

**IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF NEW YORK**

**JOSEPH HENRY and MICHAEL
MALINKY,**

Plaintiffs,

vs.

**Civil Action No. 01-CV-1681
(DNH/RFT)**

**CHAMPLAIN ENTERPRISES, INC.
dba COMMUTAIR, ANTONY VON ELBE,
JOHN ARTHUR SULLIVAN, JR., ERNEST
JAMES DROLETTE, ANDREW PRICE,
WILLIAM L. OWENS, CHAMPLAIN AIR,
INC., and U.S. TRUST COMPANY OF
CALIFORNIA, N.A.,**

**PLAINTIFFS' BRIEF IN SUPPORT OF
MOTION TO ALTER OR AMEND THE
JUDGMENT OR, IN THE ALTERNATIVE,
FOR RELIEF FROM JUDGMENT**

Defendants.

MEMORANDUM IN SUPPORT

**I. THE AWARD OF DAMAGES DOES NOT RESULT IN A WINDFALL TO
THE ESOP NOTWITHSTANDING THE CANCELLATION OF THE ESOP
NOTES.**

While preserving all arguments on appeal to the United States Court of Appeals for the Second Circuit, Plaintiffs submit this Motion for the limited purpose of addressing fundamental errors underlying this Court's windfall analysis. Despite the dismissal of the complaint and entry of judgment on January 5, 2007, this Court retains jurisdiction to consider this Motion brought alternatively under Rules 59(e), 60(b)(1) and/or 60(b)(6) of the Federal Rules of Civil Procedure. If finality is to be attained in this matter, the fundamental errors described below must be addressed and corrected. Upon correction with respect to the law and/or facts, it will be clear to the Court that the ESOP has in fact paid more than \$52.25 million (the maximum that could be paid under this Court's prior determination) for the CommutAir stock. Thus, there is no windfall

to the ESOP. Accordingly, this Motion should be granted and the Court should reach the merits as discussed in the Court of Appeals remand.

Although it is presumed that the Court has familiarity with this matter, nearly three years have passed since the trial. Moreover, U. S. Trust introduced new facts well after the trial, and there appears to be some question about the facts themselves. Thus, a few preliminary background comments may be helpful in clearing up the confusion that apparently exists.

In March 1994, the CommutAir ESOP was created and entered into two transactions. In the first, it borrowed \$9 million from CommutAir and gave the corporation a note in that amount. In the second, it agreed to pay \$60 million to the Sellers for stock in CommutAir. The ESOP paid \$9 million in cash to the Sellers and gave the Sellers notes totaling \$51 million.

This Court determined after trial that the fair market value of the convertible preferred stock purchased by the ESOP was \$52.25 million, rather than the \$60 million as set forth in the Stock Purchase Agreement. The Court determined that the transaction between the Sellers and the ESOP was a prohibited transaction. Accordingly, the Court awarded damages to Plaintiffs in the amount of \$7.75 million, plus pre-judgment interest running from the date of the original transaction. *Henry II*, 334 F.Supp.2d at 268, 274.

In support of its Amended Findings of Fact and Conclusions of Law, U. S. Trust submitted evidence reflecting that, in February 2006, months after the October 2005 oral argument in the Second Circuit and more than a year after the entry of the original October 2004 final judgment, CommutAir, the Sellers and the ESOP entered into a new Stock Purchase Agreement whereby CommutAir purchased 100% of the ESOP's shares in CommutAir. In connection with the transaction, the \$9 million debt from the ESOP to CommutAir, outstanding from the original transaction, was forgiven and cancelled. Further, approximately \$4.5 million of allegedly

outstanding principal on the original notes to the Sellers was forgiven and cancelled. (UST Prop. FOF ¶45.)

Relying on this “new evidence,” this Court accepted defendant’s argument that the \$14.5 million of debt forgiveness should be taken off the original Stock Purchase Agreement price of \$60 million. In doing so, the Court erroneously combined the two March 1994 transactions, but completely failed to consider the \$9 million down payment. Because of this mathematical error, the Court concluded “the ESOP only paid \$45.5 million for the preferred convertible stock that it now contends had a fair market value of \$52.25 million.” Memorandum Decision and Order (“Decision”) at 6. This conclusion, which formed the basis for the Court’s determination that the award of *any* damages to the ESOP would constitute an improper windfall, is erroneous in three respects, two mathematical and one legal:

First, the Court’s analysis is mathematically flawed because it fails to give any consideration to the \$9 million cash payment made by the ESOP to the Sellers at closing and the total obligations undertaken by the ESOP.

Second, it fails to properly amortize the total principal payments made by the ESOP to the Sellers under the prohibited transaction from a mathematical standpoint when the amount of the notes is reduced to reflect the permissible purchase price.

Third, the Court’s decision is at cross-purposes with the legislative intent of ERISA and ignores established law that holds that the ESOP’s assumption of indebtedness is a valid basis for an award of damages.

A. Even if the Court Were Correct to Look Only at Cash Payments by the ESOP, the Court Failed to Take into Account the \$9 Million Cash Payment Made by the ESOP to the Sellers at Closing.

Prior to trial, the parties stipulated that the ESOP paid \$54,519,799.98 of principal for the CommutAir stock and \$17,707,360.68 of interest, for total payments of \$72,227,160.66 as of January 2004. Stip at 25. Thus, even by its own admission, U. S. Trust caused an overpayment of principal based on this Court's determination that the fair market value of the stock was only \$52.25 million. In fact, this is exactly the position taken by U. S. Trust before the Second Circuit, where it argued that \$54.52 million of principal had been paid. At the very least, it should be bound by its stipulation in which it admits an overpayment.

Somehow, this Court has ignored those admissions and determined that the ESOP only paid \$45.5 million of principal. In doing so, the Court looks only at the payments made to the Sellers on the original notes of \$51 million, but fails to consider the \$9 million paid in cash at the closing. As will be explained below, the Court also fails to consider that, under its own decision setting the fair market value of the stock at \$52.25 million and taking into account the \$9 million cash payment at closing, the notes to the Sellers could only total \$43.25 million. Inasmuch as the initial principal amount of the notes must be reduced, the notes must be subject to a new amortization schedule.

To understand how the Court missed or failed to consider the initial \$9 million payment, it must be remembered that two separate transactions took place on March 15, 1994. The first was the loan from CommutAir to the ESOP. Although technically a prohibited transaction under ERISA Section 406(a)(1)(B), Plaintiffs did not contest the adequacy of consideration and the fact that the loan transaction was exempt under ERISA Section 408(b)(3). It should be pointed out that Plaintiffs also did not include the \$9 million note to CommutAir as part of the overpayment for the stock in computing its damages. Although if this note had been repaid the ESOP would have paid a total of \$69 million (\$60 million to the Sellers and \$9 million to the corporation), the separate nature of the loan transaction should be respected.

In the second transaction, the ESOP purchased the shares for a total consideration of \$60 million. It paid \$9 million in cash and \$51 million in notes. As determined by this Court, this was a *per se* prohibited transaction under ERISA Section 406(a)(1)(A). With a fair market value of the stock of only \$52.25 million and \$60 million of consideration, this transaction did not meet the criteria for an exemption under ERISA Section 408(e)(1).

In determining that the ESOP's unpaid note to CommutAir should be subtracted from the damages to avoid a "windfall" to the ESOP, the Court effectively combined the two March 1994 transactions. While Plaintiffs believe the integrity of the two transactions should be respected, if they are to be combined, they must be combined in full. The Court needs to give credit for the \$9 million cash payment and recognize that under the two transactions, the ESOP was to pay a total of \$69 million. Even if credit is given because of the forgiveness of the note to CommutAir, it should be taken against the total consideration of \$69 million. Thus, even without consideration of a new amortization schedule for the notes to the Sellers, under the Court's analysis, the ESOP should be viewed to have paid \$54.5 million (\$69 million less the \$14.5 million), exclusive of interest or an award for attorneys' fees. With a Court-determined value of \$52.25 million, there has already been an overpayment. As will be shown below, the actual overpayment is much greater than the \$2.25 million demonstrated in this analysis.

B. Even if the Court Were to Look Only at Cash Payments, The Court Erroneously Failed to Develop a New Amortization Schedule to Reflect All Principal Payments.

On October 29, 2004, in awarding the judgment previously entered in this case, the Court denied Plaintiffs' request for a compound interest or an "interest overcharge." Instead, the Court determined that Plaintiffs were entitled to 9% pre-judgment interest. Perhaps with the passage of time, issues have become somewhat confused. The earlier denial was not the same as determining

that the ESOP did not pay excess interest. In fact, even the use of the term “excess interest” is misleading. As we will show, there can only be principal payments and interest payments under the notes given to the Sellers. Again, this should be a simple question of mathematics.

Upon closing, the ESOP paid \$9 million in cash and gave the Sellers notes in the amount of \$51 million. For approximately seven years, the ESOP made payments to the Sellers based on the original principal amount. Based upon the fair market value as determined by this Court, however, the notes could only total \$43.25 million,. Under the terms of the notes themselves, payments are to first be applied to interest (*see* Plaintiffs’ Ex. 5). Amounts in excess of the original amortization were prepayments of principal, resulting in the notes being satisfied sooner. Proper amortization of the notes, based on payments actually made by the ESOP, is set forth in the exhibits to the Declaration of Philip R. Nichols, which is submitted herewith. It demonstrates that based on the proper principal for the notes totaling \$43.25 million, the entire fair market value of the stock as fixed by this Court was paid by September 1999.

In fact, additional payments were also made to the Sellers after the fair market value was paid in full, such that the total overpayment of principal by the ESOP was in the amount of \$8,778,800.93. Thus, the ESOP actually paid total consideration of \$63,236,412.12 for stock worth only \$52.25 million. In such event, interest should be awarded from the dates of actual payment. As set forth in the Nichols’ Declaration, interest at the 9% pre-judgment rate awarded by the Court would be in the amount of \$3,501,153.79 just through the date of the original judgment on October 29, 2004. Although the overpayment under the Court’s new approach is actually higher than that originally fixed by the Court, interest is lower because it is computed only from the date of actual payment, as opposed to the date of delivery of the notes.

Sellers' post-judgment cancellation of indebtedness does not change the fact that the ESOP had already paid more than fair market value for its stock. Even assuming *arguendo* that the ESOP is credited only with amounts paid in cash, as opposed to by delivery of notes, simple mathematics demonstrates that the ESOP has overpaid for the stock. Under such analysis, the ESOP has paid \$8.78 million more than the \$52.25 million fair market value. There can be no argument that there has been a windfall to the ESOP.

C. Permitting Breaching Fiduciaries to Avoid Liability Retroactively by Canceling Remaining Loan Indebtedness Is Wrong as a Matter of Law and Will Encourage the Very Abusive Practices that ERISA's Prohibited Transaction Was Intended to Prevent.

Congress adopted ERISA Section 406 (a) to prevent plans from engaging in certain types of transactions that had been used in the past to benefit other parties at the expense of the plan's participants and beneficiaries. Prior to ERISA's enactment, plans could generally engage in "arms-length" transactions with related parties. The difficulty in policing the "arms-length" rule led to Congress' enactment of Section 406(a) "to bar categorically a transaction which was likely to injure the pension plan." *Comm'r v. Keystone Consol. Indus., Inc.*, 508 U.S. 152, 160 (1993). In order for a prohibited transaction to properly proceed, it must meet the criteria for an exemption under ERISA Section 408.

Here, this Court determined that U. S. Trust caused the ESOP to engage in a prohibited transaction and to pay \$7.75 million more than adequate consideration for the stock purchased from the Sellers. No analysis or discussion of the loan transaction between the ESOP and CommutAir was made because it was not at issue in the case. Only after the liability of the trustee was determined at trial did the ESOP even enter into the transaction that resulted in the cancellation of indebtedness.

The breaching fiduciary now contends that it should benefit from the cancellation of indebtedness and argues that damages result in a windfall to the ESOP.

The Court's acceptance of the U. S. Trust argument, ignoring for now the fundamental mathematical flaw in that position, effectively endorses the entering into of prohibited transactions without regard to whether or not the prohibited transaction exemption applies. If a prohibited transaction is subsequently discovered, and a judgment obtained as occurred here, the transaction need only be unwound by cancellation of any remaining ESOP indebtedness. In such case, the selling shareholders simply pocket the amounts paid up until that time, and the fiduciary avoids liability even if, as here, the stock owned by the ESOP is by then completely worthless and the ESOP participants have been deprived of their retirement savings.

It bears noting here that Plaintiffs were permitted to introduce almost no evidence of facts occurring after the date of the purchase of the stock (*see* Tr. Vol. I at 37-38). Notwithstanding such a restriction on Plaintiffs, U. S. Trust is now permitted to introduce evidence from almost 14 years after the transaction to avoid liability. Such a result cannot be permitted to occur under ERISA.

As addressed in Plaintiffs' Reply in Support of its Proposed FOF/COL at pages 5-6, other courts have addressed windfall arguments similar to what is being offered here and have soundly rejected them, recognizing that an ESOP's assumption of indebtedness to pay for stock constitutes a basis for damages in a prohibited transaction. *See, e.g., Chao v. Hall Holding Co., Inc.*, 285 F.3d 415, 423, 439, 443-44 (6th Cir. 2002); *Horn v. McQueen*, 215 F. Supp.2d 867, 877-80 (W.D. Ky. 2002); *Reich v. Hall Holding Co., Inc.*, 990 F. Supp. 955, 961 (N.D. Ohio 1998); *Reich v. Valley Nat'l Bank*, 837 F. Supp. 1259, 1285 (S.D.N.Y. 1993). The *Valley National Bank* transaction was similarly leveraged as in *CommutAir* and, in both instances, the loans were to be repaid by the ESOPs only from cash payments made by the companies to the ESOPs. *See Valley National Bank*,

837 F. Supp at 127 (“[t]he ESOP’s obligation to make payments on its promissory notes was effective under the Plan documents only upon contributions being made by [the company] to the ESOP”). The *Valley National Bank* court nevertheless deemed it “irrelevant how the ESOP got the \$35.5 million in cash in regard to the question of whether the ESOP paid more than fair market value for the stock.” *Id.* at 1274. Were the courts to hold otherwise, fiduciaries could cause an ESOP to borrow huge sums of money to pay more than adequate consideration for company stock and then avoid all liability if the overly-leveraged company subsequently failed and the remaining debt was forgiven.

Permitting breaching fiduciaries to avoid liability on the basis of any such post-transaction events will fundamentally undermine the protections of ERISA’s categorical bar of prohibited transactions. *See Horn v. McQueen*, 215 F. Supp. at 877 (rejecting defendants’ contention that a post-transaction increase in value of stock for which more than adequate consideration was paid eliminates the loss to the plan resulting from the prohibited transaction).

II. CONCLUSION

For all the foregoing reasons, this Court should grant Plaintiffs’ Motion to Alter or Amend the Judgment or, in the Alternative, For Relief from Judgment. Upon review of the merits on the remand from the Second Circuit, the Court should award Plaintiffs judgment in the amount of \$7.75 million plus fees and interest from March 15, 1994, totaling \$15,713,745.11 through October 29, 2004 consistent with its prior decision, or in the least, judgment in the amount of \$8,778,800.93, plus fees and interest from September 30, 1999 totaling \$12,832,762.34 through October 29, 2004 based on the reasoning set forth above. In either case, Plaintiffs would be entitled to additional interest through the date of a new judgment in an amount to be determined by the Court.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that on January 16, 2007, I presented the foregoing to the Clerk of the Court for filing and uploading to the CM/ECF system which will send notification of such filing to the following:

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