FEDERAL DISTRICT COURT DENIES MOTION TO DISMISS FIDUCIARY BREACH LAWSUIT AGAINST OWNERS OF COMPANY WHO TRANSFER OF OVERVALUED STOCK TO ESOP

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The owners of Bowers + Kubota Consulting, Inc. sought to dispose of their interest in their company by forming an ESOP. They appointed attorney, Saakvitne as trustee of the ESOP and obtained a valuation of the company before negotiating the sale of their shares to the ESOP. The Department of Labor sued the owners, company, and trustee for breaches of fiduciary duty and prohibited transactions in Hawaii federal district court. The DOL alleged that the appraisal of company shares used to fund the ESOP was flawed, resulting in an inflated value for the company's stock because the appraiser used unreasonable revenue projections and improperly applied a 30% control premium when no change in control of the company occurred.

The federal court denied defendants' motion to dismiss the fiduciary breach and prohibited transaction claims, and concluded that the company was properly joined as a defendant. First, the court found that the company was a necessary party to the lawsuit. Using a legal standard that permitted joinder of a party when "desirable in the interests of just adjudication," the court concluded that the company's presence in the suit was necessary to enable the DOL to seek modification of the ESOP contracts to remove improper indemnification provisions in favor of defendants, as a form of equitable relief.

Next, the court rejected the owners' motion to dismiss the fiduciary breach claims on the grounds that they could not be held accountable as fiduciaries for allegations related to conduct before the ESOP was funded. The court explained that ERISA defines fiduciary in functional terms and requires an examination of defendant's control and authority over the plan. As the owners were the sole members of the company's board of directors and had been primary decision makers in the formation of the ESOP, selection of the trustee, and management and disposition of the plan's assets, the court concluded the owners were fiduciaries.

The court refused to dismiss claims against the owners based on breaches as fiduciaries, and as co-fiduciaries to the trustee. Allegations that the owners knowingly provided the trustee with flawed information about the company, which

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led to the trustee to direct the ESOP to purchase the shares for an inflated valued were sufficient to survive a motion to dismiss. The court found significant the DOL's allegations that neither owner made an effort to correct the valuation information, or to remedy the breaches made by the trustee. On similar grounds, the court refused to dismiss the prohibited transaction claims based on the owners' intimate involvement in the establishment of the ESOP and negotiation of the overstated sales price.

The court's decision allows the DOL to proceed to attempt to make its case that defendants committed fiduciary breaches and prohibited transactions, based on a flawed company valuation that resulted in a loss to the plan. *Acosta v. Saakvitne*, Case Civ. No. 18-00155 SOM-RLP, D. Hawaii (January 18, 2019).