

The Danger Of Fiduciary Status For Valuation Firms

Law360, New York (March 18, 2011) -- The U.S. Department of Labor has issued a proposed regulation that would substantially expand the definition of “fiduciary” under the Employee Retirement Income Security Act of 1974.

Under the new definition, valuation firms would, for the first time since ERISA’s passage, be subject to its stringent fiduciary duties and their attendant liability. Many predict that an unintended consequence of this expanded definition could be a concerted exit from the valuation market by firms that have traditionally performed valuation services.

Background

Enacted in 1974, ERISA applies fiduciary status to a person with respect to an ERISA-regulated plan to the extent it:

1. exercises any discretionary authority or discretionary control with respect to the management of the plan.
2. exercises any authority or control with respect to the management or disposition of the plan’s assets.
3. renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of a plan, or has any authority or responsibility to do so.
4. has any discretionary authority or discretionary responsibility in the administration of a plan.

In 1975, shortly after ERISA’s enactment, the DOL published a regulation defining the circumstances under which “investment advice” is rendered. The regulation applied a five-part test that significantly narrowed the statutory language. For the last 35 years, an adviser who does not have discretionary authority or control with respect to the plan is only considered a fiduciary for ERISA purposes if it:

1. renders advice as to the value of securities or other property, or makes recommendations as to the advisability of investing in, purchasing or selling securities or other property;
2. on a regular basis;
3. pursuant to a mutual agreement, arrangement, or understanding with the plan or plan fiduciary that;

4. the advice will serve as a primary basis for investment decisions with respect to the plan's assets;
5. the advice will be individualized based on the particular needs of the plan.

In an advisory opinion issued in 1976, the DOL concluded that a valuation of closely held employer securities that an employee stock ownership plan (ESOP) would rely on in determining the adequate consideration for purchase of the securities did not constitute investment advice and therefore fiduciary status did not attach to the valuation firm.

The DOL found that providing valuation advice to the sponsor of an existing ESOP or to the ESOP itself would not serve as the primary basis for investment decisions with respect to plan assets, nor would it constitute advice as to the value of securities, within the meaning of the regulation.

The Proposed Regulation and the Meaning of "Fiduciary Status" Under ERISA

The proposed regulation makes four significant changes. First, it eliminates the requirement that the advice be rendered on a regular basis.

Second, any advice that may be considered in connection with investment or management decisions is now covered by the rule, thereby eliminating the "primary basis" element of the current regulation.

Third, the advice no longer need be provided pursuant to a mutual agreement.

Fourth, the regulation specifically includes appraisals and fairness opinions. The proposed regulation explicitly overturns the DOL's 1976 advisory opinion.

Fiduciaries are subject to the "prudent man" rule of Section 404 of ERISA. The prudent man rule states that fiduciaries must act prudently and with undivided loyalty to the plan participants and their beneficiaries, subject always to the terms of the plan. The prudent man standard is a higher standard than the reasonable person standard required by many states' corporate laws.

Further, ERISA fiduciaries may be held personally liable for their breach of these duties. Until recently, many believed that fiduciaries can be exculpated from liability that results from a breach of their fiduciary duty to act prudently. Some recent court decisions involving abusive practices have raised broader questions as to whether fiduciaries can be indemnified by the plan and/or a plan sponsor wholly owned by an ESOP.

The Potential Implications of the Proposed Change

The potential implications of this change should not be underestimated. Because ERISA imposes stringent duties and potentially costly liability upon fiduciaries, persons who trigger fiduciary status typically purchase fiduciary liability insurance to protect themselves.

Because valuation firms that provide fairness opinions to ESOPs have never been considered fiduciaries under ERISA, they have not had to invest in fiduciary liability insurance. If the proposed regulation passes, however, that will change.

Because it will essentially require firms that provide fairness opinions to ESOPs to purchase fiduciary liability insurance (assuming that insurance companies would write this type of insurance for which there is currently no market) and to contemplate litigation in the event they are accused of breaching a fiduciary duty, the proposed regulation could have the unintended consequence of driving experienced firms out of the ESOP valuation market.

Such a concerted exit from the ESOP valuation market by firms that have long provided valuation services would likely dampen competitiveness in that market and diminish the quality of those services. A large majority of appraisals are done by a relatively small number of firms that specialize in this work, and the exit of even a few firms could have a substantial impact and further increase the market rate for appraisals.

For the firms that do not exit the market, applying fiduciary liability to valuation firms would increase the firms' operating costs, which would increase the cost of obtaining appraisals and fairness opinions. (A comment letter from the National Center for Employee Ownership cited estimates that appraisal costs could double or triple, representing an added \$20,000 to \$60,000 for initial appraisals and about half that amount for ongoing appraisals.)

The increased costs charged to plans would further complicate the burdens of administering ESOP plans, which already incur substantial administrative expenses that reduce plan assets available to pay participants. The ability for small companies to sponsor ESOPs could also be at risk.

Comment Letters Submitted

The DOL has received nearly 200 comment letters on the proposal. Nearly half of the letters were addressed to the proposed fiduciary status of appraisals and valuations. Most of the comments were against the proposal, with only a handful of the comments being in favor of the proposal.

Several commentators challenged the DOL's conclusion that there are widespread problems concerning incorrect valuations and the prevalence of appraiser's undisclosed conflicts of interest. A letter from the National Center for Employee Ownership (NCEO) noted that in the last 20 years there have been only 17 lawsuits specifically concerning ESOP appraisals and that leveraged ESOPs have a default rate of approximately 0.2 percent, while LBOs in general have default rates of 3 percent to 6 percent.

NCEO commented that if appraisals were consistently faulty, ESOPs should often be overpaying for stock and ending up unable to repay the loan. Given that most ESOPs are leveraged at some point, the data presented by the NCEO suggest that valuations are rarely excessively overstated.

Questions were also raised as to whether the DOL exceeded its authority, as commentators challenged how the proposed regulation fit within the statutory definition of "fiduciary" under Section 3(21)(A) of

ERISA. In particular, commentators questioned how an independent appraisal could constitute investment advice if the appraisal does not include a recommendation as to whether the plan should purchase employer stock.

The Tax Reform Act of 1976 included a strong statement in support of ESOPs and directed the Internal Revenue Service to rewrite proposed ESOP regulations that Congress considered burdensome. Commentators questioned whether the DOL's regulation violates the congressional directive that federal agencies not hinder the creation or operation of ESOPs.

On Jan. 18, 2011, President Barack Obama issued an executive order directing the executive branch to avoid burdensome regulations. Several commentators stated that the DOL's proposed regulation should be withdrawn in light of the president's executive order.

Commentators also noted that the DOL's proposed rule would be incompatible with the IRS's requirements for an independent appraisal of employer securities under Code Section 401(a)(28)(C). Fiduciaries have a duty of loyalty to act solely in the interest of participants and beneficiaries for the exclusive purpose of providing benefits and defraying reasonable plan administrative costs.

Commentators questioned how an appraiser could be independent while having an obligation to participants to ensure company stock is purchased at the lowest possible price. This conflict would likely induce a shareholder selling to an ESOP to hire a second appraiser, which would increase the cost of ESOP transactions and could delay the process, especially if further negotiations were required over the disparate valuations.

Additional questions were raised regarding annual valuations and conflicts regarding duties to participants nearing retirement (who would benefit from a high valuation which would produce a larger benefit) versus participants further from retirement (who would benefit from a low valuation which would keep more assets in the plan).

The proposal could also cause an appraiser to violate ethical rules which require appraisers to be fully independent. Under the Uniform Standards of Professional Appraisal Practice (USPAP), an appraiser is "expected to perform valuation services competently and in a manner that is independent, impartial and objective," and an appraiser is prohibited from advocating the cause or interest of any party. Any such violation could ultimately result in the appraiser losing its state-issued license or certification.

Several commentators noted that other federal agencies have adopted appraisal reform projects and the DOL's proposal is inconsistent with the other agencies' approaches. None of the agencies applied fiduciary duties to the appraisal.

Instead, the reliability of the appraisals was bolstered by requiring that appraisals only be performed by individuals with professional appraisal designations who adhere to the Uniform Standards of Professional Appraisal Practice (USPAP).

Commentators also questioned why the DOL did not consult with the IRS in the rulemaking process, as

the IRS has a long history and trained staff who work exclusively in the area of ESOP regulation and specific issues related to tax-related valuations for gifting and estate tax purposes.

The automatic classification of an appraiser as a fiduciary would cause confusion regarding who is responsible for errors and how responsibility is allocated amongst the trustee and the appraiser, according to many commentators.

For instance, in the case of an erroneous valuation, would an ESOP trustee have a legitimate defense that it can and should have relied on the greater expertise of its co-fiduciaries? Commentators also asked what standards will apply to expert fiduciaries, in particular how the prudent man standard would apply to an expert appraiser.

Questions regarding ERISA preemption of state law were also raised, in particular whether the plan will be precluded from suing appraisers under state law and whether professional malpractice/negligence actions will all be governed by ERISA and triable only in federal courts without a jury.

The NCEO's comment letter noted that faulty appraisals typically come from two sources: 1) appraisers who only occasionally do ESOP valuations and do not become sufficiently educated in the special issues ESOPs raise; and 2) appraisers who have a financial interest or other conflict with the company.

Many commentators questioned how the proposed changes would address these two issues or improve the quality of appraisals. In a separate rule-making, the DOL recently issued interim final disclosure rules for plan services arrangements under Section 408(b)(2) of ERISA which would require disclosure of direct and indirect compensation arrangements and conflicts of interest.

Commentators questioned whether the DOL took into consideration whether and how the 408(b)(2) regulation would affect independence and appraisal quality, mitigating the need to adopt a broader fiduciary standard for appraisals.

Alternatives

Commentators also proposed alternative approaches, including:

1. *Penalties*: Increase the existing penalties for erroneous appraisals.
2. *Valuation Regulations*: Issue final ESOP valuation regulations to provide clearer guidance to fiduciaries and appraisers (the DOL's proposed regulation regarding adequate consideration was issued 23 years ago (1988) and was never finalized).
3. *Independence Guidance*: Issue regulatory guidance on appraiser independence.
4. *Appraisal Standards*: Adopt standards for ESOP appraisals, which could be modeled on the IRS "qualified appraiser" standards under IRS Notice 2006-96 or the DOL's definitions of "qualified independent appraiser" and "qualified appraisal report" under a proposed prohibited transaction class exemption.
5. *Appraiser Credentialing*: Require appraiser credentialing by a professional appraisal organization (which already have conflict of interest and other ethical rules, including prohibitions on an appraiser having any undisclosed financial or other economic interest in the property to be appraised or in the transaction giving rise to the appraisal).

6. *ESOP Valuation Certification*: Require appraisers to have an ESOP valuation certification from an appraisal organization.
7. *Approval by Independent Outside Fiduciary*: Require that any leveraged ESOP transaction be approved by an independent outside fiduciary and that any ESOP with majority ownership of the sponsor company have an independent outside fiduciary.
8. *Third-Party ESOP Trustee*: Prohibit employees from serving as an ESOP trustee.
9. *Independent Legal Counsel for ESOP Trustee*: Require that ESOP trustees have their own independent legal counsel.
10. *Standards for Use of Valuations*: Establish specific standards for existing fiduciaries in using valuations, including requirements that a) at least one plan fiduciary certify in writing that he or she has the requisite financial skills to read and understand a valuation report; b) fiduciaries sign an acknowledgement that the fiduciary is responsible for judging the appropriateness of the appraisal, not just accepting it because it was performed by an appraiser; and/or c) fiduciaries sign a statement acknowledging financial liability as a fiduciary.
11. *Checklist*: Develop a checklist of issues fiduciaries should look for and ask about in reviewing appraisal reports.
12. *ESOP Trustee Qualifications*: Establish rules with respect to the qualifications of an ESOP trustee.
13. *DOL Advance Notice and Right to Audit*: Require ESOP sponsors to notify the DOL in advance of private sales of stock to an ESOP and permit the DOL to conduct a valuation audit as precondition to the transaction.
14. *Peer Review*: Require ESOP valuation reports to be reviewed by an independent review organization composed of qualified appraisers on a periodic basis or as deemed appropriate by the trustee or named fiduciary. Alternatively, require that the ESOP valuation firm undergo a peer review of its processes, procedures and reports by an independent review organization on a periodic basis.
15. *Appraisal Report Audits*: Require that the appraisal report be “audited” by an independent CPA firm in all cases where the ESOP fiduciary is neither an institutional trustee nor an independent fiduciary.
16. *Bad Boy Fiduciary Standard*: Impose fiduciary valuation standard only on those who have previously overvalued stock, although who makes such a determination was not stated.
17. *Exclusive Engagement*: Prohibit ESOP appraisers from providing other services, such as analysis of the feasibility of an ESOP and the structuring and execution of the transaction, to the company, the selling stockholder(s), or employees.
18. *DOL Advisory Committee*: Establish an advisory committee to the DOL to address alternative approaches to protect participants’ interests.
19. *Separate Rule-Making*: To the extent the DOL is concerned about valuation, it should enter a separate rulemaking, taking into account the comments made on the proposed regulation.
20. *Existing Enforcement Powers*: Increase enforcement to address abuses in ESOPs, without promulgating the broad proposed changes.
21. *Additional Enforcement Powers*: If the DOL concludes that it is powerless to sanction misconduct by appraisers or others under existing authority, it should ask Congress to provide it with additional enforcement powers under ERISA.

Public hearings on the proposal were scheduled for March 1 and 2, in Washington, D.C. Thirty-nine individuals and groups were scheduled to give testimony.

--By Jonathan J. Boyles (pictured) and Jeffrey L. Rothschild, McDermott Will & Emery LLP

Jonathan Boyles and Jeffrey Rothschild are partners in McDermott's New York office.

The opinions expressed are those of the authors and do not necessarily reflect the views of the firm, its clients, or Portfolio Media, publisher of Law360. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

All Content © 2003-2010, Portfolio Media, Inc.