ERISA Litigation Insights: *Walsh v. Bowers*

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In Walsh v. Bower,[1] *the U.S. Department of Labor (the "DOL") sued Brian Bowers and Dexter Kubota, the former owners of Bowers + Kubota Consulting, Inc. ("B+K"). The DOL alleged that Bowers and Kubota had violated the Employee Retirement Income Security Act of 1974 ("ERISA") by manipulating data to induce the B+K newly formed employee stock ownership plan ("ESOP") to pay more than the company's fair market value. This judicial decision is noteworthy because it provides discussion of certain ERISA issues that other courts have avoided. This judicial decision provides practitioners with professional guidance as the DOL has not lost a major ESOP case on a valuation issue for over a decade.*

Introduction

On September 17, 2021, the judicial opinion was issued for *Walsh v. Bowers*. In that matter, the U.S. Department of Labor ("DOL") sued Brian Bowers and Dexter Kubota, former owners of Bowers + Kubota Consulting, Inc. ("B+K").

The DOL alleged that Bowers and Kubota had violated the Employee Retirement Income Security Act of 1974 ("ERISA") by manipulating data to induce the B+K newly formed employee stock ownership plan ("ESOP")to pay more than the company's fair market value.

The case was tried in the United States District Court for the District of Hawaii by Judge Susan Oki Mollway (the "District Court"). The District Court ultimately concluded that neither Bowers nor Kubota had violated his fiduciary responsibilities, nor were they liable for any damages owed to the B+K ESOP.

According to the defense experts, the District Court demonstrated a strong understanding of the underlying concepts of business valuation.[2] The judicial opinion echoed this statement. This judicial decision provides the practitioner with professional guidance regarding the application of important ERISA issues, particularly fiduciary duty, which other courts have avoided.

Case Background

B+K is an architectural and engineering firm based in Hawaii. B+K specializes in construction management, project management, architecture, civil engineering, and electrical engineering projects.[3]

B+K manages commercial, educational, government, infrastructure, and transportation projects from preliminary analysis and planning through complete design. The B+K award-winning work exists on all major islands of Hawaii and other areas of the Pacific Rim.

The firm was originally established in 1980 as KFC Airport, Inc. Brian J. Bowers purchased 100 percent of the shares of KFC Airport in 1997.

Dexter C. Kubota subsequently purchased a 49 percent interest in the firm from Bowers. After that time, the company became known as Bowers + Kubota Consulting, Inc.[4]

Prior Discussions of a Sale Transaction

From the period of 2008 through 2012, Bowers and Kubota explored selling B+K to several different types of buyers, including the following:

1. B+K management
2. Private parties
3. An ESOP

After ruling out a sale to B+K management, Bowers and Kubota entered into preliminary discussions with potential buyer URS Corporation ("URS"), a California-based engineering and design firm. In 2011, Bowers and Kubota discussed a possible purchase of B+K with URS. URS submitted a preliminary nonbinding indication of interest around December 5, 2011.[5]

The letter of interest stated that URS was interested in purchasing B+K for $15 million plus or minus "cash and debt on the B+K balance sheet." After considering cash and debt at the time, the indication of interest landed at about $29 to $30 million for 100 percent of the B+K equity.

Importantly, as will become relevant to the *Walsh v. Bowers* matter, URS stipulated in its letter that it did not constitute an offer: "If the proposal contained in this letter is acceptable to you, we are prepared to move to the next steps in the acquisition process, enter into an agreement for exclusivity for a period of 90 days, and begin initial due diligence."[6]

Bowers acknowledged and agreed to the terms of the letter (i.e., to begin the due diligence process and continue negotiations of the sale).

During discussions with URS, B+K retained a valuation analyst with GMK Consulting to provide a valuation of B+K "for internal use only." The valuation analyst concluded a fair market value for B+K of $39.7 million, about $10 million higher than the URS letter of intent implied.[7]

B+K delivered the business valuation to URS as a part of its negotiations.

However, the negotiations between URS and B+K ultimately ended by mid-2012, presumably because the parties were not able to agree upon a sale price. Bowers and Kubota, now over three years into its search to find a buyer, were back at square one.

Background of the ESOP Transaction

In late August 2012, Bowers and Kubota met with Gregory M. Hansen, an attorney with the Honolulu law firm of Case Lombardi & Pettit, to help with a potential ESOP transaction. On September 2, 2012, Bowers and Kubota signed a formal agreement with Hansen to draft preliminary plans.[8]

Soon thereafter, Bowers and Kubota concluded that they would form an ESOP for B+K.

The GMK Consulting valuation analyst withdrew from participating in a formal ESOP business valuation for Bowers and Kubota, stating they were "uncomfortable with the structure of the transaction."[9]

As a result, Bowers and Kubota were advised by Hansen to hire Greg Kniesel of LVA, a Chicago-based valuation firm to provide the formal business valuation.

On November 21, 2012, LVA sent the board of trustees of the proposed B+K ESOP and Trust a "preliminary fair market value of the common stock" of B+K. LVA's report appraised the ESOP controlling interest value between $37,090,000 and $41,620,000.[10]

LVA did not provide a final value to the board of trustees.

B+K hired Nicholas L. Saakvitne on November 26, 2012, to be the trustee of the ESOP on Hansen's referral. As trustee, Saakvitne's responsibilities included evaluating any proposed sales of the shares of B+K, negotiating terms on behalf of the ESOP in the sale, and continuing to serve as the ESOP's trustee thereafter.

Bowers and Kubota stood to benefit from tax advantages if the sale closed before the end of 2012.[11]

In addition, Hansen, who represented the Bowers and Kubota in the impending deal, had a vacation scheduled for late December. The approaching year end created a time crunch for Saakvitne to close the ESOP deal.

Bowers and Kubota, as board directors, officially formed the ESOP on December 3, 2012, and subsequently adopted the ESOP for B+K.

Saakvitne also hired Greg Kniesel of LVA to provide a business valuation of B+K for the ESOP, even though he had absolute discretion to hire any independent appraiser to perform the work.

The *Walsh v. Bowers* judicial opinion states that "on December 7, 2012, LVA changed its engagement letter to indicate that it was working for Nicholas L. Saakvitne." This decision became a concern identified in the DOL complaint.

The LVA business valuation report was sent to Saakvitne on December 14, 2012, and valued the company at $40,150,000.[12]

ESOP Transaction Description

Bowers and Kubota initially offered to sell B+K to the ESOP for $41 million and financed at a 10

percent interest rate over 20 years. Saakvitne countered, offering to pay $39 million and financed at a 6 percent interest rate over 25 years.

Bowers countered at $40 million and financed at 8 percent over 25 years. Finally, Saakvitne offered to buy B+K for $40 million and financed at 7 percent over 25 years, to which Bowers and Kubota agreed.[13]

On December 14, 2012, Bowers and Kubota, through their respective trusts, sold 100 percent of the B+K stock to the ESOP for $40 million. The ESOP was structured as a leveraged ESOP, receiving a loan from B+K to pay for the transaction with an interest rate of 7 percent over 25 years.

Saakvitne, the ESOP's independent fiduciary and trustee, executed the purchase agreement on behalf of the ESOP.

Overall, the deal was a straightforward leveraged ESOP transaction with few, if any, additional complicating considerations.

After four years of considerations and discussions, Bowers and Kubota had found a buyer for their company. However, between the failed deal with URS, business valuation from multiple valuation consultants, and the final transaction, the process had generated several indications of value, at times conflicting, and left open questions about the independence of the Saakvitne negotiations.

Post-ESOP-Transaction Developments

After Bowers and Kubota sold B+K, the employees, through the ESOP trust, became the owners of the company.

LVA submitted a valuation report for B+K as of December 31, 2012, just two weeks after the sale, valuing B+K at $6.53 million.[14]

The significant reduction in value of B+K was due to B+K now holding a large debt burden on its balance sheet as a result of the transaction. B+K had recorded this debt to finance the ESOP purchase of the company equity from Bowers and Kubota.

Bowers and Kubota filed Form 5500 with the Internal Revenue Service ("the "Service") in October 2013. Form 5500 is a required filing for employee benefit plans under ERISA, which describes basic details about the ESOP, such as contact information, employer identification number, and employee count.

Supplemental attachments described the ESOP transaction terms. The initial Form 5500 filing indicates to the Service and to the DOL that an ESOP has been formed.

Investigators at the DOL began reviewing the B+K transaction in December 2014 on the initial suspicion that the $40,000,000 sale price must have been predetermined and that the ESOP had paid significantly more than fair market value.

Particularly, the $40,000,000 value was a far stretch from the $15,000,000 (plus cash and minus debt) proposed by URS in 2011 and from the LVA valuation of B+K for $6,530,000 performed after the valuation date. At the time, the DOL did not recognize that the values were not reasonable representations of the fair market value of B+K.

The DOL filed a lawsuit against Bowers, Kubota, and Saakvitne on April 27, 2018.

Before trial, the DOL settled its claims against Saakvitne, the original trustee of the ESOP, and against the Saakvitne Law Corporation.

At trial, Bowers and Kubota argued in their defense that the three-year statute of limitations had begun when they filed the Form 5500 in October 2013.[15]

However, the DOL argued that the Form 5500 was not reviewed internally until December 2014.

The DOL and Bowers and Kubota had entered into a tolling agreement to toll the statute of limitations under ERISA from October 16, 2017, to April 30, 2018. As a result, the District Court sided with the DOL and concluded that the statute of

limitations was effectively extended beyond April 27, 2018, and the defense argument proved to be invalid.

The District Court Proceeding

The DOL complaint listed the following violations that it sought to redress:[16]

- Failure of Bowers and Kubota to discharge fiduciary duties with the proper care, skill, prudence, and diligence in violation of ERISA, specifically as follows:
  - Fiduciary duty related to a 2012 revenue prediction
  - Fiduciary duty related to 2013 through 2017 revenue predictions
  - Fiduciary duty by relying on LVA's "preliminary and fairness opinion"
  - Fiduciary duty by causing the ESOP to purchase the company shares for more than fair market value
  - Fiduciary duty to monitor Saakvitne
- Bowers and Kubota are liable for breaches of fiduciary duty by other fiduciaries, including the following:
  - Liability for each other's provision of allegedly inaccurate financial data to LVA in 2012
  - Liability for each other's failure to monitor Saakvitne
  - Liability for behavior by any other fiduciary that caused or contributed to payment by the ESOP of more than fair market value for the company
- Bowers and Kubota are liable for engaging in transactions prohibited by ERISA as follows:
  - Engaging in prohibited transactions between a plan and a party in interest
  - Engaging in prohibited transactions with the ESOP
- Bowers and Kubota are liable for knowingly participating in transactions prohibited by ERISA

The DOL complaints significantly relied upon the argument that Bowers and Kubota caused the ESOP to pay more than fair market value for B+K. The fair market value of the company, in turn, relied on the accuracy of revenue predictions for 2012 through 2017.

The Trial Court opinion in this case also provides a robust discussion of certain issues related to fiduciary duty.

Valuation Issues

The Trial Court qualified three expert witnesses to opine on the fair market value of B+K as of December 14, 2012, the ESOP transaction closing date:

1. A financial expert on behalf of the DOL
2. Two financial experts on behalf of the defense

2012 Revenue

The DOL argued that Bowers and Kubota provided inflated earnings and revenue projections for fiscal 2012 to their consultant, LVA, which contributed to an inflated fair market value conclusion.

Bowers and Kubota provided a 2012 earnings before interest, taxes, depreciation, and amortization ("EBITDA") of $9,235,000, while the DOL concluded that an EBITDA of $4,849,000 was more appropriate.

The District Court found, after taking into account relevant circumstances, that the DOL failed to prove that Bowers or Kubota breached their fiduciary duty based on the 2012 EBITDA projection. According to the defendants' experts, the DOL did not consider the upward trend in EBITDA, the size of the B+K contract backlog, and how certain contract accounting influenced the projection.[17]

B+K management had produced a detailed analysis of its contract backlog to support its projections that pointed towards a backlog of approximately $54,000,000. In comparison to 2011 revenue of $22,005,000, the backlog indicated over two years of work booked in advance, a strong indication of future income.

The DOL expert used an estimate of $17,000,000 in contract backlog, which would indicate weaker future earnings potential.

The defendants' experts stated after the case that the plaintiff's expert used increased operating expenses. They went on to describe that plaintiff's expert was likely assuming that increased earnings and revenue would result in increased operating expenses.

However, certain accounting rules for its contracts meant that subconsultant expenses charged in its contracts passed through the B+K accounting books. These rules can effectively result in one-for-one increased (or decreased) revenue and expense.

The plaintiff's expert applied adjustments to its valuation to increase subconsultant operating expenses without applying a corresponding adjustment to revenue, violating the relationship between these entries on the B+K income statement.

The District Court ultimately rejected the DOL claim that 2012 earnings were inflated and as a result found that neither Bowers nor Kubota had breached its fiduciary duties.

2013 through 2017 Revenue

The District Court determined that Bowers and Kubota also did not breach their fiduciary duty related to 2013 through 2017 projections. It is likely that this DOL complaint was contingent upon similar adjustments to the 2012 revenue figure and, therefore, collapsed when that argument was struck down.

Fair Market Value of B+K

The District Court quickly realized that the two value indications on which the DOL originally based its complaint—$15,000,000 (plus cash and minus debts) proposed by URS in 2011 and the LVA business valuation of B+K for $6,530,000 performed after the valuation date—were not suitable comparisons for the fair market value of B+K.

With respect to the URS proposal, the District Court also understood the URS proposal to be an opening offer to commence negotiations, not a closing sale price. The District Court provided the analogy of "an individual who makes an offer of $15,000 for a used luxury car with a Blue Book value of $40,000 does not, by virtue of making a 'lowball' offer that is never accepted, tend to establish that the car is worth only $15,000."[18]

The plaintiff's financial expert testified that the fair market value of B+K on the transaction date was $26,900,000. The plaintiff's expert valuation consisted of an initial fair market value of $32,197,000 less a 7 percent discount for lack of marketability and an additional $2,994,000 discount for the ESOP's lack of "limited control."[19]

One of the defendants' experts testified that the plaintiff expert failed to follow the *Uniform Standards of Professional Appraisal Practice* in developing its valuation. The defendant expert stated that the plaintiff expert did not perform sufficient research, such as conducting an interview of B+K management, and as a result his analysis suffered from certain missing accounting considerations related to the subconsultant expense pass-throughs.

Additionally, the defendants' expert argued that the plaintiff's expert was mistaken to apply a discount for the ESOP's lack of "limited control."

The plaintiff's expert based the discount on the argument that Bowers and Kubota themselves continued to exercise meaningful control of B+K after the transaction, evidenced by significant bonuses the company paid them without documenting approval by Saakvitne.

The judicial opinion recognizes that an ESOP is subject to limitations in its control relative to an independent buyer. However, the opinion also raises the defendant expert's argument that the plaintiff's rationale relies on bonuses paid after the sale and were not known or knowable as of the transaction date. The judicial opinion in this matter does not definitively conclude whether or not a discount for lack of control was appropriate.[20]

This control issue raises interesting questions, including whether B+K was aware of these bonuses at the time of the transaction; what degree of control Bowers and Kubota retained as managers after the transaction, whether these bonuses truly implied a degree of control over B+K, and under what circumstances a valuation analyst may rely on facts available only after the valuation date (for instance, it is likely that management would have an understanding of fiscal 2012 management bonuses on December 14, 2012).

However, the judicial opinion does not address these issues and does not further explore these questions as the DOL's fair market value indication

was already severely weakened by its error related to the subcontract expenses.

The defense expert provided additional testimony that the plaintiff expert undervalued B+K in aggregate by $13,515,000 ($10,521,000 related to the subcontract expenses and $2,994,000 related to an inappropriate discount for lack of control). Adjusting for these factors from the plaintiff expert's value of $26,900,000 results in a fair market value of B+K of $40,415,000, which exceeds the sale price.

The defendants' financial experts both concluded fair market values of the company greater than the sale price. One of the defendants' experts concluded a value of $43,200,000 and the other one of the defendants' experts concluded a value of $43,050,000.[21]

Fiduciary Duty

Since many of the complaints outlined by the DOL were based in the fiduciary responsibilities within ERISA and corresponding 29 U.S.C. Section 1104(a)(1), carried by Bowers, Kubota, and Saakvitne, the District Court provided a case review and discussion of fiduciary duty in its opinion.

The District Court cited conclusions from several Ninth Circuit cases, including the following citations:[22]

- "ERISA defines 'fiduciary' not in terms of formal trusteeship, but in functional terms of control and authority over the plan." (*Johnson v. Couturier*, 9th Cir. 2009)
- The Ninth Circuit "construe[s] ERISA fiduciary status 'liberally, consistent with ERISA's policies and objectives." (*Arizona State Carpenters Pension Trust Fund v. Citibank*, 9th Cir. 2015)
- "We have repeatedly stated that ERISA is remedial legislation that should be construed liberally to protect participants in employee benefits plans." (*Batchelor v. Oak Hill Medical Group*, 9th Cir. 1989)
- "ERISA fiduciary responsibilities thereunder, can exist even where a formal employee benefit plan ha[s] not been adopted." (*Solis v. Webb*, N.D. Cal. 2012)

The District Court determined that fiduciary responsibility applied to Bowers and Kubota from June 2012, when the ESOP was first proposed, to December 3, 2012, the date on which Bowers and Kubota formed the ESOP.[23]

The District Court conclusions related to the valuation issues resulted in the dismissal of a set of the DOL's fiduciary duty complaints. Two complaints were not immediately dismissed and required further scrutiny.

First, the complaint stated that Bowers and Kubota breached their fiduciary duty by relying on the LVA preliminary and fairness opinion.

The complaint implied that the LVA opinion included misstatements and errors which Bowers and Kubota should have identified prior to the transaction. The Bowers and Kubota failure to identify the alleged misstatements would have caused the ESOP to pay more than fair market value for B+K.

However, the District Court concluded that since the DOL failed to prove that the fair market value of B+K was less than the sale price of $40 million, the DOL does not have further basis to argue that the LVA opinion included misstatements and errors.[24]

If the DOL had identified a specific issue with the LVA analysis, then further arguments could have been contemplated. However, the DOL allegation relied on a gross difference in fair market value, not a specific issue. As a result, by failing to present a different fair market value for the company, the DOL failed to meet the burden of establishing a breach of fiduciary duty.

Monitoring the ESOP Trustee

The second DOL complaint was related to the Bowers and Kubota fiduciary duties to monitor the trustee, Saakvitne. Throughout the case, the DOL contested actions taken by Saakvitne, though these actions were not litigated in court as Saakvitne settled separately prior to the trial.

Therefore, the *Walsh v. Bowers* judicial decision focuses on the Bowers and Kubota responsibilities to monitor Saakvitne.

The District Court acknowledged that Bowers and Kubota, according to the ESOP agreement, held the power to appoint and remove a trustee.[25] Consequently, Bowers and Kubota held the fiduciary duty to monitor the ESOP trustee pursuant to both the ESOP agreement and ERISA guidance from the DOL.

Saakvitne was accused of not conducting due diligence in its preparations to buy B+K on behalf of the ESOP. The DOL alleged that this was, in part, the fault of Bowers and Kubota. Bowers and Kubota placed an unreasonable time frame on Saakvitne to close the transaction.

Saakvitne was hired on November 26 and Hansen had indicated he was leaving for vacation on December 19. The argument continues that this short time line forced Saakvitne to hire LVA as a valuation consultant since LVA had already developed

a fair market value analysis for Bowers and Kubota.

This analysis, according to the DOL position, was developed with errors or misstatements.

In short, the District Court found that the ESOP stood to benefit from tax advantages if the deal closed by the end of 2012.[26] Therefore, Saakvitne had a reasonable basis for closing the transaction before the end of the year.

In the Bowers and Kubota defense, they stated that no hard requirement was ever imposed by them that the deal close by the end of 2012, even though it was to their advantage.

The District Court concluded that the DOL failed to prove a breach of fiduciary duty by Bowers and Kubota on this issue.

In another allegation of breach of fiduciary duty, the DOL suggested that Bowers, Kubota, and Saakvitne conspired to arrange a sale price of $40 million.

In the opinion, the District Court stated that "the Government's concerns are understandable. The Government was looking at a high sale price that had been shared ahead of time with the ESOP trustee. But knowing what a seller wants does not make a buyer complicit in wrongdoing."[27]

In addition, Saakvitne fought for a favorable interest rate on the loan to the ESOP, an important consideration not reflected in the sale price alone. Once again, the District Court concluded that the DOL did not meet its burden of proof on this issue.

Summary and Conclusion

The *Walsh v. Bowers* judicial decision stands out among the canon of ESOP litigation as the DOL has not lost a major ESOP case on a valuation issue for over a decade.[28]

Many of the DOL complaints relied on the allegation that the fair market value of B+K was significantly overvalued. Naturally, this allegation implied that the ESOP trustee did not conduct due diligence or knowingly relied on an inaccurate appraisal.

However, as the District Court proceeding revealed, neither of the values that the DOL initially based its allegations on—the URS proposal and the December 31, 2012, valuation—accurately reflected a sale price that would occur between a willing buyer and seller with reasonable knowledge of relevant facts.

As a result of the findings related to the fair market value of B+K, the District Court concluded that the sale price did not exceed the fair market value of the company.

In other words, the valuation prepared by the DOL expert did not convince the District Court that the transaction price was inconsistent with the fair market value of the company. Therefore, the plaintiff's fair market values were not relied upon by the District Court.

Like a house of cards, the remaining allegations against Bowers and Kubota fell down largely as a consequence of this foundational blow to the DOL case.

Notes:

1. Walsh v. Bowers, —— F.Supp.3d ——, 2021 WL 4240365 (D.Hawai'i 2021).
2. Ian C. Rusk and Kenneth Pia, "Landmark ESOP Ruling: Inside the Walsh v. Bowers Case with the DOL," Training Event Transcript, Business Valuation Resources (November 2, 2021): 10.
3. https://www.bowersandkubota.com/about/
4. Walsh v. Bowers, 2021 WL 4240365 at *2.
5. Id. at *4.
6. Id.
7. Id. at *5.
8. Id. at *6.
9. Id.
10. Id. at *7.
11. Id. at *6.
12. Id. at *9.
13. Id. at *8.
14. Id. at *12.
15. Id. at *16-18.
16. Id. at *18–26.
17. "An Inside Look at the Landmark ESOP Valuation Case," *Business Valuation Update* 27, no. 12 (December 2021): 19–21.
18. Walsh v. Bowers, 2021 WL 4240365 at *5.
19. Id. at *12.
20. Id. at *14.
21. Id. at *14–15.
22. Id. at *19–20.
23. Id. at *20–21.
24. Id. at *22.
25. Id.
26. Id. at *23.
27. Id. at *24.
28. "An Inside Look at the Landmark ESOP Valuation Case": 19.

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