LEGAL *Update*

Case Law Developments for March 2013

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Joseph Enneking v. Schmidt Builders Supply, Inc., et al (United States District Court, D. Kansas, January 7, 2013)

The case of *Enneking v. Schmidt Builders Supply, Inc.* was previously covered in the September, 2012 Legal Update column. This case arises out of a complaint filed by a group of full-time employees of Schmidt Builders Supply, Inc. who were also participants in the Schmidt Builders Supply, Inc. ESOP sometime during the period of January 1, 2002 and July 31, 2011. The initial complaint alleged that on November 26, 2002, Defendants Timothy Schmidt, John Duncan and Mary Duncan entered into a stock purchase agreement to sell all of the Schmidt Builder's stock to Mary Duncan and a newly created ESOP. Pursuant to the terms of the purchase agreement, the ESOP purchased 40% of Schmidt Builders for $1,455,000 and Mary Duncan purchased the remaining 60% for $3,395,000. To finance the ESOP's portion of the purchase price, at least $1,100,000 was required to be transferred from the existing 401(k) plan to the ESOP. Although the transfer required the employees to affirmatively elect to transfer funds to the ESOP, the 401(k) plan would be discontinued on December 31, 2002. The employees were not told about this 401(k) transfer opportunity until May 2003. At that time, the employees were told that SS&C Solutions, Inc., a valuation expert, was hired solely to represent the ESOP and the ESOP trustee to ensure the ESOP pay a fair price. SS&C was originally retained by Schmidt Builders to establish the ESOP.

As a part of the voluntary transfer of funds from the 401(k) to the ESOP, the plaintiffs alleged that the Defendants intentionally failed to disclose and concealed the true nature of the underlying transaction, the fiduciary Defendants' inherent conflicts of interest, SS&C's conflict of interest, John Duncan's criminal background, Timothy Schmidt's recent purchase of Schmidt Builders for far less than the 2003 purchase price, and the extraordinary bonus payments paid to Timothy Schmidt. Plaintiffs further alleged that concealment of the material information associated with the creation of the ESOP and the transfers from the 401(k) plan were not discovered until the financial collapse of Schmidt Builders in July 2011 when Schmidt Builders entered into a settlement agreement with Kaw Valley Bank.

In a decision rendered on June 19, 2912, the Court dismissed all but one of the Plantiffs' claims. A state law claim for negligence was retained, but the remaining claims were dismissed for failure to plead sufficient facts to state a claim for a fiduciary breach and/or because the statute of limitations had run. Subsequently the plaintiffs filed a Motion for Reconsideration and in the alternative, made a Motion for Leave to File an Amended Complaint and a Motion to Intervene. As to the Motion for Reconsideration, the Court said the motion may be granted only if the moving party could establish an intervening change in the controlling law, the availability of new evidence that could not have been obtained previously through the exercise of due diligence, or the need to correct clear error or prevent manifest injustice. The Court denied the motion because the plaintiffs cited no change in the controlling law and the second ground of relief was unavailable because the Court evaluated only factual allegations and not evidence in ruling on a motion to dismiss.

As to the Motion for Leave to Amend, the Court focused its analysis on whether leave to amend would cause undue delay. Although the Court stated that "this is a case where plaintiffs obviously thought their original allegations were sufficient to withstand the statute of limitations defense and therefore failed to seek leave to amend prior to a ruling on the motions to dismiss," the Court found the reasons for the delay excusable. Plaintiffs cited additional facts in the Proposed Amended Complaint to trigger the federal concealment rule and allow the statute of limitations to toll until the time the fraud was discovered instead of when the breach occurred. Accordingly, because the fraud was not discovered until 2011, the Court concluded the claim was timely filed. Plaintiffs further attempted to have the statute of limitations for the Kansas common law fraud claim tolled but the Court declined and concluded that the claim was preempted by ERISA. Finally, the Plaintiffs alleged that the statute of limitations was tolled for the fraud and misrepresentation of SS& C and associated with the annual stock valuations it provided to the ESOP participants. The Court agreed with the Plaintiffs and found that the statute of limitations did not begin to run until July 2011 and that the claim was timely filed.

Also in the Proposed Amended Complaint the Plaintiffs sought punitive damages from the Defendants in connection with the breach of fiduciary duty claim under ERISA and attempted to assert claims on behalf of

Schmidt Builders by the ESOP as a minority shareholder. The Court rejected both of these claims. The plaintiffs were given 14 days to file the amended complaint.

Smith v. Delta Airlines, Inc. (11th Circuit, February 22, 2013)

The class action lawsuit of *Smith v. Delta Air Lines, Inc.* was originally filed in 2004 by participants in Delta's Employee Stock Ownership Plan. From September 29, 2000 to September 30, 2004, Delta lost more than six billion dollars and it's stock value declined by more than 92%. The plaintiffs filed an action in September 2004 alleging that the plan fiduciaries breached their ERISA fiduciary duties by failing to prudently and loyally manage the ESOP's investment in Delta stock and for failure to monitor the investment committee and provide the committee members with accurate information.

All of the defendants, including Delta, moved to dismiss the case in April 2005, however when Delta filed for Chapter 11 bankruptcy in September, 2005, the claims against Delta were stayed. Nonetheless, the U.S. District Court for the Northern District of Georgia proceeded to rule on the claims with respect to the remaining fiduciary defendants and, in 2006, granted the Motion to Dismiss as to all defendants other than Delta. The District Court concluding that the plaintiffs' prudent investment claim was really a claim for failure to diversify ERISA. The District Court then reasoned that since ERISA provides an exception to the duty to diversify for investment in employer securities in an ESOP, that the plaintiffs had no action against the fiduciaries and approved the Motion to Dismiss. The lawsuit was administratively closed in September, 2007 but in November, 2011, the District Court granted an joint motion to reopen the case and entered a Motion to Dismiss in favor of Delta. The plaintiffs then appealed the District Court's decision dismissing the claims against the ESOP's fiduciaries.

As noted in this Legal Update column in the last year, in May of 2012, the 11th Circuit reached a decision in *Lanfear v. Home Depot, Inc.*, another stock drop case. In *Lanfear*, the 11th Circuit determined that prudent investment claims should not be treated as failure to diversify claims which may be dismissed because of the ERISA exception to diversification for ESOPs. The 11th Circuit asserted that *Lanfear* also clarified that the 11th Circuit had adopted the *Moench* presumption for claims involving the prudence of investment in employer securities.

Because of the intervening decision in *Lanfear*, the 11th Circuit partially vacated the District Court's decision and remanded the case back to the District Court to determine whether the plaintiffs' complaint sufficiently alleged that the ESOP's investment committee breached their fiduciary duty to prudently managed the plan's assets. The 11th Circuit did affirm the District Court's decision to dismiss other defendants after it determined that the compliant failed to adequately plead that those defendants were fiduciaries with respect to investment decisions. The Northern District of Georgia will now proceed to determine whether or not the complaint adequately pled a breach of fiduciary duty claim against the Delta investment committee under the *Moench* presumption.

The author reviewed this article with Committee Chair, Susan D. Lenczewski, Fafinski, Mark & Johnson, P.A., Minneapolis, MN.

The ESOP Association Announces Nominees for Board of Governors

The following individuals have been nominated to serve on The ESOP Association's Board of Governors starting in May 2013.

For election to another three-year term to the Board of Governors as a representatives of a Corporate Member of the Association:

Spencer A. Coates, President, Houchens Industries, Inc., Bowling Green, KY
Robert G. Sanchez, CFO, National Wire & Cable Corporation, Los Angeles, CA
Michael Silverman, General Counsel, SmithBucklin Corporation, Chicago, IL
Andrew Todhunter, President, KAPCO, Brea, CA

For election to another three-year term to the Board of Governors as a representative of a Professional Member of the Association:

Kim S. Abello, Senior Vice President, JP Morgan Chase, Wheaton, IL
James G. Steiker, Chairman & CEO, SES Advisors, Inc., Philadelphia, PA

For election to the Board of Governors for the first time for a three-year term as a representative of a Corporate Member of the Association:

Jeffrey S. Gelburd, Vice President, Murray Securus, Mechanicsburg, PA
Jeri W. Lassiter, Chairman of the Board & CEO, ASM Research, Inc., Fairfax, VA
J.L. Nichols, III, Chairman of the Board & President, Nichols Foodservice, Inc., Wallace, NC

For election to the Board of Governors for the first time for a three-year term as a representative of a Professional Member of the Association:

Susan D. Lenczewski, Counsel, Fafinski Mark & Johnson, P.A., Eden Prairie, MN