reliance on [the trustee's financial adviser's] report was 'reasonably justified' in light of all the circumstances because [Wilmington] has not shown that it thoroughly probed the gaps and internal inconsistencies of the report."

The court reached this conclusion based on the trustee's failure to:

1. review previous valuations of Constellis prepared by an independent appraiser,
2. probe the financial adviser's reliance on management's representations and projections,
3. investigate the appropriateness of a control premium, and
4. understand the impact of rounding on the value conclusion.

In addition to the valuation issues listed above, the court noted several trustee procedural issues.

The McLean Group Valuation Report

The McLean Group performed annual valuations of a single share of Constellis stock over the three years prior to the ESOP transaction. The valuation reports were prepared (1) to price the company's outstanding employee stock options and (2) to comply with financial reporting requirements.

The controlling equity value from the most recent valuation, which was performed as of January 31, 2013, was more than $100 million lower than the controlling equity value estimated by the financial adviser as part of the ESOP transaction.

At trial, the defense experts explained that the valuation conclusions were different because (1) the reports were prepared for different purposes and (2) the performance of the macro economy and Constellis changed from December 2013 to July 25, 2014.

The court found these defense arguments unpersuasive. The failure of the trustee to understand the differences between the financial adviser's analysis and the McLean Group analysis was a significant factor in the court's decision.

Reliance on Management's Representations

For the ESOP transaction, the financial projections that the financial adviser relied on were prepared by company management. The management team that prepared the financial projections did not have an equity interest in the company.

However, as part of the transaction, the managers received a bonus equal to 5 percent of the overall purchase price. This bonus reflected a conflict of interest that was not documented by the trustee.

Additionally, the trustee did not review previous financial projections prepared by company management. Previously, Constellis management prepared projections for (1) the Vestar proposed transaction and (2) the McLean Group valuation analysis.

A review of previous projections would have revealed that Constellis management had previously only prepared one-year financial projections (as opposed to the five-year financial projections that were provided for the ESOP transaction).

Customer Concentration

The trustee was deemed to have failed to understand how the Constellis customer concentration affected its value. In December 2013, two contracts accounted for 70 percent of the Constellis revenue. The trustee did not consult with either of the primary customers of Constellis (though Forte requested access to key customers and job sites during its due diligence).

At trial, the trustee explained that there is a different level of diligence between ESOP transactions and third-party acquisitions due to the representations and warranties provided in ESOP transactions that are not provided in third-party transactions.

The court took issue with this explanation because many of the representations and warranties in the 2013 ESOP transaction were provided by Constellis, not the sellers. Representations and warranties provided by Constellis could not benefit the ESOP.

DCAA Audit

The court also noted that there was significant liquidity risk due to the terms of the DCAA audit indemnification. As of the ESOP transaction date, the DCAA liability of $62 million was greater than the amount of cash on the Constellis books.

The terms of the DCAA indemnification provided for the amount collected under the DCAA claim to be offset with the seller debt. Therefore, the DCAA claim could result in an immediate liquidity issue for Constellis.

Ownership Control Premium

The trustee was deemed to have no support for the 10 percent ownership control premium that the trustee's financial adviser applied in the 2013 ESOP transaction fairness analysis. The trustee was aware that the ESOP did not acquire a controlling ownership interest in the company.[5]

The financial adviser applied a 10 percent control premium to the guideline publicly traded company ("GPTC") method and performed the discounted cash flow ("DCF") method on a controlling basis.

The language in the valuation presentation regarding the ownership control premium was generic. The court found that the trustee's failure to question the appropriateness of the ownership control premium was "inexplicable."[6]

Rounding

The court noted that the trustee failed to investigate the effects of rounding in the valuation. The court noted that the median per-share value indication was rounded up from $4,232.50 to $4,235.00.

The increase in the price from rounding provided a higher median value per share. The median value indication was relied on by the trustee in its negotiations.

Procedural Issues

The trustee failed to investigate the motivations of Constellis and the sellers for establishing an ESOP, a criteria to determine an ESOP's eligibility under ERISA and the Internal Revenue Code ("Code"). The trustee did not review the ESOP pitch materials provided by the Constellis sell-side advisers and did not seek an opinion from trustee legal counsel regarding the eligibility of the plan.

The trustee was given an abbreviated time period to make its investment decision. The trustee was officially retained on October 25, 2013, and the purchase price range was approved on November 14, 2013. The only reason identified for this abbreviated time period was due to the tax benefits of approving the deal in calendar year 2013.

The frequency and timing of meetings suggested that the trustee was "not fully engaged." The transaction was discussed by the trustee's internal committee a total of three times, none of which exceeded 90 minutes.

One of the four voting members of the trustee committee missed two of the meetings. Only one meeting with Constellis management occurred, and the trustee was represented by only one member of its team at the meeting with Constellis management.

The court found that the trustee's negotiations were not representative of a prudent fiduciary. Specifically, the court questioned the trustee's prudence of beginning the negotiation process at $3,900 per share, an amount *within* the fair market value range.

The court also speculated that the trustee's "lack of engagement and willingness to negotiate favorably with CSG may have been motivated by its significant business relationship with CSG, which refers more ESOP business to Wilmington than all other firms combined." Also, the trustee's familiarity with its advisers may have caused it to overlook certain aspects of the fairness analysis.

However, the court found that the trustee did not violate either Code Section 1106(b)(2) or Code Section 1106(b)(3).

Constellis Litigation Damages Conclusion

The court distinguished the amount of damages incurred by the ESOP, as opposed to the damages attributable to the ESOP participants. The plaintiff's financial expert was the only expert to provide an opinion of damages. The plaintiff's financial expert calculated individual damages amounts based on certain inputs and methodologies utilized by the trustee's financial adviser in the original fairness analysis.

These certain items included the following:

1. The growth projections
2. The equity beta
3. The company-specific risk premium
4. The perpetual growth rate
5. The weighting applied to the valuation indications
6. The assumptions used to generate a controlling interest value
7. The GPTC method multiple selection
8. The dilution from the value of SARs
9. Rounding throughout the fairness analysis

The total amount of damages estimated by the plaintiff's expert was $103,862,000.

The court considered the nine adjustments suggested by the plaintiff's financial expert and concluded total damages of $29,773,250. The damages attributable to each of the nine inputs are presented in Exhibit 1.

The court adopted the damages indication provided by the plaintiff's financial expert for the

industry beta, control premium, and SARs. With regard to the reliance on management's growth projections, the court decided to cut the plaintiff's damage estimate of $8.65 million in half because the court found that the plaintiff financial expert's "analysis was likely impacted by his incentive to work on behalf of the plaintiff."

The plaintiff's financial expert estimated damages of $6.72 million for rounding and other damages. The court accepted the damages amount for rounding but concluded that the support for the "other" damages was underdeveloped.

The court rejected the plaintiff financial expert's damages calculations related to the company-specific risk premium, the perpetual growth rate, the weighting applied to the two valuation indications, and the GPTC multiple selection.

Exhibit 1
The Constellis Litigation
Judicial Determination of Damages Analysis Variables

Valuation-Related Damages Component	Concluded Damages
Reliance on Management's Growth Projections	$ 4,325,000
Below-Industry Beta	2,936,000
Company-Specific Risk Premium of 1%	-
Perpetual Growth Rate of 3%	-
Valuation Indication Weighting	-
Control Premium	17,901,250
GPTC Pricing Multiple Selection	-
Dilution from SARs	1,611,000
Rounding Up	3,000,000
Total Damages	29,773,250

The concluded damages amount implies that the ESOP should have paid $171,755,782.77, or $3,609.33 per share, to purchase the Constellis stock, rather than the $4,235 per share paid as part of the transaction.

The SJP Litigation

The *Perez v. First Bankers Trust Services, Inc.* (the "SJP litigation"), opinion was released on March 31, 2017. The litigation stemmed from a transaction that took place on April 16, 2007.[7]

The transaction involved the controlling shareholder of SJP selling a 38 percent interest in SJP to a newly formed ESOP. The ESOP paid $16 million to Vincent DiPano, the selling shareholder, for the 38 percent interest.

Plaintiff asserted that First Bankers Trust Services, Inc. (the "trustee"), breached its fiduciary duties of loyalty and prudence to the SJP ESOP under ERISA Section 404(a)(1)(A) and (B) and engaged in a prohibited transaction under ERISA Section 406 when it authorized the ESOP to purchase the 38 percent interest in SJP.

The litigation was heard in the New Jersey District Court by Judge Michael A. Shipp. The case was tried over 17 days in May 2016.

Ultimately, the judge sided with the plaintiff, the Department of Labor, on behalf of the SJP ESOP, and awarded the SJP ESOP $9,485,000 plus interest in damages. Damages were estimated based on the fair market value estimate proffered by the plaintiff's financial expert.

Company Background

SJP was a closely held site preparation company with headquarters in New Jersey. The company was founded in 1959 by Carmen Yacuzzio. Mr. Yacuzzio was the company's primary shareholder until his death in 2004. The company provided a variety of site preparation services through its three subsidiaries.

Mr. DiPano assumed the CEO position following Mr. Yacuzzio's death. Mr. DiPano became the controlling owner of SJP in March 2005 when he acquired shares from Mr. Yacuzzio's trust.

SJP experienced significant revenue growth in 2005 and 2006 and achieved record revenue, gross profit, and earnings in 2006. The company's success coincided with the change in ownership.

The company marketed itself as the only vertically integrated site developer in the region.8 Through its subsidiaries, the company had the capability to (1) clear a work site, (2) process refuse from the site, and (3) perform work on the site such as paving.

SJP also had a competitive advantage due to its mobile rock crushers. Its mobile rock crushers were the first of their kind in the United States, and they allowed SJP to work in rocky areas that were difficult for stationary rock crushers to develop.9

In 2006, approximately 60 percent of the SJP revenue generated was from one customer, Hovnanian Homes ("Hovnanian").

ESOP Transaction

Prior to the transaction, Mr. DiPano held 70 percent of the SJP outstanding equity. The remaining

30 percent interest was held by Frank Dugan, who served as the SJP vice president. In early 2006, SJP retained a law firm to advise it on an ESOP installation transaction.

Shortly thereafter, SJP retained a sell-side financial adviser for the proposed ESOP transaction. SJP retained the trustee, and the trustee retained its own financial adviser and legal adviser. All parties were retained in the fourth quarter of 2006, and each party was represented at a meeting at company headquarters that occurred on November 15, 2006.

In January 2007, the SJP sell-side financial adviser issued a confidential information memorandum ("CIM") to obtain third-party financing for the transaction. The CIM contained financial statement projections for 2007 to 2011. These projections included 0 percent revenue growth in 2007, 4 percent revenue growth in 2008, 8 percent revenue growth in 2010, and 6 percent revenue growth in 2011.

The sell-side financial adviser provided a copy of the CIM to the trustee's financial adviser in early March 2007.

Representatives from the trustees's financial adviser visited several SJP work sites on March 12, 2007. On March 13, 2007, bank financing in the form of a $22.5 million credit facility was secured. The credit facility consisted of term loans totaling $18.5 million and a $4 million line of credit.

On April 11, 2007, the trustee's financial adviser sent its draft valuation report to the trustee. The trustee's financial adviser gave a presentation to the trustee on April 13, 2007.

In the analysis, the trustee's financial adviser provided a fairness opinion. The purpose of the fairness opinion was to opine on whether the proposed transaction was fair to the ESOP from a financial point of view and whether the financing terms were reasonable.

The trustee's financial adviser's fairness opinion was dated April 16, 2007. The fairness opinion provided that (1) the consideration the SJP ESOP was paying as part of the transaction did not exceed fair market value and (2) the terms and conditions of the transaction were fair to the ESOP.

The trustee's financial adviser relied on the DCF method and the GPTC method, placing even weighting on the value indications from the two methods. The trustee's financial adviser's DCF method conclusion for SJP was approximately $36.1 million, and its market multiple conclusion for SJP was $53.6 million.

The trustee's financial adviser provided a range of fairness for the 38 percent interest of $16.4 million to $16.8 million—the fairness range was above the proposed purchase price of $16 million.

On April 16, 2007, the ESOP transaction closed with the trustee accepting the $16 million offer on behalf of the ESOP. The transaction closed with the same material terms as those proposed by the seller during the November 15, 2006, meeting. SARs were issued as a component of the transaction.

The trustee's financial adviser issued a post-transaction valuation report on April 27, 2007. This report contained a final analysis of the transaction. This valuation report included industry and regional economy sections, which were notably absent from the April 11, 2007, draft valuation report.

Following the transaction, First Bankers Trust was retained to serve as the ESOP's ongoing trustee. The trustee's financial adviser was retained to provide annual valuation reports. First Bankers Trust served as the ESOP's trustee until 2014.

Court Proceedings

The allegations in the SJP litigation relate to the level of due diligence, or lack thereof, performed by the trustee. A significant portion of the plaintiff's arguments made in court relates to the First Bankers Trust review of the valuation analysis.

There were also a number of fiduciary process items that were contested in court.

Valuation Issues

The plaintiff's financial expert raised a number of general issues with the analysis prepared by the trustee's financial adviser.

These issues are summarized as follows:

1. Failure to understand SJP's growth drivers
2. Failure to understand the nature of the company's competitive advantages
3. Failure to understand the risk of the business (i.e., top customers)
4. Over-reliance on fiscal year 2006 financial results
5. Failure to incorporate results from the first quarter of 2007
6. Propensity to take material from SJP and sellers at face value

Both valuation methods utilized by the trustee's financial adviser heavily relied on the 2006 financial results. SJP experienced significant growth in 2005 and 2006 and reported record levels of revenue, gross profit, and earnings before interest, taxes, depreciation, and amortization ("EBITDA") in 2006.

Defendants understood that the success of SJP was due to the company's (1) new bidding strategy

that was the result of the 2004 change in management, (2) vertical integration, and (3) use of mobile rock crushers. The plaintiff's financial expert argued that these advantages were not sustainable because none of the stated advantages were proprietary.

The plaintiff's financial expert critiqued the lack of diligence performed by the trustee and its financial adviser regarding SJP's top customers. Hovnanian accounted for approximately 60 percent of SJP revenue in 2006, and approximately 78 percent of its December 31, 2006, backlog was due to Hovnanian projects.[10]

The CIM stated that SJP had been "steadily diversifying away from Hovnanian."[11] The CIM statement appears contradictory to SJP's historical performance. The trustee and its financial adviser did not ask SJP management the following questions:

1. How does the company plan to diversify its customer base?
2. What is the potential impact of losing Hovnanian as a customer?

As of the transaction date, Hovnanian was a publicly traded company that was one of the largest home builders in the country. In its 2006 annual report, Hovnanian management characterized 2006 as a "challenging year for our company as we encountered a sudden downturn in many of our housing markets."[12]

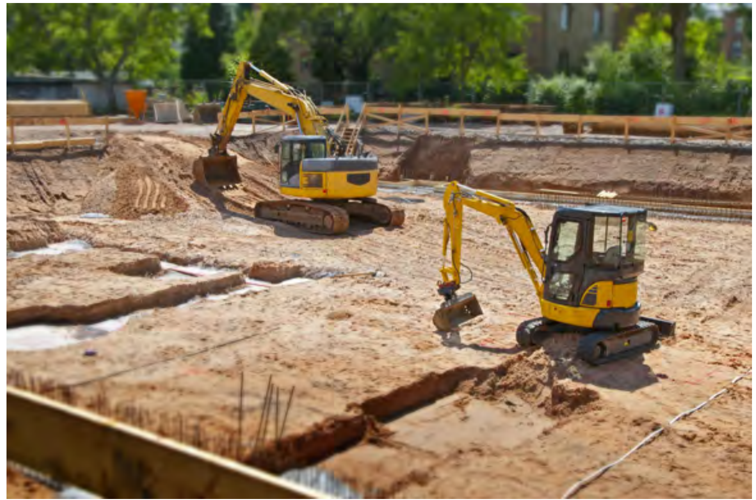
The report also stated that Hovnanian planned to operate its business as if housing markets were in a prolonged downturn. Part of Hovnanian's tightening strategy involved "aggressively renegotiating with key partners" to reduce costs.[13]

The trustee and its financial adviser did not review the Hovnanian report in their review of the transaction.

SJP management told the trustee's financial adviser that the company's diversification plan was to add commercial and municipal developers. However, SJP management did not provide sufficient details regarding how it would diversify its business other than by offering services for a reasonable price and doing quality work.[14]

SJP also mentioned that its diversification plan included regional diversification, specifically entering the New York market. The trustee's financial adviser did not ask how the diversification plan would affect profit margins.[15]

Plaintiff's financial expert also argued that it was inappropriate to rely on the SJP 2006 results due to the cyclical nature of the homebuilding industry. The financial statement projections that the trustee's financial adviser relied on used the 2006 financial results as the starting point for the five-year projection.



From the perspective of the trustee and its financial adviser, the projections appeared "conservative" due to:

1. the 0 percent projected growth in 2007;
2. the SJP backlog as of December 31, 2006; and
3. the moderate revenue growth throughout the remaining projected periods.

The company's 2006 financial results were (1) the starting point for the financial statement projections used in the trustee's financial adviser's DCF method and (2) the primary financial fundamental period used in the GPTC method.

The plaintiff's expert adjusted the projected financial statements downwards to "account for SJP's abnormally profitable year of 2006 and the peaks and troughs of a typical cycle."[16]

The plaintiff's expert criticized the trustee and its financial adviser for failing to consider the first quarter of 2007 results. The trustee's financial adviser reviewed the financial results for January and February 2007 as of the April 13, 2007, financial adviser presentation. However, the latest financial statements included in the draft valuation report were through December 31, 2006.

At the end of the fairness opinion presentation, the trustee requested that its financial adviser review the first quarter of 2007 financial statements. It is unclear whether the financial adviser reviewed the first quarter financial statements. The first quarter financial statements were not included in the "documents relied on" section of the draft valuation report dated April 11, 2007, or in the post-transaction valuation report dated April 27, 2007.

The SJP first quarter revenue decreased by 56.4 percent in 2007, from the first quarter of 2006.[17] Net income was negative in the first quarter of 2007. Given the negative first quarter performance, the question at hand was whether the company could make up for its losses from the first quarter of 2007 and meet its projections for the full year of 2007.

At trial, the trustee took the position that the negative results were based on bad weather in the first quarter of 2007. While there was some evidence to support this position, it appeared that there was a lack of contemporaneous due diligence on the first quarter results.

The trustee's financial adviser relied on financial statement projections prepared by the seller financial advisers. The trustee's financial adviser made some minor adjustments to the projected financial statements that resulted in a higher level of projected cash flow.[18]

According to the opinion, the trustee's financial adviser "assumed that the projections provided by SJP reflected SJP's best estimates," and it "did not undertake any independent analysis to verify whether the stated reasons supporting the projections were correct apart from reviewing updated financials and speaking with the company."[19]

Additional points of contention regarding the trustee's financial adviser work product included allegations that it:

1. copied and pasted large sections from the offering memorandum regarding SJP and
2. failed to assess potential litigation expenses from the Kara Homes bankruptcy.

The trustee's financial adviser included a 5 percent discount for lack of marketability. The discount for lack of marketability was not contested by the defendant's expert.

DCF Method

The DCF method provides a value estimate using projected cash flow and a present value discount rate. The plaintiff raised several concerns about the projected cash flow and present value discount rate.

The cash flow critique was based on the trustee financial adviser's adoption of the projected financial statements provided by the sell-side financial adviser.

The trustee's financial adviser applied a present value discount rate of 18.25 percent to 19.25 percent to the projected cash flow. The trustee's financial adviser did not specify the amount of company-specific risk related to customer concentration.

The plaintiff's financial expert adjusted the cash flow projection by applying a negative 15 percent revenue growth rate in 2007, followed by a constant revenue growth rate of 5 percent.

The plaintiff's financial expert also set the projected EBITDA margin to the five-year historical average EBITDA margin. The plaintiff's financial expert applied a 20 percent discount rate to projected cash flow. This resulted in a value indication from the DCF method of approximately $13.9 million.

GPTC Method

In the transaction analysis, the trustee's financial adviser placed 50 percent weight on the GPTC method. The trustee's financial adviser selected the following guideline publicly traded companies: Fluor, Perini, Jacobs Engineering Company, Granite Construction Inc., Meadow Valley Corp., URS, and Sterling Construction.

The trustee's financial adviser relied on earnings before interest and taxes ("EBIT"), EBITDA, and revenue pricing multiples to estimate value using the GPTC method. The trustee's financial adviser decreased the indicated pricing multiples by 40 percent to adjust for differences in size, access to capital, geographic diversity, and economies of scale.[20]

The trustee's financial adviser did not consult with SJP management when it selected the guideline companies.[21]

The plaintiff's financial expert disagreed with the trustee financial adviser's selected guideline companies, stating that the peer group was incomparable due to, among other things, their lack of exposure to the housing market. The plaintiff's expert relied on 18 guideline companies from the homebuilding industry in his analysis.

The plaintiff's expert also relied on pricing multiples based on five-year average historical financial fundamentals—as opposed to financial fundamentals from 2006. The five-year historical average financial fundamentals were selected to adjust for the cyclicality of the industry and to normalize the SJP "abnormally strong performance" in 2006. The value indication from the plaintiff expert's GPTC method was approximately $13.9 million.[22]

Trustee Procedural Issues

As a fiduciary, the trustee made key decisions through its employee benefit committee. As of the transaction date, the employee benefit committee consisted of eight or nine members. The committee members played various roles with regard to new engagements.

Typically, a salesperson would receive a 20 percent commission on new business brought in and an additional 20 percent commission on fees generated in the first year that the First Bankers Trust was retained to serve as the plan's ongoing trustee.

For the SJP ESOP transaction, the salesperson was designated as the "team leader." She was the only member of the trustee's Trust team to participate in the due diligence meeting with SJP. In fact, she was the only one to communicate directly with SJP management throughout the ESOP transaction.[23]

A second team member was assigned to the SJP transaction. However, she "wasn't necessarily there every step of the way."[24]

There was confusion among the members of the employee benefits committee as to which member(s) were responsible for reviewing financial documents and understanding the valuation report. No members reviewed or received the SJP audited financial statements prior to the transaction.[25] Additionally, no member assigned to the SJP transaction had valuation expertise.

The trustee's valuation review was criticized by plaintiff due to the condensed time period allowed to review the report. The draft report was provided on April 11, 2007, for a presentation on April 13, 2007. The transaction was then scheduled to close on the next business day, April 16, 2007.

The trustee repeatedly deferred to its financial adviser. The team leader stated that she "felt comfortable with [the financial adviser's] projections because [the financial adviser] felt comfortable about the projections."[26]

The trustee also did not independently review the accuracy of the financial information that SJP provided to the financial adviser.

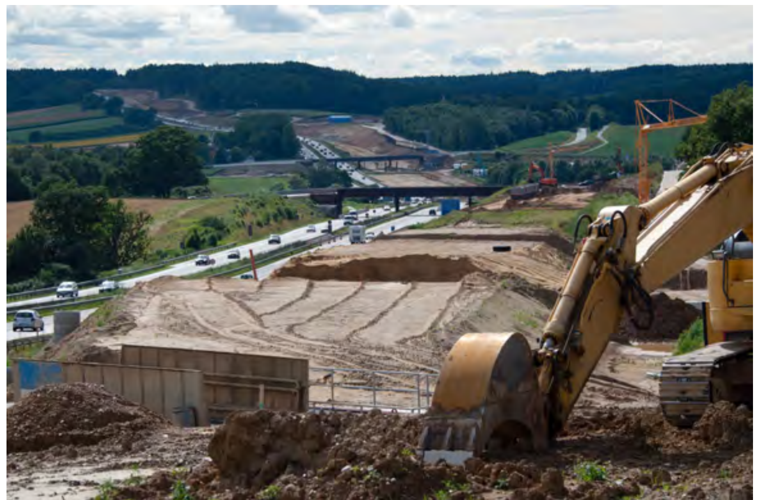
Legal Positions

The plaintiff claimed that the trustee failed to meet its duty of loyalty and duty of prudence to the ESOP, which resulted in a prohibited transaction.

Duty of Prudence

The plaintiff argued that defendant breached its duty of prudence by failing to:

1. follow up on the errors and inconsistencies in the draft valuation report,
2. independently verify material information,
3. ensure that the draft valuation report was reliable, and
4. employ an adequate review process.[27]



The defendant argued that it maintained its duty of prudence by obtaining the advice of a financial expert. The defendant was then able to make its own decision based on the financial expert's advice.

Duty of Loyalty

The plaintiff asserted that the defendant was biased because it sought retention as the ESOP's ongoing trustee upon completion of the transaction. The plaintiff supported this position based on First Bankers Trust (1) accepting, without verification, the seller's representations and (2) failing to negotiate the purchase price.

The defendant argued that it did not breach its duty of loyalty because it "verified all information" and ensured the information was complete. Also, the defendant stated that there was no information that it "should have considered, but did not." The defendant argued that it was not required to negotiate, especially in this instance when the offer price was below fair market value.

Prohibited Transaction

The plaintiff argued that the defendant was prohibited from causing the ESOP to enter the transaction because the transaction price was above fair market value. The plaintiff's financial expert concluded that the fair market value of the interest in SJP was $6,515,000. The plaintiff also argued that the bank financing did not support the fair market value of the interest.

The defendant argued that the ESOP paid at or below fair market value for the interest in SJP based on the First Bankers Trust financial adviser's analysis. The defendant also argued that the plaintiff expert's valuation analysis "improperly considered SJP's performance in hindsight" and was not credible.[28]

"According to the court, the cumulative issues . . . demonstrate that the trustee failed to fulfill its duty of prudence under ERISA."

Indemnification

The defendant asserted that the indemnification clauses in the stock purchase agreement indemnified the ESOP against damages related to flawed or inaccurate information provided by the seller.

The plaintiff argued that the indemnification provisions did not provide a safe harbor for the fiduciary against all material representations, but rather, the provisions only protect against false information that the seller knowingly provided.

Loan Forgiveness

The defendant communicated that sometime after the transaction, SJP forgave $9.6 million of the loan to the ESOP. Defendant proposed that the loan forgiveness should lower the purchase price commensurately.

In response, the plaintiff stated that (1) the write-down of the loan did not retroactively adjust the proceeds paid to Mr. DiPano and (2) the argument should not be considered because the loan documents and loan forgiveness documents were not entered into evidence.

SJP Conclusions

Duty of Prudence

The court found that the trustee breached its duty of prudence by failing to make an honest, objective assessment of the valuation report and by failing to understand and question the methods and assumptions underlying the valuation analysis.[29]

The court cited the *Chesemore v. All. Holdings, Inc.*, opinion, stating "[employing] a financial advisor is evidence of adequate investigation . . . reliance on experts is not a shield—it is 'but a single factor to be weighed in determining whether a fiduciary has breached [its] duty.'"

In this instance, the trustee relied on information provided by its financial adviser, who in turn relied entirely on information provided by the seller and its advisers.

The court determined that the indemnification did not preclude the trustee from conducting an independent inquiry into the information provided by the seller and SJP.

The court noted several "glaring issues" regarding the trustee's opinion to enter the transaction. These issues are as follows:

- A prudent investor would not enter into a transaction with a valuation report that lacked regional economy and industry sections.
- A prudent investor would question the differences between the projected EBITDA from the CIM and the projected EBITDA that was relied on in the trustee financial adviser's analysis.
- A prudent investor would question the "verbatim copying-and-pasting" by the trustee's financial adviser and the financial adviser's "blanket adoption" of the seller financial adviser's position.
- The trustee failed to question and follow up with its financial adviser about obvious errors in the valuation report.
- There was a failure to inquire about critical assumptions in the draft valuation report.[30]

The trustee's fiduciary review process for the transaction was also deficient. The trustee received the draft valuation report with insufficient time to review the report. The trustee's team lead was the only individual from the trustee team who met with SJP management, and she (1) lacked financial expertise and (2) failed to take notes at the meeting.

There was miscommunication among the team regarding who was responsible for reviewing the company's financials and the valuation report. The trustee's failure to negotiate the transaction price was evidence of a flawed fiduciary process.

According to the court, the cumulative issues listed above demonstrate that the trustee failed to fulfill its duty of prudence under ERISA.

Duty of Loyalty

The court found that the trustee breached its duty of loyalty to the ESOP. The primary reasons for this conclusion was due to the trustee's failure to:

1. conduct an adequate amount of due diligence,
2. negotiate the purchase price, and
3. conduct the transaction at arm's length as evidenced by the adoption of seller's representations.

Prohibited Transaction

Based on the evidence presented, the court ruled that the trustee failed to meet its burden of proof that the transaction price represented adequate consideration at fair market value. Therefore, the trustee caused the ESOP to enter a prohibited transaction.

Remedies

The defendant made an argument that the purchase price should be adjusted for the $9.6 million in loans for which SJP subsequently forgave the ESOP. Therefore, the purchase price would be $6.3 million. The court found that the case law did not support defendant's position.

The court determined that the appropriate damages amount was the amount that the SJP ESOP paid in excess of fair market value. The court adopted the plaintiff expert's fair market value estimate of $6,515,000, which resulted in damages of $9,485,000. This amount, plus interest, was awarded to the SJP ESOP.

The plaintiff also sought injunctive relief to permanently prohibit the trustee from serving as a fiduciary to an ERISA-covered plan in the future. The court determined that the trustee's conduct did not warrant the requested injunctive relief.

Conclusion

The Constellis litigation opinion and SJP litigation opinion detail the fiduciary process and, particularly, the fiduciary review of the valuation analysis for the subject ESOP installation transactions.

Consideration of these judicial opinions should prove useful both for prospective ESOP companies—and for ESOP practitioners—implementing successful future ESOP installation transactions.

"[T]he trustee failed to meet its burden of proof that the transaction price represented adequate consideration at fair market value."

Notes:

1. Brundle, on Behalf of Constellis Employee Stock Ownership Plan v. Wilmington Trust N.A., No. 1494, 2017 WL 979106 (U.S. Dist. Ct. E.D.Vir., March 13, 2017).
2. It is important to note that the final Stock Purchase Agreement included certain representations and warranties that were guaranteed by Constellis and not the sellers.
3. Brundle v. Wilmington Trust, 2017 WL 979106 at *9.
4. Id. at *13.
5. Control was given to the Class A warrant holders for a period of 10 years following the transaction close date. After the 10-year period, the ESOP would hold a controlling interest in the company.
6. Brundle v. Wilmington Trust, 2017 WL 979106 at *22.
7. Perez v. First Bankers Trust Services, Inc., No. 12-4450, 2017 WL 1232527 (U.S. Dist. Ct. D.N.J. Mar. 31, 2017).
8. Perez v. First Bankers Trust, 2017 WL 1232527 at *26.
9. Id. at *35.
10. Id. at *47.
11. Id. at *13.
12. 2006 Hovnanian Annual Report, 1.
13. Ibid., 3.
14. Perez v. First Bankers Trust, 2017 WL 1232527 at *49.
15. Id. at *50.
16. Id. at *65.
17. Id. at 40.
18. Id. at *29.
19. Id. at *30.
20. Id. at *53.
21. Id. at *54.
22. Id. at *64.
23. Id. at *6.
24. Id.
25. The only financial document received by the trustee was the financials presented in the CIM.
26. Perez v. First Bankers Trust, 2017 WL 1232527 at *30.
27. Id. at *66.
28. Id. at *70.
29. Id. at *73.
30. These assumptions included failure to verify the SJP historical growth drivers; failure to understand the assumptions in the financial statement projections; failure to independently verify critical facts, such as backlog; failure to raise issues regarding industry cyclicality; failure to understand competitive advantages; failure to consider the SJP poor performance in the first quarter of 2007; and failure to consider SJP's customer concentration.

Chip Brown is a managing director in our Atlanta practice office. Chip can be reached at (404) 475-2306 or at cbrown@willamette.com.

Kyle Wishing is a manager in our Atlanta office. Kyle can be contacted at (404) 475-2309 or at kjwishing@willamette.com.