



# **Is Failure to Apply DLOM A Breach of ESOP Trustee's Fiduciary Duty?**

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## LEGAL & COURT CASE UPDATE

### ***Is Failure to Apply DLOM A Breach of ESOP Trustee's Fiduciary Duty?***

***Armstrong v. LaSalle Bank National Ass'n, 2006  
U.S. App. LEXIS 11077 (May 4, 2006)***

A critical point in the administration of an ESOP for a privately held company is establishing the price at which departing employees may redeem their shares. Too low, and employees may feel short-changed; set the price too high, however, and too many may leave, threatening the company's solvency. Adding to the difficulty is the lack of a market for closely held stock—and certainly, one way for ESOP trustees to comply with their fiduciary obligations is to retain an independent appraiser to assist with pricing the shares.

#### **Post-acquisition redemption sets record**

Employees for railroad manufacturer Amsted Industries received company stock from the date of their hiring until date of departure, at which they could redeem all their shares for cash. The ESOP plan reset the price of company stock every September 30; employees had until the following June 30 to redeem their shares at that value.

In mid-1999, the company obtained \$1 billion unsecured credit to purchase a trucking operation for \$800 million, leaving a \$200 million reserve. That September, appraisers from Duff and Phelps, LLC (Chicago) valued the company at \$184 per share—or nearly 32% higher than the prior year's valuation. The trustee accepted the valuation, perhaps expecting employee departures to fall within the historic range of 9% to 11%. But the 2000 redemptions turned out to be 32%.

Given the excessive demands on cash flow, the trustee amended the ESOP to permit deferred eligibility and redemption. A class of plaintiffs sued for breach of fiduciary duty, charging the trustee with an imprudent valuation for failing to apply a discount for lack of marketability (DLOM).

#### **Prudence vs. panache**

At trial, the federal district court granted the trustee a summary judgment, applying the due deference standard (the same granted to adjudicators), and finding the trustee had acted within its discretion by accepting the valuation without a DLOM. The company's history of redeeming employees' stock in full and in cash, as though sold on the open market, supported the finding.

On appeal, the Seventh Circuit confirmed the standard of review. Unlike entrepreneurs, in whom prudence may be less desirable than panache, trustees are supposed to be careful, especially in their fine balancing act of competing interests. "We must not seat ESOP trustees on a razor's edge," the Court said, and their decisions merit due deference.

"But a discretionary judgment cannot be upheld when discretion has not been exercised." Although the pre-trial record was incomplete (it lacked description of the valuation method used by Duff and Phelps, for example), it also revealed no "indication that [the trustee] considered how best to balance the interests of the various participants in the ESOP in the novel circumstances created by [the company's] acquisition," including the latter's effects on the risks borne by ESOP participants.

Instead, the trustee had acted "as though nothing had changed." The case required remand, to consider whether the trustee—although exercising its discretion had possibly abused it. One way to determine the issue—and not the only way, the Court was careful to point out—is to review whether, under the circumstances, the trustee acted unreasonably by failing to apply a marketability discount to the redemption price.