Trends in ESOP Litigation from 1990–2013: Special Focus on Recent Valuation and Bankruptcy Cases

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Since 1990, there have been two large waves of "stock drop" litigation, the first following the accounting scandals of the early 2000s and the second following the financial crisis of 2008. The large majority of this litigation involved public company 401(k) plans where employer stock was an optional investment and/or the company matched employee deferrals in employee shares. In cases where there was an employee stock ownership plan (ESOP), it was almost always used as a match to the employer corporation 401(k) plan, and it usually owned relatively little sponsor company stock. These kinds of plans are noticeably different from private company ESOPs. Approximately 97 percent of ESOPs are in closely held sponsor companies. Most of these ESOPs own 30 percent or more of the employer corporation stock, with perhaps 40 percent of these ESOPs owning or planning to own 100 percent of the employer corporation stock.[1] Public companies with ESOPs or 401(k) plans with employer corporation stock rarely have more than five percent of their shares in these plans. Due to the readily determinable nature of the publicly traded employer corporation share prices, they are not required to have independent appraisals performed. The lack of readily available closely held employer corporation share price data creates the need for independent valuations and also creates the circumstances that give rise to issues such as breaches of fiduciary duty, disputes the over fair market value of sponsor company shares, disputes over transaction fairness and other points of disagreement that result in litigation. This discussion focuses on the trends in ESOP litigation over the last 23 years, with a special focus on valuation and bankruptcy issues.

Introduction

During the period from 1990 to 2013 (the "period analyzed"), ESOP litigation cases have generally involved issues of (1) standing, (2) distributions and administrative errors, (3) breaches of fiduciary duty, (4) disclosure requirements, or (5) the presumption of prudence rule. Within these broad categories, there have also been notable ESOP valuation and bankruptcy cases. This discussion provides (1) an overview of the trends in the five broad ESOP litigation categories as outlined above and (2) a review of notable recent ESOP litigation cases involving bankruptcy and valuation issues.

Broad Trends in ESOP Litigation[2]

The most common judicial decisions during the period analyzed concerned standing. Courts generally sided with ESOP participants, dismissing arguments that they were seeking individual (not plan) remedies or that the participants claims were time-barred in terms of their ability to file suit based on the statute of limitations. The complication with determining the statute of limitations is that the beginning of the period during which a legal proceeding may be initiated depends on when the plaintiff had actual knowledge of the breach or violation for which the legal proceeding is being initiated.

In a few cases, courts looked to whether participants had agreed to take a distribution as part of a transaction based on misleading information. Of course, the decisions are based on specific facts and circumstances and have sometimes favored plan fiduciaries, who are most commonly the defendants in these cases.

The second common set of claims has to do with whether (1) distributions were made at the proper time or in the proper manner or (2) other administrative errors involving issues such as participant eligibility or vesting occurred. Because the issues on which the courts based their decisions are so varied and fact specific, there is not much useful broad guidance to be gained, except that plan rules should be followed as closely as possible.

A third common area of litigation involves which parties, other than fiduciaries named in the plan, have fiduciary responsibility to the ESOP. Courts have been clear that boards of directors may be considered fiduciaries and held responsible for failing to monitor the activities of the named fiduciaries of an ESOP.

Similarly, management and/or boards of directors may be considered to be fiduciaries of the ESOP subject to Employee Retirement Income Security Act (ERISA) requirements, if they have withheld critical information from trustees or otherwise led them, even in the absence of specific instructions, to make improper decisions. Finally, directed trustees should give deference to the decisions of those providing the direction, but not if the directions clearly violate ERISA or retirement plan requirements.

Another set of influential decisions are on the "presumption of prudence" rule. The presumption of prudence rule was first articulated in *Moench v. Roberston*,[3] an ESOP case in which the plan sponsor, a bank, used company contributions to purchase shares for its ESOP. The bank suffered substantial losses and eventually went bankrupt. Plan participants sued.

The court ruled that because Congress specifically directed that ESOPs be invested "primarily" in employer stock, it would be unfair to require that fiduciaries make judgments on a regular basis about whether continuing to do so was prudent.

If the sponsor company stock price declined, for instance, and employees could sue, may they also sue if it then went up and fiduciaries had sold the shares? The court ruled that expecting fiduciaries to predict the value of shares was unreasonable. However, if the fiduciaries knew or should have known that the company was in financial distress or imminent danger of collapse, then the presumption did not apply (versions of this language have been used in several decisions). Specifically, the court said:

> In light of the analysis detailed above, keeping in mind the purpose behind ERISA and the nature of ESOPs themselves, we hold that in the first instance, an ESOP fiduciary who invests the assets in employer stock is entitled to a presumption that it acted consistently with ERISA by virtue of that decision. However, the plaintiff may overcome that presumption by establishing that the fiduciary abused its discretion by investing in employer securities.[4]

This standard makes it very difficult for plaintiffs to overcome the presumption of prudence, as subsequent reliance on the doctrine has shown in multiple circuits.

During the last 12 to 18 months, the Court of Appeals for the Fifth Circuit joined the Second, Third, Seventh, Ninth, and Eleventh Circuits in ruling that fiduciaries in defined contribution plans are presumed to be prudent when they continue to hold employer stock or to offer it as an investment.

The Sixth Circuit, however, reinforced its view that the presumption should not apply at the pleading stage, and the Eleventh Circuit narrowed the circumstances under which the prudence presumption should apply. Altogether, there were 11 appellate court decisions on this issue.

A fifth common litigation issue is disclosure, which has occurred almost entirely in public companies where fiduciaries must sometimes choose between ERISA and Securities and Exchange Commission (SEC) disclosure requirements. Courts have been split on these issues

Valuation Issues in ESOP Litigation

Perhaps the most notable fact about the litigation history is, despite all the discussion about ESOP valuations being improper over 23 years, only 22 valuation cases have made it to a judicial decision. This does not mean there were not more improper valuations that plan participants decided were not worth challenging given the time and costs involved in litigation. Further, other disputes may have settled before reaching the litigation trial stage.

A few trends in valuation decisions are clear. Appraisals not performed by independent, qualified appraisers and stale valuations do not hold up in court. Outside these clear violations, however, courts have come to mixed conclusions about valuation accuracy. However, courts have sided with experts with the more compelling support for their valuation analysis.

Therefore, ESOP employer stock valuations should be performed by valuation analysts with experience and knowledge relating to the nuances of ESOP valuation. The following cases illustrate how the courts have treated certain valuation and fiduciary issues in the context of ESOP litigation.

Dan Neil et al. v. Sam Zell et al.[5]

In this case involving the Tribune Company ESOP, the court ruled on a complex 2007 transaction involving a leveraged buyout of the Tribune Company ("Tribune"). The transaction was designed to convert Tribune from a publicly traded company to a private company that was 100 percent owned by the Tribune Company ESOP. The ESOP purchased the Tribune shares for $250 million financed by a note with a principal amount of $250 million and a 5.01 percent interest rate.

As part of the transaction, Sam Zell loaned Tribune $225 million and paid $90 million for a warrant giving him the ability to purchase 40 percent of Tribune for $500 million, ten years after the transaction. Tribune had approximately $12.8 billion in debt, including $8.3 billion in new debt, after the transaction. Ultimately, Tribune was unable to service its debt when profits declined and, by 2009, Tribune had filed for Chapter 11 bankruptcy.

The court's analysis found that this was a transaction that should not have occurred and that the mere reliance on opinion letters or appraisal reports indicating that a transaction is prudent doesn't necessarily shield the fiduciary from liability for fiduciary breach. The court also ruled that voting rights associated with ESOP stock were a plan asset that could be considered when (1) estimating fair market value and (2) determining whether a transaction is impermissible under ERISA on the grounds of plan assets being used for the benefit of a party in interest.

The court subsequently granted summary judgment for the plaintiffs on the claim that the trustee breached fiduciary duty when it approved the ESOP's purchase of Tribune stock. The court found that the Tribune stock was not a qualifying employer security under ERISA at the time it was purchased.[6]

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The trustee subsequently sought to limit its liability for damages related to its breach of fiduciary duty to either (1) $2.8 million, the 2008 principal payment on the transaction debt, or (2) $15.3 million, which was the principal and interest paid by the ESOP at that point in time.

The court determined that the recovery for the breach should put the plaintiffs in the same financial position that they would have been in if the $250 million had been invested prudently, properly, and legally. The court ruled that the recovery should be viewed as a make-whole payment to give the plaintiffs what they would have received if the trustee had not been in breach of its fiduciary duty.[7] The court denied the trustee's motion to limit the recovery to $15.3 million. The case later settled for $32 million.

Chesemore v. Alliance Holdings Inc.[8]

On July 24, 2012, the court found that Alliance Holdings, Inc., A.H.I., Inc., AH Transition Corp., David B. Fenkell, Pamela Klute, James Mastrangelo, and Jeffrey A. Seefeldt (the "defendants") breached fiduciary duty to the Trachte Building Systems, Inc., employee stock ownership plan ("Trachte ESOP") and the Alliance Holdings Inc., Employee Stock Ownership Plan ("Alliance ESOP") related to a leveraged buyout transaction. The defendants leveraged the Alliance ESOP participants' accounts to purchase Trachte Building Systems, Inc., ("Trachte") on behalf of the Trachte ESOP at a price that the court determined was in excess of fair market value.

The Trachte ESOP paid approximately $38.3 million for 100 percent of the Trachte shares in 2007. The court found that the valuation analysts produced a wide range of values for Trachte to the extent that the court was compelled to determine its own reasonable estimate of the Trachte fair market value at the time of the 2007 transaction. The court identified two methods of estimating the fair market value of the Trachte shares.

The first method involved attempting to correct errors found in the 2007 fairness opinion. The court (1) subtracted the $1.9 million value of the tax shield because it determined that the tax shield should not be included in the valuation under the fair market value standard of value, (2) subtracted $1.7 million in cash working capital needs (the fairness opinion assumed that Trachte had no need for operating cash in excess of customer deposits and treated the cash in excess of customer deposits as an asset), and (3) applied a 10 percent discount for lack of marketability.

Ultimately the court concluded that the fair market value of Trachte ranged from $20.3 million to $32.8 million with a median of $26.6 million after accounting for the corrections to the fairness opinion.

In a second attempt to correct the fairness opinion, the court averaged the high and low ends of the ranges of value for the discounted cash flow and market approach methods to arrive at a fair market value for the Trachte shares ranging from $26.6 million to $33.2 million with a median of $29.9 million. The court averaged the results of these two attempts at correction to arrive at an indicated fair market value of $28.2 million for the Trachte shares.

The second method the court used to estimate the fair market value of the Trachte shares was by reviewing the HIG December 2006 letter of intent to purchase Trachte. After making certain adjustments to make the HIG offer more comparable to the 2007 transaction price, the court found that the fair market value of Trachte indicated by the HIG offer was $31.7 million.

The court then took the average of (1) the median of the adjusted valuation based on the fairness opinion and (2) the fair market value indicated by the HIG offer to arrive at the concluded fair market value of $30 million for the Trachte shares. The $30 million fair market value for the Trachte total equity indicated that the Trachte ESOP paid $8.3 million in excess of the fair market value of the Trachte shares at the time of the transaction.

Estimation of Damages

The court considered the following three ways to estimate the damages to the Trachte ESOP: (1) compare the Trachte ESOP's actual performance after the breach with what the Trachte ESOP would have earned if funds had been used for proper alternative investments, (2) the difference between the purchase price and the current fair market value of the shares, and (3) the difference between the amount originally paid for the stock and the fair market value of the stock at the time of the transaction.

The court found that Trachte failed primarily due to the 2008 financial crisis. Therefore, the proper estimate of damages was the $8.3 million overpayment for the Trachte shares, which equaled the difference between the transaction price and the fair market value of the Trachte shares at the time of the transaction.

The $8.3 million was reduced to $6.5 million to account for the difference between the purchase price of the Trachte shares purchased with debt and the fair market value of Trachte on the date of the transaction. In addition, the court ordered that the participants' accounts in the Alliance ESOP be restored to their $7.8 million balance as of the date of the transaction and that Fenkell restore to Trachte the $2.9 million received in phantom stock proceeds. The court ordered that Alliance and Fenkell indemnify Mastrangelo, Seefledt, and Klute for any compensatory relief they were required to pay and barred Fenkell from serving as trustee to the Alliance ESOP.

ESOP Bankruptcy Litigation Cases

In addition to the Alliance and Tribune cases, both of which involved companies that later went bankrupt, a number of cases have specifically revolved around bankruptcy issues. The following bankruptcy cases involved issues of (1) standing, (2) bankruptcy reorganization plan approval, (3) debtor corporation valuation, and (4) breach of fiduciary duty.

The following cases illustrate how these issues have been treated by the courts in certain cases in the context of ESOP bankruptcy litigation.

In re Mercedes Homes, Inc.[9]

On January 26, 2009, Mercedes Homes, Inc., (MHI) and certain of its affiliates (collectively the "debtor corporations") filed voluntary petitions for relief under Chapter 11 of the U.S. Bankruptcy Code.

Participants in the Mercedes Homes, Inc., employee stock ownership plan (the "MHI ESOP") objected to the nondebtor release for the benefit of the officers and directors contained in the debtor corporations' joint reorganization plan (the "plan").

The objecting ESOP participants argued that (1) the release was not necessary or fair because it would preclude them from being able to pursue claims against the debtors officers and directors for breaches of fiduciary duty in their individual capacities and (2) the directors and officers did not provide actual consideration to the bankruptcy estates in order to warrant relief.

The court determined that with the exception of claims against the MHI ESOP or its fiduciaries, any other state law claims by the objecting ESOP participants were preempted by ERISA. The court also noted that the ability to pursue any derivative shareholder actions against the directors and officers belongs to the bankruptcy estates. Consequently, any recovery resulting from a successful shareholder derivative action would also be property of the bankruptcy estates and subject to the absolute priority rule.

The court determined that nondebtor releases provided in Chapter 11 reorganization plans are appropriate under certain circumstances, but only if the releases are determined to be necessary and fair. The court applied the so-called Dow Corning Test to evaluate whether the nondebtor releases were necessary and fair. The Dow Corning Test includes the evaluation of the following seven factors:

1. Whether there is an identity of interests between the debtor and the third party, usually an indemnity relationship, such that a suit against the nondebtor is, in essence, a suit against the debtor or will deplete the assets of the debtor
2. Whether the nondebtor has contributed substantial assets to the reorganization
3. Whether the injunction is essential to reorganization, namely, the reorganization hinges on the debtor being free from indirect suits against parties who would have indemnity or contribution claims against the debtor
4. Whether the affected class, or classes, has overwhelmingly voted to accept the plan
5. Whether the plan provides a mechanism to pay for all, or substantially all, of the class, or classes, affected by the injunction
6. Whether the plan provides an opportunity for those claimants who choose not to settle to recover in full
7. Whether the bankruptcy court made a record of specific factual findings that support its conclusions

The court determined that factor one was satisfied through the indemnification obligations set forth in the plan such that any suit brought against the directors and officers would essentially be a suit against the reorganized debtors.

The second factor was satisfied through the directors and officers (1) agreeing to waive the unsecured deficiency claim of Real Estate Investment Ventures, LLC (a creditor of the debtor corporations that was owned by the directors and officers), enabling a $6 million distribution to unsecured creditors and (2) continuing to work for the reorganized debtor.

Factor number three also favored the releases. The commitment of the directors and officers to manage the reorganized debtor rather than compete against them was deemed "critical to the successful operation of the reorganized company" and "essential to the feasibility of the plan."[10] Further, new financing arrangements with the first lien lenders required that there be no litigation (other than disclosed litigation) and no pending litigation against the debtors and certain related parties. Therefore, the release was essential to the plan.

All of the impaired classes entitled to vote on the plan approved it, thus satisfying factor number four of the Dow Corning Test.

The court determined that the objecting ESOP participants did not have standing to assert claims against the directors and officers of the debtors. Therefore, no claims of the objecting ESOP participants against the officers and directors were being released as part of the plan. Further, clarifying language was added to the plan in order to preserve the claims the objecting ESOP participants may have had against the officers and directors in their capacities as fiduciaries to the ESOP. Therefore, factor number five was satisfied.

The ESOP settlement preserved the claims and causes of action of any ESOP participants against the ESOP, ESOP trustees, other fiduciaries of the ESOP, the ESOP service providers, and persons that engaged in prohibited transactions with the ESOP. Additionally, the debtor had approximately $55 million in fiduciary liability insurance. Therefore, factor six was satisfied.

The court addressed factor seven by hearing testimony in support of and against the release and found the evidence in support of the release more compelling. As a result, the court overruled the objection of the ESOP participants.

Fish v. GreatBanc Trust Company[11]

Antioch Company ("Antioch") was a printing and paper products company that was founded by the Morgan family. In 2003, the Antioch employee stock ownership plan (the "ESOP") owned approximately 43 percent of the Antioch shares, the Morgan family owned approximately 46.5 percent of the shares, and 38 other shareholders owned approximately 11 percent of the Antioch shares.

The ESOP was managed by the ESOP advisory committee (the "committee") which consisted of Lee Morgan, Asha Morgan Moran, and Chandra Attiken. The purpose of the committee was to direct the actions of the ESOP trustee, who was also an Antioch executive ("internal trustee").

In early 2003, the committee and the Morgan family sought to make Antioch a 100 percent ESOP owned company. Along with the help of professional advisers, Antioch designed a transaction that would result in the ESOP owning 100 percent of Antioch while allowing the Morgan family to maintain operational control of Antioch.

GreatBanc was engaged to be the trustee for the transaction because the internal trustee was an ESOP participant and, therefore, had a conflict of interest regarding the transaction.

The transaction called for a new entity to be formed and merged into Antioch through a tender offer for all Antioch shares owned outside of the ESOP. The transaction was to be financed with cash or a combination of cash, notes, and warrants.

The transaction required the ESOP to decline the tender offer so that it would be the sole remaining Antioch shareholder. As trustee for the transaction, GreatBanc agreed to decline to sell the ESOP shares in exchange for the following:

1. Certain annual distributions
2. Floor price protection for ESOP participants who terminated employment between 2003 and 2006 that sets the repurchase price based on when employment was terminated not when distributions began

The put price protection agreement stipulated that employees who terminated employment before October 1, 2004, were to be paid $841 for each Antioch share redeemed. Employees who terminated employment after October 1, 2004, were to be paid fair market value plus an incremental amount, representing tax savings related to the transaction, for each share redeemed. The court noted that the ESOP shares had never been valued above $640 prior to 2004.

Due to the cyclicality of the business and the high redemption price relative to historical prices for the Antioch shares, employees decided to leave Antioch in order to cash in their ESOP shares before the next down cycle came about. Antioch and its advisers had not adequately accounted for the potential surge in redemptions in the estimation of the Antioch ESOP repurchase obligation.

Consequently, even after taking on additional debt to fund share repurchases, Antioch had insufficient cash to repurchase the shares when the business did indeed hit a down cycle. Antioch subsequently filed for bankruptcy.

In March of 2009, the ESOP participants filed a class action under ERISA claiming that GreatBanc and the Committee breached fiduciary duty by allowing the tendered Antioch shares to be redeemed at a price that was in excess of adequate consideration. The ESOP participants claimed that the overvaluation of the stock was the catalyst of Antioch's financial distress that ultimately led to its bankruptcy filing. GreatBanc and the committee members (collectively the "defendants") sought summary judgment related to the timeliness of the lawsuit, claiming that the statute of limitations had expired.

The court noted that ERISA Section 1113 states that:

> No action may be commenced under this subchapter with respect to a fiduciary's breach of any responsibility, duty, or obligation under this part, or with respect to a violation of this part, after the earlier of—
>
> (1) six years after (A) the date of the last action which constituted a part of the breach or violation, or (B) in the case of an omission the latest date on which the fiduciary could have cured the breach or violation, or
>
> (2) three years after the earliest date on which the plaintiff had actual knowledge of the breach or violation;
>
> except that in the case of fraud or concealment, such action may be commenced not later than six years after the date of discovery of such breach or violation.

In order to analyze the timeliness issue and when the plaintiff had actual knowledge of a breach, the court analyzed (1) who the true plaintiff was, (2) when they had knowledge of the breach, and (3) whether they could have acted effectively on that knowledge. It could be argued that the plaintiff in the case referred to the individuals listed in the case caption or the ESOP. However, the plaintiffs in this case were ESOP participants and representatives seeking damages payable to the ESOP.

If the ESOP was assumed to be the plaintiff, then the question became whether the internal trustee's knowledge of any breach would be considered to be imputed ESOP knowledge and would therefore set the starting point for the statute of limitations.

The court ultimately did not have to come to any conclusions regarding the true plaintiff in the case. The court determined that even if the internal trustee, and thus the ESOP, had knowledge of a breach, the motion for summary judgment could only be granted if it was clear that the internal trustee could have effectively acted on any knowledge of the breach. The court noted that the trustee agreement was very constraining in its definition of the role of the internal trustee. The court stated that:

> Indeed, a fair reading of the Agreement is that the only action that Hoskins [Internal Trustee] could have taken as to the alleged breach of fiduciary duty would have been to go to the Committee and ask for permission to sue them. It is hard to conceive a more futile act than that.

The court determined that there were material issues of fact regarding the internal trustee's authority or ability to act effectively, even if the internal trustee had knowledge of the alleged breach. The court ruled that the lawsuit against GreatBanc and the committee in connection with Antioch's ESOP was not time-barred (that is, the statute of limitations for filing the suit had not expired) and denied the defendants' motion for summary judgment.

In a September 12, 2012, opinion, the court reversed its first ruling and dismissed the claims of the plaintiffs against plan fiduciaries on the grounds that the plaintiffs were "willfully blind" of the information they had received from the fiduciary detailing the risks associated with the transaction. The court found that the trustee and Lee Morgan had distributed adequate information and that the plaintiffs admitted to only skimming it. That meant the statute of limitations for filing the suit started in 2003. Because the plaintiffs had knowledge of the alleged breach in 2003, the three years that they had to file suit had passed by the time the class action was filed in 2009.[12] The plaintiffs filed an appeal, and the Department of Labor filed an amicus brief in the case.

Conclusion

In many ESOP litigation cases, fiduciary duty and valuation are points of contention. ESOP litigation over the last few decades has generally been very favorable to those fiduciaries that (1) follow standard procedural prudence, (2) make good faith and well-informed efforts to arrive at proper valuations and follow appropriate rules for ESOP management, and (3) don't try to push the legal limits of favorable treatment allowable to parties outside of the ESOP.

The fact that ESOPs have not suffered greatly at the hands of the courts, however, should not be read to mean that there are not under-the-radar transactions that do not follow proper procedures, most notably using advisers who claim more expertise than they have. While this is often more ignorance of what should be done than malfeasance, ignorance is ultimately no excuse.

Valuation is at the heart of many ESOP disputes. Whether it's a bankruptcy, contested fairness opinion, or flawed handling of the repurchase obligation, the common theme is valuation. Even when a case revolves around standing, it can be reasoned that the underlying issue for legal action is related to share price.

"Valuation is at the heart of many ESOP disputes."

Therefore, it is important for employer corporations to work with competent and experienced analysts, attorneys, administrators and trustees. Being aware of specific trends as well as the broader trends as presented in this discussion will assist ESOP service providers to better fulfill client needs and may help employer corporations to avoid certain actions that could result in litigation.

Notes:

1. Corey Rosen, *ESOP and 401(k) Plan Employer Stock Litigation Review 1990–2013* (Oakland: National Center for Employee Ownership, 2013).
2. This analysis is based on the 217 ESOP-specific cases that the NCEO identified for its *ESOP Cases and 401(k) Plan Employer Stock Litigation Review, 1990-2013*. While there were 203 separate cases, some of these involved decisions in more than one issue in the same decision.
3. 62 F.3d 553 (3d Cir. 1995), cert. denied.
4. Ibid.
5. Dan Neil et al. v. Sam Zell et al., No. 08 C 6833 (E.D. Ill. Dec. 17, 2009).
6. Dan Neil v. Sam Zell, No. 08 C 6833, 753 F.Supp.2d 724 (2010).
7. Dan Neil v. Sam Zell, 767 F.Supp.2d 933 (2011).
8. Chesemore v. Alliance Holdings Inc., No. 3:09-cv-00413-WMC (W.D. Wis., June 4, 2013).
9. In re Mercedes Homes, Inc., 431 B.R. 869 (Bkrtcy.S.D.Fla. 2009).
10. Ibid.
11. Fish v. GreatBanc Trust Co., No. 09 C 1668 (N.D. Ill. Aug. 31, 2010)
12. Fish v. GreatBanc, No. 0-9-C1668 (N.D. Ill., Sept. 21, 2012)

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