

CASE LAW DEVELOPMENTS

Kenny Christopher, as Trustee of Embroidery Library, Inc. ESOP and Embroidery Library, Inc. v. Harlan L. Hanson et al., 2011 U.S. Dist. Lexis 60201 (D. Minn. June 6, 2011).

This lawsuit revolves around two 2006 transactions between Embroidery Library, Inc. (“ELI”) and ELI’s Employee Stock Ownership Plan (the “ESOP” and, together with ELI, “Plaintiffs”) on the one hand, and ELI’s founder, Harlan L. Hanson, his wife Marcia, and their children Mark and Scott (each referred to by his or her first name, and collectively, “Defendants”) on the other hand. ELI and the ESOP each purchased shares from the Defendants in January and December, 2006. The Plaintiffs filed suit, alleging that the Defendants breached various duties under ERISA and Minnesota law by inflating the stock price and requiring ELI to enter into burdensome restrictive covenants. This decision addresses the Defendants’ motion for summary judgment dismissing all counts.

Prior to 2000 the Defendants owned 100% of ELI’s stock. In 2000, the ESOP was formed and acquired 30% of ELI’s stock. Harlan acted as trustee of the ESOP from its inception until he resigned from that position in mid-December, 2006. Three of ELI’s executive employees became ESOP trustees at various times through mid-December, 2006. The Defendants made up ELI’s Board of Directors until December 31, 2006.

Lyndon Steele (“Steele”) of Gerald Gray & Associates acted as the independent appraiser for the ESOP. In 2004 Harlan hired Prestwick Partners (“Prestwick”), an investment banking firm, to market ELI for sale. Prestwick found several potential buyers interested in purchasing ELI for up to \$4.4 million plus an earn-out. One valuation given during the marketing process valued ELI at \$5.6 million. Prestwick disagreed strongly with Steele’s valuation of ELI which appraised ELI at \$15.2 million.

On January 25, 2006, the ESOP purchased stock and ELI redeemed stock from the Hansons, both at a price of \$168.25 per share, based on Steele’s appraisal. After this transaction, the ESOP owned 50.2% of the ELI stock. The transactions were financed entirely by the Hansons.

In spring 2006 Harlan told ELI’s president and chief operating officer, who was also one of the ESOP trustees, that he intended to sell the rest of the Hansons’ ELI shares to the ESOP and ELI in December 2006, and that she would be fired if she did not make the transactions happen. The proposed transactions closed on December 31, 2006. They involved selling

some of the remaining shares to the ESOP in exchange for promissory notes, and converting the rest of the shares to seven-year bonds, both at a price of \$275 per share. In connection with financing the transactions, Harlan also insisted that ELI’s officers and directors agree to restrictive covenants including a covenant not to sell the company for three years. ELI’s attorney advised that these covenants would impact the value of the shares and would make it difficult to reach the targeted price, and that applying the restrictions to the shares already owned by the ESOP, without any consideration to the ESOP, would constitute a breach of fiduciary duty. With regard to both 2006 transactions, there was no independent ESOP trustee and the ESOP was not represented by its own attorney, contrary to the advice of ELI’s attorney; there were no arm’s-length negotiations between the Hansons, ELI, and the ESOP; and Harlan did not give Steele any information about Prestwick’s failed attempts to sell ELI and did not inform Steele of the restrictive covenants.

In order to prevail in a motion for summary judgment the moving party must show that there is no genuine dispute as to any material fact and the movant is entitled to judgment as a matter of law. The Court denied all but one of the Defendants’ arguments for summary judgment, finding as follows:

- To the claim that the Defendants were not fiduciaries as of the December 31, 2006 transaction because they resigned as Board members as of that date, the Court responded that (i) there was no evidence that the Defendants’ resignations from the Board took place prior to approval of the transaction which occurred on the same day; and (ii) the evidence that Harlan strong-armed ELI’s non-Hanson executives, ESOP trustees and directors into agreeing to the December 31, 2006 transaction and that the other Hansons allowed this to occur could lead to a finding that Defendants breached their fiduciary duties prior to December 31, 2006.
- To the claim that there was no evidence that the Defendants breached ERISA fiduciary duties, the Court responded that there was sufficient evidence to find that the Defendants, as ERISA fiduciaries, breached the ERISA duties of loyalty and prudence, which caused a loss to the ESOP. The Court pointed to the Defendants’ interest in maximizing the share value; the apparent failure to follow the advice of ELI’s attorney that the ESOP should be represented by independent counsel and that the negotiations should be arm’s-length; the failure to advise Steele of

the failed attempts to sell ELI through Prestwick; the lack of evidence that the Defendants scrutinized the financial projections given to Steele; evidence that an appraiser other than Steele should have been used for the transactions because of his past history with Harlan, ELI, and the ESOP; and Harlan's failure to inform Steele of the restrictive covenants, instructing ELI's attorney not to communicate with Steele and threatening ELI's president that she would be fired if the December 31, 2006 transaction was not completed at \$275 per share. The Court also found that the same facts that support Plaintiff's ERISA fiduciary-duty claims also support ELI's state law fiduciary-duty claim.

- To the claim that the transactions fell within the "adequate consideration" exception to ERISA's "prohibited transaction" rule, the Court responded that there was sufficient evidence showing that the share prices for both transactions were much too high and that Harlan withheld information from the appraiser, thereby raising an issue of fact as to whether the transactions fell within the adequate consideration exception.
- To the claim that Marcia, Mark and Scott did not breach their duty to monitor and evaluate Harlan's performance as an ESOP trustee, because they did not know or have reason to know of Harlan's alleged misdeeds, the Court responded that there was sufficient evidence to find that Marcia, Mark and Scott were liable as co-fiduciaries for Harlan's acts, because their failure to monitor Harlan enabled his alleged breach of fiduciary duty.
- To the claim that Plaintiffs' state-law claims are preempted by ERISA, the Court responded that the state-law claims are not preempted insofar as they are claims by ELI against the Hansons, relating to the redemption of stock by ELI, stating, "These claims exist with or without an ERISA plan and assert independent state-law causes of action."
- To the claim that Plaintiffs' unjust enrichment claims fail because "equitable relief cannot be granted where the rights of the parties are governed by a valid contract" the Court responded that the Plaintiffs' allegations are not based upon the contracts, but rather that the contracts were entered into in violation of Defendants' duties under state and federal law, and, thus, it could not find, at the summary judgment stage, that there were valid contracts governing the rights of the parties.

The Court granted Defendants' motion for summary judgment only on the aiding and abetting claim against Marcia, Mark, and Scott, finding that there was no evidence that the three individuals had actual knowledge of Harlan's wrongdoing and that "the tortious conduct was not so clearly illegal or unlawful so as to justify imputing constructive knowledge."

Kurt Sollberger v. Commissioner of Internal Revenue, T.C. Memo 2011-78; 2011 Tax Ct. Memo

LEXIS 77 (Tax Ct., April 4, 2011).

Kurt Sollberger sold stock to an ESOP in 1999, elected non-recognition of gain under Code §1042, and purchased floating rate notes ("FRNs") as qualified replacement property ("QRP"). In 2004 he entered into a transaction with Optech Ltd. ("Optech"), an affiliate of Derivium Capital, LLC ("Derivium"), in which he borrowed money equal to 90% of the value of the FRNs from Optech (the "Loan") and pledged the FRNs to Optech as collateral for the loan.

The loan was for a term of seven years and was non-recourse, meaning that if Sollberger did not repay the loan Optech could keep the collateral, but would have no further obligation to repay the loan. The loan agreement provided that Sollberger remained the beneficial owner of the FRNs and that the FRNs would not be subject to the claims of any of Optech's creditors. However, it also provided that Optech could "assign, transfer . . . and/or sale" the FRNs without notifying Sollberger. In addition, Sollberger waived his rights to receive interest and other benefits from the FRNs during the term of the loan, and was not permitted to prepay the loan. Two days after entering into the loan transaction, Optech sold the FRNs.

One of the requirements to defer recognition of gain under Code §1042 is that the proceeds of the sale to an ESOP must be invested in QRP. Gain that is deferred under §1042 must be recognized if and when the QRP is sold or otherwise transferred. Sollberger did not report any of the previously deferred gain from the 1999 ESOP stock sale because he treated the transaction with Optech as a loan --- not a sale --- of the FRNs. The IRS determined that the transaction with Optech was a sale rather than a loan and, accordingly, determined a deficiency in Sollberger's federal income tax for 2004.

The Court found that there was no genuine issue as to any material fact, and granted summary judgment to the IRS. The Court held that for a transaction to be a loan "there must be an unconditional obligation on the part of the transferee to repay the money, and an unconditional intention on the part of the transferor to secure repayment. Accordingly, there must be a bona fide debtor-creditor relationship for the transaction to be characterized as a loan." Contrary to this standard the Court found that the benefits and burdens of the FRNs passed from Sollberger to Optech and, therefore, that petitioner sold his FRNs to Optech, thereby triggering capital gain in 2004 from the 1999 ESOP stock sale.

The author reviewed this article with Committee Chair, Susan D. Lenczewski, Gray, Plant, Mooty, Mooty & Bennett, P.A., Minneapolis, MN. For a complete list of Legal Update articles, please visit The ESOP Association's website.