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Client Alert

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Trustees Beware, as Seventh Circuit Gives No Deference to Reliance on Experts in ESOP Valuation Case

In *Armstrong v. LaSalle Bank National Ass'n*, 446 F.3d 728 (7th Cir. 2006) (Posner, J.), the Seventh Circuit reversed a summary judgment for an ESOP trustee on whether the trustee breached its fiduciary duty in valuing a company's stock. In so doing, the Seventh Circuit seemed to give no deference to the trustee's reliance on an expert ESOP valuation firm, Duff & Phelps, and indicated that a heightened standard of prudence applies to valuing ESOP stock.

Background

Understanding the sometimes cryptic Seventh Circuit opinion requires reviewing the underlying district court opinion of Judge Moran in *Armstrong v. Amsted*, 2004 WL 1745774 (N.D. Ill, July 30, 2004). Amsted Industries ("Amsted") manufactures railroad and other transportation equipment, and has for many years been owned entirely by its employees through the company's ESOP. Before this lawsuit, the company stock price was set once a year, on September 30. Pursuant to the plan terms, this stock price was then used for all stock transactions for the following nine months, including honoring Amsted's repurchase obligations. When an employee left employment with Amsted, pursuant to the ESOP terms, Amsted repurchased his or her stock at the most recently set stock price for a lump sum in cash. Amsted had honored these repurchase obligations for years, and its bylaws required that the stock be valued as if it were publicly traded, *i.e.*, without any discount for lack of marketability.

In August of 1999, Amsted bought Varlen Corporation ("Varlen"), a manufacturer of trucking equipment, for approximately $800 million. This acquisition had a substantial impact on Amsted because Amsted's value, on the eve of the acquisition, was not much greater than the purchase price of Varlen. Amsted financed the acquisition by a $1 billion unsecured bank loan. After completing the acquisition, Amsted had remaining a $200 million unused line of credit. On September 30, 1999, one month after the acquisition, Duff & Phelps, an undisputed expert in valuing ESOP stock, was hired by the ESOP trustee, LaSalle Bank ("LaSalle"), to value the ESOP stock. Duff & Phelps valued Amsted's stock at $184 a share, without any discount for lack of marketability. As part of its extensive due diligence in making this valuation, Duff & Phelps also reviewed Amsted's projected cash flow statements, which included Amsted's estimates of its repurchase obligations for the upcoming year. LaSalle accepted Duff & Phelps' valuation and, again pursuant to the ESOP's terms, the $184 stock price was used for all stock transactions until June 30, 2000.

In prior years, approximately 8% to 10% of the workforce left Amsted each year. At the price of $184 per share this would have cost Amsted $100 million, which Amsted could easily finance through its cash flows or by borrowing against its unused line of credit. However, the redemption rate for the 2000 fiscal year ultimately turned out to be 32%, which cost the company $330 million in redemptions, thereby using up the $200 million unused line of credit plus other available cash. These liquidity problems apparently had a negative impact on Amsted, as Amsted's shares were revalued at $90 the next year and at $44 the following year. In addition, to avoid these liquidity problems in the future, Amsted amended its ESOP to require quarterly valuations and to limit the cash flow drain from redemptions by: (i) by imposing a five-year wait before stock could be redeemed for departing employees other than those who qualified for retirement, and (ii) paying this amount out over four years instead of as a lump sum.

After much procedural wrangling and shifting of case theories, plaintiffs, on behalf of a class of current participants in the Amsted ESOP, claimed that LaSalle breached its fiduciary duty by relying on Duff & Phelps' valuation of Amsted's stock. Plaintiffs did not dispute Duff and Phelps' credentials as an expert in valuing ESOP stock, but instead alleged in relevant part that LaSalle failed to ensure that Duff & Phelps had complete and correct information regarding Amsted's repurchase obligation and expected redemption rates, and that LaSalle or Duff & Phelps should have applied a marketability discount.

The district court granted LaSalle summary judgment. Although the court recognized that securing a reputable independent expert does not, by itself, satisfy a trustee's duty of prudence, the court concluded that plaintiffs could not prove that LaSalle was imprudent in relying on the valuation under these circumstances. Initially, the court noted that there was no credible claim of self-dealing or conflicts; rather, by setting the stock price LaSalle was effectively balancing the interests of current ESOP participants against those who plan to leave during the upcoming year. The court then concluded Duff & Phelps was sufficiently informed of Amsted's repurchase obligation through its review of Amsted's financial and cash flow statements, which included Amsted's estimates of its projected repurchase obligations. Amsted used its historical average repurchase rate of 9% in making these estimates. In its review of plaintiffs' and defendant's litigation experts, the court noted that all experts agreed that any estimate of repurchase rates depended on numerous subjective factors, such as the mood of the workforce, and that even plaintiffs' experts admitted there was no way of knowing whether there would be an increase in repurchase rates, much less what that increase would be. In contrast, based on historical rates, defendant's expert noted the chance of the repurchase obligation ultimately reaching 33% was less than one percent.

The district court also rejected plaintiffs' claim that a marketability discount should have been applied to the price of Amsted's ESOP stock. The court based this on Amsted's long history of paying terminated plan participants their benefits quickly, in full and in cash. The court also noted that Amsted's bylaws required the stock to be treated as if it were sold on the open market, and that the ESOP's stock has always been valued without applying a marketability discount.

The Seventh Circuit Holding

On appeal, the Seventh Circuit, in an opinion by Judge Posner, started its analysis by labeling ESOPs as imprudent per se because of an ESOP's lack of diversification. Although Judge Posner had to concede this was lawful because of Congress's exemption of ESOP fiduciaries from the duty to diversify, he used this to justify a heightened standard of prudence: "There is a sense in which, because of risk aversion, an ESOP is imprudent per se, though legally authorized. This built-in imprudence (for which the trustee is of course not culpable) requires him [the trustee] to be especially careful to do nothing to increase the risk faced by the participants still further."

The Seventh Circuit held that a trustee's valuation of the ESOP stock is entitled to "abuse of discretion review" when, like here, a trustee is balancing the interests of current ESOP participants against those who want to leave. The court then chided LaSalle for failing to take into account the potential liquidity problems that Amsted would face if its purchase of Varlen were followed by redemptions exceeding $300 million. In various parts of the opinion, even though it admitted the reason for the surge in departures was "not entirely clear," the court concluded that a "run on the ESOP" was likely in light of the drop in the Dow Jones average after the valuation was set, the increased business risks Amsted faced from the Varlen acquisition, and the fact that many employees with large ESOP balances were near retirement age. The court suggested LaSalle could have lessened this risk by lowering the redemption price, and held that no abuse of discretion review is permitted if the trustee in fact did not exercise discretion in considering these factors. The court also suggested that a marketability discount should have been applied – concluding that Amsted's post-valuation change in the plan terms was an increased risk in light of the limitations on liquidity imposed by the Varlen acquisition.

Conclusion/Comment

This decision is potentially troublesome for ESOP trustees for two reasons. First, the Seventh Circuit applied a heightened standard of prudence to ESOP trustees and fiduciaries in the valuation context. Second, it imposes what appears to be a troubling "balancing of interests" duty in valuing stock. Instead of determining a company's true value, the ESOP trustee is now apparently supposed to set the value so as to not encourage too many departures that could harm the company. What is particularly striking here is that, by analytically collapsing the ESOP and the company, the Seventh Circuit is telling fiduciaries to balance a participant's interests against those of the company, who may want to keep its workforce in thrall. And given that departures will ultimately depend on subjective or unknown factors such as the workforce's mood and what happens with the company and the economy post-valuation, under this standard, there appears to be few instances in which a trustee could safely assume no marketability discount should be applied. The net result of such a rule is, of course, that the value of ESOP stock for *all* participants would be lowered, even when, as in Amsted, a company has had a long history of honoring its repurchase obligations.

Armstrong also raises troubling issues for ERISA fiduciaries beyond the ESOP context. LaSalle relied on an uncontested expert in valuing Amsted's stock. That expert in turn relied on the company to project its repurchase obligations. No one could plausibly argue that the company was not the one best positioned to make these assumptions, which depend on subjective factors, such as workforce mood, and unknowns, such as market and business changes post-valuation. Yet the Seventh Circuit indicated that unless the fiduciary independently considered the repurchase risk in light of the Varlen acquisition, it was imprudent. The whole point of a fiduciary hiring experts is to acquire and rely on their expertise, and the court failed to suggest how LaSalle (or Duff & Phelps) could know better than the company what its workforce intended to do in the upcoming year.

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