

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

August Term, 2008

(Argued: October 21, 2008 Decided: June 19, 2009)

Docket No. 07-0355-cv

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JOSEPH HENRY and MICHAEL MALINKY,

Plaintiffs-Appellants,

v.

U.S. TRUST COMPANY OF CALIFORNIA, N.A.,

Defendant-Appellee,

CHAMPLAIN ENTERPRISES, INC., doing business as COMMUTAIR, ANTHONY  
VON ELBE, JOHN ARTHUR SULLIVAN JR., ERNEST JAMES DROLLETTE,  
ANDREW PRICE, WILLIAM L. OWENS, CHAMPLAIN AIR, INC.,  
Defendants.

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B e f o r e: FEINBERG, WINTER, and POOLER, Circuit Judges.

Appeal from a judgment of the United States District Court  
for the Northern District of New York (David N. Hurd, Judge),  
dismissing appellants' complaint of alleged violations of the  
Employee Retirement Income Security Act. The court held that  
appellants suffered no damages even if violations did occur. We  
hold that when an Employee Stock Ownership Plan incurs debt to  
finance a purchase of shares of stock and then later sells the  
shares in exchange for cancellation of some of that debt, the

1 debt cancellation in the second transaction should not be  
2 construed as having reduced the purchase price paid in the first  
3 transaction. We therefore vacate and remand to the district  
4 court.

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6 Shayne, Shayne Nichols, LLC,  
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9 Arizona, on the brief), DeGraff,  
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16 N. Eccles, Jonathan D. Hacker, and  
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22  
23  
24 WINTER, Circuit Judge:

25 Joseph Henry and Michael Malinky appeal from Judge Hurd's  
26 dismissal of their complaint after a remand from this court,  
27 Henry v. Champlain Enterprises, Inc., 445 F.3d 610 (2d Cir. 2006)  
28 ("Henry III"). The complaint alleged violations of the Employee  
29 Retirement Income Security Act ("ERISA"). After the remand, the  
30 district court held that appellants suffered no damages even if  
31 ERISA violations occurred. Henry v. Champlain Enters., Inc., 468  
32 F. Supp. 2d 368, 373 (N.D.N.Y. 2007) (mem.) ("Henry IV"). The  
33 principal issue is whether the district court properly concluded  
34 that an award of damages to appellants would constitute a

1 windfall. For the reasons set forth below, we disagree and  
2 vacate the judgment.

3 BACKGROUND

4 We assume familiarity with the facts and procedural  
5 history as set forth in our prior decision, see Henry III, 445  
6 F.3d at 613-17, and recite only those relevant to the present  
7 issues.

8 CommutAir is a corporation that provides regional commuter  
9 airline services. Appellants are participants in CommutAir's  
10 Employee Stock Ownership Plan ("ESOP"). In 1994, the ESOP  
11 purchased 540,000 shares of CommutAir convertible preferred  
12 stock from CommutAir's three owners -- Anthony von Elbe, John  
13 Arthur Sullivan, Jr., and Ernest James Drollette ("the  
14 sellers") -- at a total price of \$60 million. The ESOP  
15 financed this purchase by paying \$9 million in cash, for which  
16 the ESOP issued a promissory note to CommutAir, and by issuing  
17 a total of \$51 million in promissory notes to the three  
18 sellers.

19 Appellee U.S. Trust was the ESOP's trustee during this  
20 transaction.

21 In 1999, CommutAir settled a dispute with the Internal  
22 Revenue Service over CommutAir's deductions for its  
23 contributions to the ESOP. The settlement was based on an  
24 assumption that the fair market value of the purchased stock,  
25 at the time of purchase, was only \$51 million rather than \$60

1 million. This settlement triggered Section 5.7 of the 1994  
2 stock purchase agreement, which provided, inter alia, that in  
3 the event of a "final determination" that the shares' purchase  
4 price exceeded the purchased shares' fair market value as of  
5 the date of the sale, the sellers would make up the difference  
6 (plus interest) either in cash or in additional shares "valued  
7 in accordance with their actual fair market value" at the time  
8 of the 1994 purchase and sale.<sup>1</sup> Accordingly, in 2004 the  
9 sellers gave the ESOP an additional 191,000 shares.

10 Meanwhile, in November 2001, appellants had brought the  
11 present action against U.S. Trust and others, alleging in  
12 pertinent part that the 1994 stock purchase had violated  
13 Section 406 of ERISA, which generally prohibits an employee  
14 plan's fiduciaries from causing the plan to engage in  
15 transactions with a "party in interest," including purchases of  
16 the employer's securities. 29 U.S.C. § 1106(a). Section 408  
17 of ERISA provides an exception to this general prohibition,

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<sup>1</sup>Section 5.7 of the agreement reads as follows:

In the event of a final determination by the Internal Revenue Service, the Department of Labor, a court of competent jurisdiction or otherwise that the fair market value of the shares of ESOP [c]onvertible [p]referred [s]tock as of the [c]losing is less than the [p]urchase [p]rice, then the [s]ellers, jointly and severally, shall pay to the [t]rust an amount equal to the difference between the [p]urchase [p]rice and said fair market value for the such shares of ESOP [c]onvertible [p]referred [s]tock, plus interest at a reasonable rate [from] the date of [c]losing to the date of such payment. Such payment may be made either in cash, or in the form of shares, valued in accordance with their actual fair market value as of the [c]losing.

1 allowing a plan in certain circumstances to purchase the  
2 employer's stock if the plan receives "adequate consideration,"  
3 which in this case would have been the "fair market value of  
4 the asset as determined in good faith by the trustee." 29  
5 U.S.C. §§ 1002(18), 1108(e)(1).

6 After a bench trial, the district court held that Section  
7 406 applied to the 1994 agreement but the Section 408 exception  
8 did not, because U.S. Trust had failed to demonstrate that it  
9 had undertaken an "adequate, good-faith" investigation of the  
10 stock's value. Henry v. Champlain Enters., Inc., 334 F. Supp.  
11 2d 252, 268-70, 274 (N.D.N.Y. 2004) ("Henry II"). Finding that  
12 the fair market value of the stock that the ESOP received had  
13 not been \$60 million, but only \$52.25 million, the district  
14 court awarded appellants \$7.75 million in damages against U.S.  
15 Trust. Id. at 274-75. A subsequent amendment to the judgment  
16 added awards of prejudgment interest and of attorneys fees and  
17 expenses. Henry IV, 468 F. Supp. 2d at 370-71.

18 U.S. Trust appealed. In April 2006, we vacated the  
19 district court's judgment and award of damages and remanded for  
20 the district court to: (i) identify the specific errors, if  
21 any, that occurred in the \$60 million valuation of the  
22 CommutAir stock; (ii) determine whether a prudent fiduciary  
23 would have detected those errors under the circumstances  
24 prevailing at the time of the 1994 transaction; (iii)  
25 articulate reasons for its specific award of prejudgment

1 interest; and (iv) if the district court did award damages on  
2 remand, explain why those damages would not result in a  
3 windfall to the ESOP. Henry III, 445 F.3d at 621, 623-24. In  
4 discussing the windfall issue, we specifically called attention  
5 to the 2004 grant of 191,000 extra shares to the ESOP. Id. at  
6 624.

7 In February 2006, while the first appeal was pending, the  
8 ESOP sold all of its CommutAir stock to CommutAir in exchange  
9 for CommutAir's cancellation of the outstanding \$9 million  
10 promissory note and for CommutAir's owners' cancellation of the  
11 balance on the \$51 million in promissory notes. Although this  
12 transaction occurred after the first appeal was argued and  
13 before our decision was issued, the parties never informed us  
14 of this transaction.

15 The 2006 sale/debt-forgiveness transaction did not purport  
16 to be a settlement of any issue relevant to this appeal. There  
17 is an indication in the record that the CommutAir securities  
18 may have been worthless in 2006, but nothing in the record  
19 explains the reason for the 2006 transaction. On the record  
20 before us, the 2006 transaction was independent of earlier  
21 transactions and was desired by the parties to it, which did  
22 not include U.S. Trust, in light of their economic  
23 circumstances.

24 On remand, the district court dismissed all claims against  
25 U.S. Trust on the ground that any award of damages would be a

1 prohibited windfall to the ESOP. Henry IV, 468 F. Supp. 2d at  
2 372-73. It concluded that addressing the other issues  
3 mentioned in our remand was therefore unnecessary. Id. at 373.

4 The present appeal ensued.

5 DISCUSSION

6 When this case was first before us, we noted that “[t]he  
7 aim of ERISA is ‘to make the plaintiffs whole, but not to give  
8 them a windfall.’” Henry III, 445 F.3d at 624 (quoting Jones  
9 v. UNUM Life Ins. Co. of Am., 223 F.3d 130, 139 (2d Cir.  
10 2000)). We also noted that in light of the provision of extra  
11 shares to the ESOP in 2004, inter alia, the district court  
12 should decide on remand whether an award of damages against  
13 U.S. Trust would constitute a windfall. Id. at 623-24.

14 On remand, the district court addressed the windfall  
15 issue, but not with reference to the 2004 provision of extra  
16 shares. Instead, it reasoned that because the February 2006  
17 sale of the ESOP’s CommutAir shares to CommutAir involved  
18 cancellation of approximately \$14.5 million of the ESOP’s  
19 debt,<sup>2</sup> the ESOP ultimately paid only \$45.5 million for its  
20 CommutAir shares. Henry IV, 468 F. Supp. 2d at 372. The  
21 district court reached that figure by subtracting the \$14.5  
22 million in loans forgiven in the 2006 transaction from the \$60

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<sup>2</sup>The amount was based on \$9 million owed to CommutAir and the approximately \$5.5 million still owed to the owners of CommutAir -- von Elbe, Sullivan, and Drollette.

1 million purchase price in the 1994 transaction.<sup>3</sup> Id. The  
2 district court then concluded that because \$45.5 million was  
3 less than \$51 million, which was the lowest estimate of the  
4 value that the purchased CommutAir shares had at the time of  
5 the 1994 purchase, "any award of damages would constitute a  
6 windfall." Id.

7 The district court assumed that when a purchaser of stock  
8 incurs debt to finance the purchase and then later sells the  
9 stock in exchange for cancellation of some of that debt, the  
10 debt cancellation in the second transaction should, for  
11 purposes of ERISA, be construed as having reduced, post facto,  
12 the purchase price in the first transaction, and thus to have  
13 reduced any loss for which damages should be awarded. We  
14 disagree.

15 Neither the district court nor appellee has offered any  
16 justification for such an assumption, which we regard as

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<sup>3</sup>The parties disagree over which figures the district court should have used in calculating the supposed effect of the 2006 transaction on the 1994 purchase price. Appellants argue that the district court should have arrived at a purchase price of \$54.5 million, rather than \$45.5 million. Appellee argues that the district court's calculation was correct. Although the details of these dueling calculations are immaterial to the disposition of this appeal, in order to avoid any inference that might arise on remand from our silence, we note that we disagree with appellants. Appellants tally up the ESOP's costs as follows: \$51 million in promissory notes to von Elbe, Sullivan, and Drollette; \$9 million in cash to von Elbe, Sullivan, and Drollette; and a \$9 million promissory note to CommutAir, for a total of \$69 million. What appellants overlook is that if the \$9 million promissory note to CommutAir is treated as part of the 1994 transaction, then what the ESOP received was not merely 540,000 shares of CommutAir convertible preferred stock, but rather those 540,000 shares plus \$9 million in cash from CommutAir. The ESOP did not give CommutAir a \$9 million promissory note in exchange for nothing. It gave that note in exchange for cash. Thus, in the corrected version of appellants' calculation, the ESOP paid \$69 million for \$9 million in cash plus 540,000 shares. Netting out the \$9 million in cash, the price that the ESOP paid for the shares alone was \$60 million.

1 incorrect.<sup>4</sup> If an investor pays \$100 for 20 shares of stock  
2 and later sells those shares back to the original seller for  
3 \$25, the result is not that the investor paid only \$75 for the  
4 shares. Rather, the result is that the investor lost \$75 on  
5 that investment.

6 Although the transactions in the present case involved  
7 payment chiefly in the form of debt obligations and debt  
8 forgiveness, rather than cash, the fundamental logic remains  
9 the same. If the hypothetical investor above paid for the 20  
10 shares with \$100 of IOU's and later resold the shares to the  
11 original seller for a cancellation of \$25 of IOU's, no one  
12 would deem the resale to have altered the original price so  
13 that no loss was incurred. So too, when the ESOP purchased  
14 CommutAir shares in 1994 for \$60 million, financed by incurring  
15 debt, and then in 2006 sold those shares (plus additional  
16 shares received in 2004) in exchange for forgiveness of \$14.5  
17 million in debt, the result was not a decrease in the price  
18 paid in 1994, but rather the realization of a substantial loss

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<sup>4</sup>Appellee also suggests that the \$9 million promissory note to CommutAir should not be included in any calculation of the ESOP's losses because, as a result of the 2006 sale that involved canceling that debt, the ESOP never expended any earnings to repay that loan. Apart from one district court case that merely notes that an employer's ESOP contributions are compensation, not a gratuity, Reich v. Valley Nat'l Bank of Arizona, 837 F. Supp. 1259, 1287 (S.D.N.Y. 1993), appellee offers no legal authority for its contention that only repayments of debt, and not the assumption of indebtedness itself, constitute a loss. Appellee nevertheless contends that the proper "economic analysis" of these transactions requires such an approach. This contention overlooks the obvious fact that the assumption of indebtedness has immediate legal and economic consequences even before the borrower begins to repay the debt. For example, the borrower's plans for the future are now constrained by the obligation to commit future income streams to repaying the loan, and the borrower's ability to obtain future loans at a low rate decreases, because the borrower is now a greater credit risk.

1 on that investment.

2 We, therefore, overturn the conclusion that, on the basis  
3 of the 2006 transaction, the ESOP paid only \$45.5 million for  
4 the CommutAir shares that it acquired. The 2006 transaction  
5 had no effect on the 1994 transaction's purchase price, which,  
6 on the record before us, was \$60 million. See supra Note 2.

7 The issue posed, inter alia, in our Henry III remand,  
8 whether an award of damages against U.S. Trust would result in  
9 an impermissible windfall, still remains impossible for us to  
10 determine. Whether the ESOP ultimately was overcharged depends  
11 not only on the purchased shares' price, but also on their  
12 value. How much the total number of shares that the ESOP  
13 acquired in 1994 and 2004 was worth at the time of the 1994  
14 transaction is a question of fact that the record before us  
15 does not answer. We therefore remand again for the district  
16 court to consider this issue, if the district court determines  
17 that appellants are entitled to recover damages from U.S.  
18 Trust.

19 As noted, supra, the district court concluded that the  
20 2006 transaction mooted the issue of the appropriateness of  
21 awarding costs against appellants and the other issues that we  
22 earlier directed it to consider on remand. Henry IV, 468 F.  
23 Supp. 2d at 373. Our decision of course restores the need to  
24 resolve these issues.

25 Appellants raise an additional argument that the ESOP's

1 interest payments were excessive because its loan amortization  
2 schedule was based on a total share purchase price of \$60  
3 million rather than on a lesser amount. As we have just noted,  
4 what is at issue in this case is not whether the ESOP paid less  
5 than \$60 million for the CommutAir shares that it received in  
6 1994 and 2004, but rather how much those acquired shares were  
7 worth at the time of the 1994 transaction. If those shares were  
8 worth less than \$60 million, and if damages are awarded against  
9 U.S. Trust, then the interest overpayment argument may perhaps  
10 be relevant to the district court's damages calculation. It is  
11 not, however, an issue for us to address in this appeal.

#### 12 CONCLUSION

13 For the foregoing reasons the judgment of the district  
14 court is vacated, and we remand to the district court for  
15 further proceedings consistent with this opinion and our  
16 opinion in Henry III.

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