



What every valuation analyst should know about employee stock ownership plans (ESOPs)



Executive summary

The goal of this paper is to provide a concise overview of Employee Stock Ownership Plan (ESOP) transactions in an understandable manner that provides practical and regulatory insights into successful installations. The paper is oriented to those CPAs serving as a financial adviser (FA), including valuation work, to the fiduciaries of the ESOP.

ESOP attractiveness was magnified with the 1997 federal legislation permitting S corporations to sponsor ESOPs. This created an opportunity for CPAs to provide services to their clients in the creation and administration of a successful ESOP.

This paper summarizes the material issues related to the installation and maintenance of ESOPs. There is a brief history of relevant events, a consideration of applicable federal regulations, an overview of ESOP valuation issues, typical transaction structures, practical success insights and a summary of practical considerations.

Included is a discussion of the Tax Cuts and Jobs Act tax law change in 2018. That change impacts tax adjustments to comparable publicly traded companies and the tax paid by beneficiaries of an ESOP, but has little effect on plan valuations and administration.

An update will be provided on the current enforcement activity by the Department of Labor (DOL) and the process agreements with the DOL that provide guidance on the ESOP fiduciary relationship with the FA to the ESOP.

Definitions

AICPA — American Institute of Certified Public Accountants

ASC — Accounting Standards Codification

DOL — Department of Labor.

ERISA — Employee Retirement Income Security Act of 1974.

ESOP — Employee Stock Ownership Plan.

ESOT — Employee Stock Ownership Trust.

FASB — Financial Accounting Standards Board.

Fiduciary — Anyone who has discretion or control over ESOP Plan Assets, typically including the plan sponsoring corporation, the board of directors who can appoint or remove other fiduciaries, a plan administrator charged with plan oversight and the plan trustee (whether directed or discretionary).

IRC — Internal Revenue Code.

IRS — Internal Revenue Service.

FMV — Fair Market Value.

KSOP — The combination of a traditional 401(k) plan with an ESOP plan.

QRP — Qualified Replacement Property.

Prohibited Transactions — Transactions that could result in self-dealing among parties in interest or harm to the participants in the ESOP plan.

trustee — Responsible for assuring that transactions involving the assets of the ESOP plan comply with fiduciary responsibilities as defined by ERISA and subsequent DOL regulations.

SSVS No. 1 — Statement on Standards for Valuation Services issued by the AICPA Consulting Services Executive Committee. This statement has been codified as VS Section 100.

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Overview of ESOPs and trusts

History

The first major federal legislation embracing the concept of employee ownership was ERISA. There is a history of Congressional support related to ESOPs. Before 1996, ESOP legislation related only to C corporations.

The following legislative acts mark the most notable developments:

ERISA of 1974 — Intended to protect the retirement plans in the United States, ERISA included ESOPs in the definition of a qualified employee benefit plan under the IRC. ERISA generally standardized the rules governing pension and retirement plans, but permitted certain exceptions to ESOPs in recognition of their special mission. ERISA permits an ESOP to borrow money in the interest of acquiring employer securities, and ESOPs are expected to be primarily invested in employer securities. These provisions are significant because non-ESOP qualified retirement plans contain specific restrictions against the inclusion of more than 10% in employer securities. ERISA established both the DOL and the IRS as federal oversight agencies for ERISA.

Revenue Act of 1978 — This act requires an ESOP that holds non-publicly traded stock to offer plan participants a “put” option back to the employer, with the employer and/or the ESOP repurchasing the stock. The mandated repurchase of the employer stock is generally referred to as the repurchase obligation. The Revenue Act of 1978 required public companies to provide full pass-through voting rights on allocated shares and closely held companies to extend voting rights on major issues of corporate governance to allocated shares.

The Economic Recovery Act of 1981 — This act increased the tax deductible covered payroll contribution limit for C corporations from 15% to 25% to an ESOP for principal payments and provided for an unlimited tax deduction for interest payments made by an ESOP. This act also allowed plan sponsors to require that plan participants departing an ESOP accept cash for the FMV of their stock, rather than the stock itself.

Deficit Reduction Act of 1984 — At a time when federal government deficits were a major concern, this act expanded financial incentives for ESOPs. Those incentives included what is today referred to as the IRC 1042 Tax Deferred Rollover and the tax-deductibility of reasonable dividends paid to an ESOP. The IRC 1042 Tax Deferred Rollover provides a tax incentive for the owner of stock in a closely held company to sell a minimum of 30% of the stock to the ESOP, if the proceeds are reinvested in QRP.

Small Business Job Protection Act of 1996 and the Taxpayer Relief Act of 1997 — These acts permitted the sale of stock by individuals to an ESOP in an S corporation. These acts are considered together because they address many technical issues specifically related to ESOPs in S corporations. These acts greatly expanded the market for ESOPs, as the preponderance of privately held companies are S corporations.

Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) — Generally, EGTRRA is responsible for aligning many (but not all) tax-related issues regarding ESOPs in both C and S corporations. Many of the provisions relating to contribution limits are indexed for inflation. The ESOP employer contribution limit was increased to 25% of qualified payroll, and self-directed contributions made by individuals to other qualified retirement plans did not count against the 25% contribution. EGTRRA also corrected abuses in S corporation ESOPs where only one, or a few individuals, participate in the plan.

Federal Statute: 90 Stat. 1520, P.L. 94-455 Section 803 — encouraging ESOP — Congress has embraced ESOPs with a series of legislative initiatives and this statute was passed to help ensure that the objectives of employee ownership are not made unattainable by regulations and rulings that treat ESOPs as conventional retirement plans by denying them the flexibility and freedom to implement the plans.

Regulations overseen by the DOL (generally Title 1 of ERISA)

The DOL is responsible for the protection of employee benefit rights. The DOL oversees such areas as the conduct of plan fiduciaries, rules for structuring plans and prohibitions against certain types of transactions.

ERISA established the requirement that all qualified ESOP plans must have an ESOP trustee. Every trustee is bound by applicable fiduciary responsibilities, and, in certain instances, fiduciary responsibilities may extend to other parties that are not trustees.

While both the DOL and IRS may overlap in certain areas where they review ESOPs, in practice, the DOL efforts are concentrated on fiduciary issues and prohibited transactions. The DOL enforcement actions are focused on identifying conflicted relationships between the parties-in-interest and resulting possible self-dealing (prohibited transactions) that result in harm to the participants in the ESOP plan.

Parties-in-interest include the following: the plan fiduciary (including the administrator, officer, trustee and custodian), plan legal counsel, service providers to the plan, sponsoring employers, employees and participants in the plan, related unions and employee organizations, certain organizations classified as a control group, direct and indirect owners of 50% or more of the common stock in the plan sponsor, and relatives of the owners, including lineal descendants. Prohibited transactions may result in the plan being subject to severe financial penalties in addition to placing the offending transaction at risk of being reversed.

Fiduciary responsibilities

One of the most significant activities by the DOL is to review the fiduciary responsibilities of the various parties-in-interest. Fiduciary responsibilities represent some of the highest standards of conduct in the business community.

The trustee has fiduciary responsibilities and generally has exclusive authority and discretion over the management and protection of the ESOP assets. ERISA permits anyone to become a trustee, including company officers, employees, selling owner(s), outside individuals and independent parties. The trustee may be an individual, a committee or an organization. While there is great flexibility in the designation of the trustee, the duties of the trustee are substantial, and these obligations must be taken seriously. Where a conflict is apparent, as in the case of a selling owner serving as a trustee, great care must be exercised to ensure that there is no prohibited transaction.

The following is a list of major fiduciary duties (not all inclusive) that should be implemented as part of the fiduciary responsibilities

Duty of loyalty — The fiduciary must act solely in the interest of the participants and beneficiaries. This duty is often referred to as the exclusive benefit rule or the duty of loyalty (ERISA Section 404(a)). This duty of loyalty imposes a high standard of conduct for officers, directors, owner(s) and other insiders. When potential conflicts arise, the fiduciary must be able to demonstrate the duty of loyalty.

Prudent man obligation — The fiduciary should discharge duties with “care, skill, prudence and diligence under circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matter would use in the conduct of an enterprise of a like character and like aims” (ERISA Section 404(a)). The fiduciary commonly relies on the advice and reports of other

professionals. Even with that reliance, the fiduciary must still perform an independent investigation into matters and should understand the work of other advisers in sufficient detail to reach a conclusion. Ultimately, the responsibility for conduct rests with the fiduciary.

Exclusive purpose rule — Generally, the trustee is required to consider the interests of the plan participants, only in their position of participants in a qualified plan, and generally may not consider other interests (ERISA Section 404(a)). The regulations are clear in this regard, but there may be some extenuating circumstances with ESOPs that may permit very limited consideration of other interests.

Compliance with plan documents — The fiduciary is expected to act only in the manner permitted by the plan documents and ERISA (ERISA Section 404(a)). The fiduciary must read and understand the plan documents. Such duties include keeping the plan in compliance with changing statutes, filing all applicable tax reports, having the company stock valued at least annually, complying with pass-through voting requirements, and discharging other specified duties, as detailed in the plan documents.

Guarding against prohibited transactions — The fiduciary must be aware of events that may lead to prohibited transactions. Such transactions typically arise between the plan and parties-in-interest. While certain exemptions regarding prohibited transactions exist for ESOP transactions specifically, the fiduciary must identify likely conflicts that could lead to either the appearance of a prohibited transaction or a finding of a prohibited transaction upon DOL review.

Tax regulations overseen by the IRS (generally Title 2 of ERISA)

While ERISA amended several sections of the IRC, only the most significant portions are discussed here. Only corporations may sponsor an ESOP. There are both similarities and distinctions in the tax code relating separately to C and S corporations. Common tax attributes are considered with all corporations; followed by C corporation attributes and finally S corporation attributes.

Common tax attributes for all corporations

The ESOP may acquire the qualified stock of the plan sponsor, the employer corporation. Generally, the qualified stock must have the highest equity attributes such as voting rights, liquidation preferences and dividend preferences (IRC Section 409(1)).

Once stock and other financial assets are contributed to the account of the ESOP participant, the participant pays no taxes until distributions begin. The individual accounts may be subject to some diversification requirements to help reduce the concentration of investment in the employer stock. Like other qualified plans, individuals may transfer ESOP assets into another qualified plan if they leave the employment of the company prior to retirement.

Individuals may also take an early distribution, subject to penalties, if the assets are not “rolled over” into another qualified plan. When distributions are made from the ESOP to the individual for the purposes of retirement, the proceeds are taxed to the individual as ordinary income, like most other qualified plans.

C Corporations

Payroll limitations — Tax deductible contributions are limited to 25% of qualifying payroll, and interest expense is not counted against the 25% limitation if no more than one-third (1/3) of the plan sponsor’s contributions are allocated to the accounts of highly compensated employees, within the meaning of applicable regulations (IRC Section 414(q)). These limitations have the effect of making highly leveraged ESOP transactions possible, since unlimited interest expense is permitted. Payroll contribution limits are indexed to inflation and are adjusted in \$5,000 increments over time. Currently, the maximum contribution limit in 2019 is \$280,000.

There are regulations that distinguish the contribution limit and the maximum allocation limit (which includes forfeitures). Generally, allocation limits are the lesser of \$56,000 (in 2019) or 100% of the participant’s salary, indexed to inflation in \$1,000 increments (IRC Section 415(c)(1)).

Deductible dividends — Dividends typically are taxed to the receiving owners. Dividends paid to an ESOP in privately held corporations are tax deductible if they are reasonable (IRC Section 404(k)). This deduction is helpful when there is a transaction with high stock value in relation to the qualifying payroll. The dividends in excess of the 25% payroll contribution limit may be used to repay acquisition debt principal. The tax-deductible dividend may be subject to corporate minimum taxes.

Sale of stock tax treatment to seller (IRC Section 1042 Tax Deferral) — The sale of stock to an ESOP is typically taxed as a capital gain to the seller, which is the case in public corporations. For owners of private corporations, subject to a three-year holding period, the sale of stock to an ESOP may qualify for a tax deferral election if all the applicable regulations are met. The IRC Section 1042 tax deferral states that an individual (not a corporation) selling owner may elect the Tax Deferral option if at least 30% of all the outstanding equity is sold to the ESOP and the sale proceeds are invested in QRP.

The QRP must be purchased in a window of time between three months prior to the sale of stock to the ESOP and not later than 12 months after the date of sale. The taxes on the gain that would be normally due on the completion of this stock transaction may be deferred if the investor retains the QRP. If the QRP is subsequently sold, that transaction will incur a tax, with the basis of the QRP equal to the basis of the stock in the employer. To optimize the tax deferral attributes of the IRC Section 1042 election, the individual typically adopts a buy and hold investment strategy. QRP generally is understood to mean individual company securities of domestic operating corporations (either public and private), including such investments as stocks, bonds, notes and debentures. QRP does not include such investments as mutual funds, real estate, government securities and municipal bonds, foreign securities, subsidiaries of the plan sponsor, partnerships and limited liability companies.

The IRC Section 1042 is subject to several restrictions. Participation in the ESOP following the sale and IRC Section 1042 election may be limited. Rules of attribution disqualify direct lineal descendants from participating in the ESOP if they are employed by the company.

Owners owning 25% of the outstanding stock are also disqualified from participating in the ESOP. The selling owner must have held the stock for three years prior to the sale (and cannot have obtained the stock through stock options), and the company may be subject to an excise tax penalty if the stock purchased by the ESOP is sold within three years.

S Corporations

Payroll limitations — By regulation, S corporation tax deductible contributions are limited to 25% of qualifying payroll, and interest expense is counted against the 25% limitation (a major distinction between C and S corporations). These limitations have the effect of making highly leveraged ESOP transactions subject to considerable advanced planning to ensure that ESOP related debt may be amortized after consideration of interest expense. Payroll contribution limits are indexed to inflation and are adjusted in \$5,000 increments over time. Currently, the maximum eligible compensation limit in 2019 is \$280,000. There are regulations that distinguish the contribution limit and the maximum allocation limit (which includes forfeitures). Generally, allocation limits are the lesser of \$56,000 (in 2019) or 100% of the participant's salary, indexed to inflation in \$1,000 increments (IRC Section 415(c)(1)).

Shareholder distributions — S corporations are pass-through entities for tax purposes since the income is "passed through" to the individual shareholders and is taxable to them, typically at ordinary tax rates. There is a single class of stock requirement with S corporations and each shareholder receives the same prorated percentage distribution. The allocation of taxable income is taxed to the S corporation shareholders individually. The ESOP is a qualified plan under ERISA

and does not have any current year federal (and in most cases state) income tax liability. The cash distribution to the ESOP stays within the plan free of all income taxes.

Subject to regulations, the cash distribution may be used to repay debt principal, in part offsetting the fact that interest expense is counted against the 25% payroll contribution limit.

Sale of stock — S corporation shareholders selling stock to the ESOP are subject to applicable capital gain taxes assuming a taxable gain. S corporation shareholders are not eligible for the IRC Section 1042 tax deferral election.

Anti-abuse restrictions (IRC Section 409(p)) — An unintended original consequence of allowing S corporations to sponsor ESOPs is that there could be a tremendous concentration of economic benefit in the account balances of corporations with only one or a few qualifying employees. Since such concentrations are not in the spirit of employee ownership, Congress, with the help of the employee ownership community, crafted what is generally referred to as S corporation anti-abuse provisions. The purpose of the legislation is to eliminate clearly unintended abusive situations that had the impact of avoiding taxes. There are two parts to the anti-abuse testing. The first test is to identify ESOP participants with more than 10% of the outstanding stock allocated to their account (“disqualified participants”). After identifying such disqualified participants, the second test applies if the combined percentage of total company equity (including synthetic equity and considering rules of attribution) exceeds 50% of the total. If the total company equity exceeds this threshold, then the company is subject to significant financial and tax penalties. If circumstances dictate the incurrence of tax penalties, this tax year is referred to as a “non-allocation year.”

As a result, S corporations may sponsor an ESOP, but it is recommended they have at least 15—20 employees in most circumstances, to avoid the anti-abuse penalties. Should a non-allocation year be determined, a prohibited transaction has occurred. IRC Section 409(p) compliance testing is highly recommended, as part of a thorough due diligence process conducted by the trustee with the assistance of knowledgeable professionals.

Switching between C and S corporation status

The tax code permits corporations to change their status between a C and S corporation, subject to applicable notice and holding periods. For example, an original C corporation may elect to be an S corporation for tax purposes at any time, subject to notification with the IRS. Typically, the change is made in alignment with a new fiscal year. Changing from an S corporation back to a C corporation typically involves the consideration of the “built-in gains” tax consequences for the first 5 years after the S election was made. There are different methods of computing allowable contributions to an ESOP, depending on the tax election of the employer, either a C or an S corporation. An important general rule is that the applicable ESOP regulations will apply to the corporation depending on its current tax status. If the corporation is making an election, the regulatory environment will apply to the plan sponsor while it is either a C or an S corporation. For this reason, if elections are made, they typically are effective with whole fiscal years to avoid the complications of allocating results between partial years. Tax deductible contributions are generally a function of the fiscal year of the corporation. Testing for individual account compliance is typically a function of the plan year. In most instances, the plan year-end and the fiscal year-end are the same; however, there are circumstances when they are different, and the compliance issues become more complex.

An unlimited number of shareholders are permitted for C corporations. There are limitations on the number of shareholders permitted for S corporations, but the ESOP is considered as a single shareholder for compliance purposes.

ESOP valuation standards overseen by the DOL and the IRS

ESOPs are unusual, since the valuation of stock in private companies is subject to standards of both the DOL and the IRS. Publicly held companies with ESOPs generally, although not always, do not have valuation standards as the stock of the plan sponsor is traded on public exchanges. Thinly traded public companies may still have a requirement for their stock to be valued by an independent valuation analyst. The IRS holds to the FMV standard that is broadly understood to apply to a wide range of tax-oriented valuation assignments, such as gift taxes and estate taxes. The common understanding of FMV is most generally stated in Revenue Ruling 59-60, with subsequent revenue rulings and Federal Court interpretations.

DOL and the definition of adequate consideration

The DOL generally agrees that all the parameters of FMV apply to the valuation of stock for the purposes of an ESOP. In 1988, David Walker, then the Assistant Secretary, Pension and Welfare Benefits Administration, U.S. Department of Labor, issued Proposed Regulation Section 2510.3-18 — Adequate Consideration. Although this proposed regulation has never been made official, it offered guidance for financial advisers to the trustee of an ESOP plan on what the Department of Labor (DOL) required to be considered when reaching a conclusion of value for ESOP purposes. The development of the conclusion of value must be no more than “adequate consideration” for stock purchased by an ESOP, as defined by the proposed regulation. The major provisions include:

The standard of value is FMV determined in good faith — The fiduciary must make a prudent investigation into the circumstances and assumptions regarding the sale of stock to an ESOP. All relevant factors are to be considered in arriving at the determination of FMV.

Control price — The ESOP is permitted to pay a control premium for the stock to the extent to which a third party would pay a control price. The DOL establishes a two-part test to determine if a control price is justified. First, determine if the ESOP has control in appearance (generally thought to be in excess of 50% of the outstanding stock). Second, does the ESOP have “control in fact.” The facts and circumstances must be carefully examined to determine if the ESOP is able to exercise control within a reasonable time. Control values are best estimated through adjustments to cash flows to reflect control, or, conversely, limited or no adjustments to cash flows that reflect a lack of control consistent with a minority interest.

Repurchase obligation — The fiduciary and the valuation analyst should assess if the plan sponsor will be able to honor the stock repurchase obligation over time. Federal statutes mandate that a departing employee may “put” his stock back to the company, and the company and/or the ESOP must repurchase the stock at FMV.

Document requests from the IRS and the DOL

The IRS and the DOL have oversight responsibility with the enactment of ERISA. These two federal agencies have the primary responsibility for compliance enforcement with ESOP regulations. ERISA and the IRC give the IRS and the DOL authority to conduct investigations to determine if there have been any violations of applicable regulations. The investigative regulations grant both agencies the authority to engage in a wide range of compliance measures, including such actions as: performing on-site audits; requiring the submission of reports, records and books; inspecting relevant documents; questioning individuals regarding the investigation; and subpoenaing records and testimony pertaining to the investigation.

Requests for information are often broad, covering multiple years and including documents related to the ESOP. Additional information of the plan sponsor, such as corporate tax returns, financial statements and

Board minutes, is often requested. There is some overlap in the areas subject to review by both the IRS and the DOL, but generally, the two agencies examine different areas of regulatory compliance.

Reviews are generally initiated in one of several ways. There may be random reviews by industry, geography, or type of plan. There may be reviews of information on Form 5500 (leveraged ESOPs, S corporation ESOPs). Finally, there may be a complaint from a plan participant or a third party. Companies have little control over reviews.

IRS

A non-comprehensive consideration of areas often reviewed by the IRS includes such items as: company and plan tax returns; payroll records and plan records; verifying contributions are made on a timely basis and within limits; testing allocations to determine proper accounting; verifying that the plan is updated with current regulations; reviewing eligibility requirements; determining that no discrimination in favor of highly compensated employees; proper accounting for termination distributions; vesting schedules and other technical considerations generally applicable to IRC regulations. The IRS may also focus on current topics of interest. One such topic is S corporations and compliance with anti-abuse testing percentages.

IRS examinations may produce non-compliance matters and they are often subject to financial penalties while the infractions are being corrected. In more egregious cases, if a prohibited transaction is suspected, the financial penalties are more substantial up to the amount of the transaction, with the possibility that the transaction will be reversed.

DOL

The DOL typically is not focused on compliance with technical matters involving the IRC. The DOL is often focused on the conduct of plan fiduciaries, conflicts of interest among parties to the ESOP transaction, and prohibited transactions. General areas of ESOP review include such areas as: fiduciary liability; factors surrounding the initial acquisition of stock by the ESOP; review of the purchase of company stock, including an analysis of valuation issues such as control premiums, lack of marketability discount and consideration of the repurchase obligation; examination of ESOP-related loans and other regulatory requirements. The DOL may also pursue current topics identified as review candidates. ESOP regulations impose substantial fiduciary duties on selected parties to a transaction, and the breach of those fiduciary duties may result in significant financial penalties to the offenders.

The DOL will review matters of a qualitative nature as they assess behavior of the parties in interest. Compliance with fiduciary standards is often a subjective judgment. The facts and circumstances of each instance under review will determine if there has been an infraction according to the DOL.

DOL concerns with business valuations for ESOP purposes

Business valuations for purposes of transactions with ESOPs are more like “statutory” valuations than other business ownership valuation assignments. There are many examples of valuations that are statutory in nature, meaning that there are regulations that govern the development of the valuation. Some other regulated valuations would include core deposit intangibles in the banking industry, insurance loss reserves, and holding values for securities held in the financial services industry.

Recently, the DOL has benefited from the “Agreement Concerning Fiduciary Engagements and Process Requirements for Employer Stock Transactions”¹ (the GreatBanc process agreement) between Tom Perez and GreatBanc Trust. Although the settlement agreement only pertains to ESOP stock purchase transactions and is not specifically applicable to annual ESOP valuations, it has become the standard checklist used by the DOL in its enforcement actions (formerly known as *investigations or audits*). In addition, the DOL and First Bankers Trust Services, Inc. (the First Bankers process agreement) entered into a settlement agreement filed in U.S. District Court for the Southern District of New York resolving a

¹ *Thomas E. Perez, Secretary of the United States Department of Labor v. GreatBanc Trust Company* case number ED-CV12-1648-R(DTBx) settled June 1, 2014.

case challenging First Bankers' performance as trustee in a transaction where the common stock of a private label denim manufacturer was sold to an (ESOP).² There are some takeaways for valuation professionals from recent presentations made by officials from the DOL on how enforcement actions will be handled. These takeaways will be discussed in more detail in the "Process agreements" section.

The DOL does not routinely perform enforcement actions on an ongoing basis for all ESOP plans. The focus of the DOL has been the initial stock price in ESOP purchase transactions and follow up to employee complaints if those complaints appear to have merit. It is more critical that the valuation expert prepare his or her report in compliance with DOL expectations, which will make the annual updates less likely to be audited by the DOL in its enforcement actions.

Independence considerations

Independence from any other past work or other relationship with the company by the financial adviser to the trustee must be documented and compliant with the settlement agreement. Financial Adviser ("FA") to the ESOP trustee is the name given to the valuation expert that the trustee of the ESOP has retained. In a stock purchase transaction, the financial adviser may provide the trustee with a range of values within which there is a transaction price that is compliant with the proposed regulation regarding adequate consideration. To be considered independent in preparation of a valuation report for ESOP purposes, the valuation expert must do the following:

1. Be retained by the ESOP trustee.
2. Work exclusively for the ESOP trustee during the development of the report.
3. Should not have prepared valuation reports for the business whose stock will be sold to the ESOP in the proposed transaction for anyone other than the trustee of the ESOP.

The best practice is to include the ESOP trustee in communications with the company sponsoring the ESOP. This would include phone calls, data gathering, interviews with management, facility tours, and any other contact with the company, its employees, and other outside advisers to the company (accountants, lawyers, bankers, and other financial advisers). Although sometimes the trustee may allow their financial adviser to contact the company without the trustee being present, the financial adviser should always let the trustee know what was discussed and share any written documents or data obtained during contact with the company.

This heightened demand for independence has caused many trustees to replace current financial advisers with other selections, even though the current financial advisers are independent in action and behavior. It often occurs that a valuation expert will be retained by the board of directors of the ESOP Company separate from the valuation expert advising the ESOP trustee. This is an opportunity to gain new valuation assignments for ESOP purposes, assuming you know the rules for ESOP valuations.

Documentation considerations

When the DOL is performing an enforcement action, it has the benefit of having perfect hindsight about whether the prospective financial information ("PFI") the financial adviser relied upon was reasonable. The DOL will use that hindsight to determine if the value of the stock purchased by the ESOP was for no more than adequate consideration. The settlement agreement offers the best approach the financial adviser can use to attempt to reduce the risk of the PFI being unreliable for the valuation of stock for ESOP purposes.

1. Document who prepared the PFI. The preparer of the PFI should not be the financial adviser to the trustee. Independence in preparation of the PFI is key.
2. Document what was done to test the reasonableness of the PFI. Compare the PFI to management's deployment of assets, marketing plans, and hiring expectations. Document

² Acosta v. First Bankers Trust Services, Inc., S.D.N.Y., case number 1:12-CV-08648-GBD, settled Sept. 21, 2017.

industry growth expectations. Explain in the valuation report whether historical operating results are comparable or not comparable to PFled future cash flows.

3. Provide sensitivity testing in the valuation report to document the impact on the stock price if the PFI is exceeded or not met. Consider using probability weighting for PFled outcomes.
4. Test cash flows of the PFI to the total cash flows of the company, including coverage of ESOP debt, the ESOP repurchase obligation, and, of course, changes in working capital and capital expenditures. If the cash flows are negative, the PFI must be revised or the conclusion of value must be reduced.
5. Ask management to prepare a new PFI and document that request if the PFI provided cannot be relied upon as reasonable based on your testing. The financial adviser should be sure to include the trustee in this process.
6. Provide the trustee with the changes in multiples, discount factors, required return on equity, adjustments made to the financial statements compared to the prior year valuation. This communication should be done whether the prior year valuation was prepared by the current valuation expert or not.

Complexities with warrants

The DOL has been concerned about the use of warrants in ESOP transactions. Warrants can be prepared in many different forms, but they normally allow the holder of the warrant to purchase stock of the company at a future date, for a price set after the assumption of debt by the sponsoring company. The DOL has identified warrants as an area of concern in an ESOP transaction regarding the possibility that the warrants, if issued to the selling shareholders, will allow the selling shareholders to receive greater than adequate consideration for the stock sold to the ESOP.

This area is complex, where each transaction stands on its own. The purpose of the warrants must be documented as a part of the ESOP purchase and related debt agreements. These warrants could be used as a credit enhancement that keeps the interest rates below that of other unsecured debt, so it is easier for the company to service debt in the initial years of the debt repayment. If the warrants are used as credit enhancements, the financial adviser should document in the valuation report to the trustee the estimated total cost of the debt, including the present value of the warrants, to assist the trustee in determining what is reasonable. If warrants are used as credit enhancement, normally, the transaction stock price is not reduced for the estimated present value of the future costs of those warrants.

Warrants may be issued to entice the seller of stock to an ESOP to accept a price the selling shareholder may feel is below market value. It is common that the board of directors may request a valuation of the business independent of the valuation provided to the ESOP trustee. This request is done so that the board of directors can document that they used good business judgment and properly represented the interest of the shareholders by entering the agreement to sell stock to the ESOP. If the board of directors feels the stock price offered by the trustee of the ESOP as adequate consideration is below the price that would be fair to the shareholders, the shareholders may receive warrants that are intended to provide additional compensation to the selling shareholders if the company hits certain milestones or growth targets. In this case, the value of the warrants should be estimated using Black-Scholes or a probability-weighted present value calculation and deducted from the price offered by the trustee for the purchase of the stock by the ESOP. Additionally, if the warrants are likely to be exercised, the number of shares outstanding should be increased to reflect the dilutive impact of the warrants.

Additional stock-based incentives considerations

The DOL will also examine stock-based incentives offered to management as part of an ESOP transaction. These stock incentives can take several forms, such as actual stock option awards to key employees, stock appreciation rights and phantom stock. The stock appreciation rights and phantom stock are forms of deferred bonuses and should be accrued by management in the financial statements

as bonus expense over time, up to the eligibility time for the employee to exercise the cash payment for the deferred bonus. The financial adviser should read the deferred bonus agreement and determine that the expense related to the agreement has been reflected in the financial statements and the PFI. If the deferred bonus costs are not appropriately included in the financial statements and the PFI, then the financial adviser should make normalization adjustments to the financial statements and the PFI for those costs in the valuation report.

Deferred bonus plans that involve the actual issuance of stock present another issue of concern for the DOL. The DOL is concerned that if those incentive stock awards are issued in the future, they will dilute the value of the stock held by the ESOP. These future awards require the financial adviser to perform an analysis of the present value of the awards at the time of the stock purchase by the ESOP, to determine the likely dilution of shares outstanding if the incentive stock is earned. Normally, incentive stock awards, or other forms of deferred bonus payments, are very effective in keeping successful management together while the debt related to the ESOP transaction is being paid. These awards are a good outcome for the ESOP participants, increasing the value the beneficiaries will receive when they terminate their plan participation and become eligible for benefits from the ESOP.

A singular difficulty in determining whether the warrants, incentive stock plan, stock appreciation rights, or phantom stock should create an adjustment to the conclusion of value in a valuation report for ESOP purposes is simply getting information from management and the selling shareholders. The disclosure of all potential or in-place plans that might reduce the future values of the stock held by the ESOP is essential for the financial adviser to the trustee of the ESOP. It is a best practice to notify the signatory to the engagement letter for a valuation for ESOP purposes that the valuation expert must be informed of all such plans. Also, the management representation letter signed before the final report is issued to the trustee of the ESOP must include a representation that all deferred compensation or other related employment agreements have been disclosed and that any warrants, preferred share agreements, stock incentive agreements, or other shareholder-related agreements have been disclosed to the financial adviser to the trustee. The valuation expert would expect the reason for at-risk future compensation plans is that they are necessary to achieve the PFled growth and profitability upon which the determination of adequate consideration was based.

Valuation concerns conclusion

It can be challenging to the valuation professional to prepare valuation reports for ESOP purposes. Although there are no formally approved regulatory requirements for ESOP valuations, the 1988 proposed regulations and the process agreements are used as the standards for enforcement actions by the DOL. Keep in mind that most ESOP trustees are internal to the sponsoring company and are conflicted. Recent enforcement actions by the DOL have served to reduce the number of organizations and professionals willing to serve as independent, non-employee, ESOP trustees. These changes result in the financial adviser to the trustee having an even greater profile in the DOL enforcement actions. Documentation of independence, testing of management's PFI, and documentation of whether all potential costs of the transaction were considered must be fully detailed in the financial adviser's valuation report. By including a copy of the settlement agreement checklist in the valuation report for ESOP purposes, the preparer of the report can reference wherein the report each requirement of the DOL was documented, if applicable. The DOL will prepare its own settlement agreement checklist in every enforcement action taken to audit an ESOP plan.

Reacting to a document or audit request

It is recommended that the company designates one knowledgeable spokesperson to work with legal counsel and other service providers in response to document requests. Respond with only the documents requested and be familiar with all of them. It is important to respond completely to the document requests, and if documents or materials are not available, respond in writing, stating this point. If a meeting is requested, decide if the meeting should be at the offices of the company or away at a third-party location, such as a law firm. Meetings at company offices may be disruptive to operations. The

response to enforcement actions by the DOL is a costly and time-consuming exercise that will place demands on all parties and advisors to the ESOP.

Audit resolution

The IRS will provide a closing letter with any required changes relating to a review of the IRC issues and any additional liability. The IRS typically will work with companies to resolve open issues in an expedient manner. The DOL often does not provide any formal closure on an investigation. Normally the DOL will issue a “Clearance Letter” once any concerns noted during their work have been addressed by the sponsor of the ESOP. The letter does not formally close the audit by the DOL, stating instead that the DOL reserves the right to re-address the issues reviewed in their “enforcement action” at any time.

There may be instances when the company realizes there is a compliance issue prior to any regulatory investigation. In such instances, there are voluntary correction procedures available to plan sponsors to make amendments. The IRS has enacted the Employee Plans Compliance Resolution System (EPCRS) to facilitate the correction of prior errors. Aspects of the EPCRS procedures include several programs. The Self Correction Program (SCP) allows a plan sponsor, at any time, to correct operational failures without paying a fee or sanction. The Voluntary Correction with Service Approval (VCP) program allows a plan sponsor, at any time before an audit, to pay a limited fee and receive approval to correct all qualification errors. The Audit Closing Agreement Program (Audit CAP) applies when an audit uncovers plan failures, and the plan sponsor may correct the failure and pay a sanction.

The DOL has several similar voluntary correction programs. The Voluntary Fiduciary Correction Program (VFCP) permits corrections in such areas as: distributions based on improper valuation of plan assets; payments of unreasonable expenses to service providers; and sales or acquisitions of property by the plan. The Delinquent Filer Voluntary Compliance Program (DFVCP) relates to the late filing of Form 5500.

One of the best protections for trustees, fiduciaries and service providers is to engage in an ongoing review of applicable regulations and make sure that all regulatory obligations are current. Both the DOL and the IRS maintain voluntary correction procedures for the resolution of errors. These procedures should be embraced and proactively applied.

Typical ESOP transaction structures

The most common application for an ESOP in a privately held company is to serve as an exit vehicle for owners. Correspondingly, the ESOP is typically leveraged with acquisition debt from third parties, such as a bank, or with financing provided by the seller.

Privately held corporations

Leveraged ESOP — The most common structure is when an owner wishes to convert investment in the corporation into liquidity for retirement or other purposes. Arrangements are made for the ESOP to borrow the funding to acquire stock from the owners. Often third— party financing from a bank is employed when the amount of stock being sold has a value that is within the debt capacity of the company. Many owners wish to move the company to an employee owned S corporation, and the amount of acquisition debt is in excess of the debt capacity of the company in the eyes of a bank. In such circumstances it is common for the selling owner to provide the financing by way of a seller note. The amortization schedule of the ESOP acquisition debt must be followed by the sponsoring employer.

Pay-as-you-go ESOP — When owners are hesitant to leverage the company with fixed obligations, they elect to sell some stock on an ongoing basis, often annually subject to the ability of the company to afford the purchase. The sale of the stock is a discretionary decision on the

part of the owners. With time the ESOP acquires a larger cumulative amount of stock. The stock is sold to the ESOP each year at the then prevailing FMV at the date of the transaction.

Pre-funded ESOP — There are circumstances where a company makes cash contributions to the ESOP with the intent of selling stock at a later date. This strategy avoids having to sell stock annually or on some other basis. The upper limit to the amount that may be prefunded is, in most instances, 25% of qualifying annual payroll. One strategy is to prefund the maximum amount at the end of one fiscal year, and then prefund another maximum amount a few days later in a new fiscal year. This strategy has the effect of contributing a substantial amount of cash to the ESOP in anticipation of a sale. For example, owners may want to take advantage of the IRC Section 1042 Tax Deferral in a C corporation, and prefunding the plan for a period of time allows the ESOP to accumulate liquidity to purchase the qualifying block of stock (30% at a minimum) and avoid or limit acquisition debt.

Contribute company stock — The company may contribute authorized but unissued shares of stock to the ESOP. The company receives a tax deduction for the FMV of the stock with no cash outlay. The contributed stock has a tax benefit equal to the FMV of the stock multiplied by the company's tax rate. Assume the FMV of the contributed stock is \$100,000, and the company has an effective tax rate of 40%, the tax savings are \$40,000 ($\$100,000 \times 40\%$).

This contribution is also referred to as a capital creation ESOP in that the company can generate capital through a non-cash deduction. There is some dilution to the existing owners, because there are more shares of stock outstanding.

Publicly held corporations

Contribute stock to an ESOP or "KSOP" — The public corporation forms an ESOP or combines an ESOP with a 401(k) plan (KSOP). KSOPs are most common in public corporations, but they can also be installed in private corporations. Stock is typically contributed to the plan and the company receives a tax deduction for the FMV of the stock (typically the price of the stock on a public market). The corporation is providing an economic benefit to its employees by placing stock into the qualified plan and generating positive cash flow by sheltering the earnings with a non-cash tax deduction. There is some dilution to existing owners, because more stock will be outstanding. An additional attraction for sponsoring an ESOP is that the financial interests of the corporation and the employees are in alignment.

ESOP parties-in-interest and installation team of advisers

An ESOP transaction is accompanied by a wide range of active parties to the transaction. Those active parties include owners, the officers of the company, employees and several professional advisers. There is typically a team of advisers involved with the installation of an ESOP. There are some professionals or service firms that will be able to provide multiple services. This section examines the parties-in-interest and the types of disciplines and knowledge typically found with ESOP transactions.

Owners — In private companies, the most common application for an ESOP is to make a market for owners who wish to diversify their ownership holdings. ESOPs are very flexible, since they permit the owners to determine when stock is sold to the ESOP, how much stock is sold, and if control in the company is being passed to the plan. If there are multiple owners, they may decide between themselves who sells stock and when the transaction is completed. The sale of stock is subject to approval by the trustee and for a price that is not more than FMV.

Company officers and employees — The plan sponsor officers may have additional responsibilities following the sale of stock to the ESOP. Often the most senior officers are asked to serve on an ESOP committee, or they have responsibilities to ensure that acquisition debt is

repaid, among other key operational duties. The employees are the financial beneficiaries of an ESOP, and they should have an incentive to help make the company financially more successful, because they participate in the success of the company through their ESOP account.

trustee — Every ESOP will have a trustee. Anyone may serve in this capacity, subject to the applicable ERISA-imposed fiduciary responsibilities. Some parties recommend that an independent trustee be engaged for the sale of stock to an ESOP. Often the trustee will be an internal trustee, after a given stock transaction with the ESOP. However, it is a best practice to use an independent trustee for any stock transaction with the ESOP.

Legal counsel — ESOP and ERISA legal counsel will have to be retained to produce the legal documents, including the ESOP Plan Document, the Summary Plan Description, the trust agreement, a stock purchase agreement, the borrowing agreements and other documents. The attorney may be engaged by the company or the ESOP. In some transactions, the company, selling owners, and the ESOP may all retain separate legal counsel.

Independent valuation professional — The trustee will typically retain the services of a valuation firm to provide the report that estimates the FMV of the stock. The trustee may also request that the valuation firm provide a fairness opinion, particularly when the transaction is complex and represents more than 50% of the outstanding stock (a control price is typically associated with such transactions). The valuation firm should demonstrate experience with ESOP valuations and familiarity with all applicable regulations from the DOL and IRS. Generally, the CPA firm for the company or the owners will not be independent for the purposes of providing an ESOP valuation. Public companies do not need a valuation firm, since the stock is freely traded on a public market.

Record keeping and plan administration — Once the ESOP is installed, there is the requirement to maintain participant's account balances. ESOPs have many separate and unique rules that distinguish them from other qualified plans. Many administration firms provide services for various qualified plans, but it is a best practice to interview a candidate firm to verify ESOP experience.

CPAs and public accounting firms — These professionals often have longstanding relationships with the company and its owners. They may be valuable advisers on tax and succession planning strategies, feasibility analysis and financial considerations. Typically, the CPA firm providing accounting or tax service is not independent for the purposes of providing the valuation report.

Other professional advisers — This is a general category that embraces a range of professional services. Investment and financial advisers may be retained to offer advice on investment options to the selling owners once stock is sold to the ESOP.

ESOP design and common documents

An ESOP is a qualified defined contribution deferred compensation plan that must be installed in compliance with all applicable DOL and IRS regulations. The following documents are commonly part of most ESOP installations:

Employee stock ownership trust (ESOT) — The ESOT is created to own the company stock for the beneficial interest of the participants and beneficiaries. The Board or its committee will identify a trustee that will be charged with protecting the plan assets, setting the stock price, and ensuring that the plan is in compliance with ERISA.

Employee stock ownership plan — The ESOP plan document provides guidance on how the ESOT is to be managed. The ESOP will contain regulatory compliance sections consistent with ERISA, IRC and other authoritative regulations.

Stock purchase agreement — In most transactions involving privately held companies, owners are selling stock to the ESOP. The stock purchase agreement is necessary to define the various parties to the transaction, list warranties and representations by the owner and the buyer, indicate the purchase price of the stock and other pertinent data.

Financing documents and qualified loan documents (third party lenders and seller notes) — Many ESOPs are leveraged and funds are borrowed so the plan can acquire the stock from the seller(s). There are specific ERISA and IRC regulations that stipulate the parameters of a loan to an ESOP. Generally, there are limits on recourse against the ESOP and the collateral that the ESOP may pledge on the loan. For example, the ESOP typically may pledge the unallocated employer stock as collateral on the loan, and the collateral must be released as the note is amortized. This limiting feature of ESOP loans typically results in lenders advancing the funds to the company and thereby securing a collateral interest in all the assets of the company (the “outside” loan). The company then advances the same funds to the ESOP, subject to the applicable regulatory restrictions (the “inside” loan). This two-step process results in the lenders being in a much stronger collateral position than they would be in if they were to lend money directly to the ESOP. Loan documents must be prepared with a thorough knowledge of the applicable rules or the sale could be reclassified as a prohibited transaction with substantial penalties. Many ESOP transactions represent substantial percentage ownership sales accompanied by material debt. Some lenders (including sellers) may require an additional yield on their debt above a stated interest rate, because of the highly leveraged circumstances. In such circumstances, the debt may carry warrants or other features to boost the yield for the debt holder. The valuation of such debt instruments must be analyzed carefully to determine if the effective interest rate is reasonable.

Senior management incentive and retention agreement — The senior management of the company often is granted a financial incentive and retention program to align their interests and those of the ESOP. Such agreements are most common when the sale to the ESOP is highly leveraged and all parties-in-interest have a vested interest in making sure the acquisition debt is amortized on a predictable schedule. Incentives are often related to achieving stipulated financial goals (such as repaying acquisition debt), longer term in orientation, and subject to vesting. Components of such agreements often comprise incentives in the form of stock appreciation rights, incentive stock options, phantom stock or deferred compensation.

Valuation report — The valuation report is addressed to the trustee and typically establishes the FMV of the employer’s stock in compliance with all DOL and IRS regulations. The report is prepared by an independent valuation analyst and recommends a conclusion of value expressed as a transaction price range for the trustee of the ESOP. If the report is completed before the transaction (frequently the case), the transaction price is revalued with an abbreviated report or letter (commonly referred to as a Bring Forward Letter) on the exact date of the sale. In many cases, the valuation may not change, or it may incrementally change, but the key point is that the value of the stock must be determined on the date of the transaction. This can process can be facilitated with a “bring down” or “update letter” prepared by the valuation expert that either modifies the conclusion of value from the most recent report, or adjusts the value to reflect changes in expected cash flows and market conditions as of the actual date of the ESOP transaction. Subsequent annual valuation updates may express the conclusion of value as a single number, but a trustee will, in most cases, need a range of values for transactions with the ESOP to assist with their negotiations with the seller.

Fairness opinion — Typically, this report is requested (but not mandatory) by a trustee when the ESOP transaction is a complex structure, or the dollar amount of the sale is significant. Complex transactions frequently involve the following: selling a control position to the ESOP, incurring a significant amount of debt from banks or owners, and establishing management agreements and

other material provisions. A fairness opinion is a FA's opinion that states whether or not the financial terms of a proposed transaction are within a range of fairness.

Stock redemptions — In the last several years, ESOP attorneys have begun advising business owners to consider a stock redemption prior to a sale of stock to the ESOP. The stock redemption involves a treasury stock purchase, typically of 95% to 99% of the outstanding stock. This treasury purchase may be partially financed by third-party debt, such as a bank or other lending institution. The remaining amount of the redemption is financed with a seller's notes. There will be no trustee involved in the stock redemption sale, however the valuation expert will be responsible for developing a conclusion of value based on the PFled cash flows assuming that 95% to 99% of the outstanding stock is about to be purchased in a leveraged transaction. The stock redemption itself does not involve an ESOP transaction, however, if an ESOP transaction is planned after the completion of the stock redemption, then there will be a trustee appointed and the trustee will select a valuation expert for the ESOP transaction. A stock redemption may be performed without an ESOP transaction, the ESOP transaction may be simultaneous with the redemption transaction or the ESOP transaction may be planned for a later date. The use of redemptions is a rapidly growing area of ESOP transaction design.

When a redemption has been performed, many legal experts would say that the ESOP trustee is only concerned with a very small ESOP transaction. The theory is that the redemption reduces the post transaction dip in stock value, due to debt used to complete the transaction. While it is true that the redemption is not an ESOP transaction, the leverage obligations of the redemption places demands on future cash flows of the ESOP company that must be accepted as reasonable by the trustee in his financial analysis. The valuation expert, as the FA to the trustee, must advise the trustee on those future cash flows and weight the risk of the demands on future earnings when advising the trustee. It is a best practice to PFI all cash flows in the future years in the valuation report to demonstrate that the ESOP company can service its obligations. Additional stress testing should be applied to test cash flows if the PFIs or other business conditions are not realized as expected. At the completion of the ESOP transaction in a company where a redemption has taken place, the trustee is taking responsibility for the redemption debt and the ESOP transaction cash flows.

Documentation related to the ESOP valuation

The preparation of the valuation report requires the valuation analyst to consider all relevant data and information helpful in arriving at a valuation conclusion. The non-exhaustive listing of data and information may include such things as: historical financial statements, interim financial statements, budgets and PFIs, tax returns, shareholder agreements, prior transactions regarding the employer stock, prior valuation reports, examination of comparable companies, analysis of the industry and competitors, analysis of the overall economy, the outlook for appropriate business segments and any other relevant data having an impact on the value of the subject company.

There is an emphasis on financial statements, and several years of historical statements should be part of the analysis if they are available. The preference is to rely on audited statements. However, reviewed statements can be satisfactory. Use of internally prepared statements should be discouraged without using some method of testing the validity of those statements. These methods may include reconciliation with the tax return, comparing cash flows to bank statements, and performing a review with the sponsoring company of the changes in the accounts from one year to the next. Since historical financial results may not be indicative of prospective results, the PFI provided by the company must be carefully analyzed by the FA. The AICPA has pronouncements on prospective financial information and members should be knowledgeable about the contents of that position ([Prospective Financial Information Guide](#)). Properly employed, a PFI, combined with appropriate business valuation theory, is a well— documented approach to establishing FMV.

If the valuation firm relied on data believed to be accurate and subsequently determined to be incorrect; steps should be undertaken by the valuation analyst once the incorrect information is verified to adjust the valuation conclusion to reflect this new information. The most common example is relying on financial statements from the employer that are not correct. If subsequent events develop that were not reasonably foreseeable at the date of the report, those events are not considered for the purposes of valuation analysis.

One common development for valuation firms is to provide the financial analysis, while some of the key information is not finalized. This analysis can occur when a transaction is scheduled just before the end of a fiscal year and the final year-end financial statements are still being prepared. Under such circumstances, estimates may be made and properly noted as such. If there is a material variance between estimated results and actual results, the valuation firm reserves the right to adjust the analysis considering any new information.

ESOP accounting and reporting requirements

The Financial Accounting Standards Board (FASB) issued Accounting Standards Codification (ASC) Subtopic 718-40 to provide guidance for share-based payment transactions with tax-qualified ESOPs and address accounting and financial reporting standards for ESOP plans. The most significant conclusion is that ESOP-related acquisition debt must appear on the financial statements of the employer as a long-term liability. The offsetting entry to this debt obligation is a contra-equity account, often titled Unearned ESOP Shares. The accounting for leveraged ESOPs typically has a negative impact on the employer's balance sheet, since the net worth of the company is reduced by the contra-equity account (Unearned ESOP Shares). This accounting may have serious financial consequences for such firms as construction companies with material bonding requirements where the bonding is a function of the reported net worth, or banks where the Unearned ESOP Shares could impact lending limits. Please see the accounting examples in ASC Subtopic 718-40-55 for additional guidance.

Interaction with the ESOP trustee

Establishment of FMV by the trustee

Contrary to common perception, the trustee has a fiduciary obligation to set the FMV of employer securities owned by the ESOP. Essentially, the trustee hires an independent financial adviser (valuation analyst) to assist the trustee in fulfilling his or her fiduciary obligations. It is the valuation analyst's task to offer to the trustee a professional estimate of the FMV of the sponsor company's shares owned by the ESOP. The FA to the trustee may also participate in negotiations with the sellers of stock to an ESOP along with the trustee. If the FA is involved, terms of the transaction such as representations and warrants, debt structure, allocation of fees and other expenses can be discussed and reflected in the valuation expert's report to the trustee.

There typically are two types of valuations performed for a trustee: one for proposed transactions involving the ESOP (either buy-side or sell-side); and the other for valuation updates that are integral to annual ESOP administration procedures. Ultimately, the trustee will set the share price and communicate the new share value to the ESOP Plan committee of the sponsoring company or directly to the company's third-party ESOP administrator.

In practical terms, if the trustee has concerns about any aspect of the valuation analyst's report or analysis, he or she will discuss the issue with the analyst and try to reach an understanding about the best way to resolve the disagreement. The trustee values the valuation analyst's expertise as a financial adviser and normally will respect and abide by the analyst's conclusion of value or position on a certain aspect of the valuation. On the other hand, trustees take their fiduciary obligations seriously and do not view the setting of the share price as a rubber stamp of the valuation analyst's conclusion of value.

Services provided by the valuation analyst to the trustee

Adequate consideration opinion — In an adequate consideration opinion, the valuation analyst will opine as to whether the transaction price between the ESOP and the buyer or seller is no more than FMV (in the context of the ESOP as the “buyer”) or no less than FMV (in the context of the ESOP as the “seller”). This type of opinion is limited, since the valuation analyst renders an opinion as to adequate consideration paid (or received) in the transaction, but does not review and analyze other aspects of the transaction, such as financing design features and terms.

Consequently, the valuation analyst’s opinion will address the question, in the context of an ESOP purchasing employer securities, “Is the ESOP paying more than adequate consideration for the employer securities that it is purchasing?”

The adequate consideration test included in an adequate consideration opinion can be looked at as the “absolute fairness test.” The adequate consideration question is: “Does the employer share price to be paid by the ESOP exceed some benchmark that represents FMV?” In contrast, the fairness opinion incorporates the concept of relative fairness. For example, in addition to looking at the adequate consideration question, the valuation analyst rendering a fairness opinion will examine the proposed transaction’s financing structure and terms and compare them to market benchmarks and conditions. The valuation analyst’s opinion that the transaction is “fair to the ESOP, from a financial point of view” involves a relative statement.

Fairness opinion — In addition to opining on whether the amount paid for or received in an ESOP transaction qualifies as “adequate consideration,” a fairness opinion will also include the valuation analyst’s opinion regarding whether the proposed transaction is fair to the ESOP, from a financial point of view.

A fairness opinion relates to the price and structure of the proposed transaction from a financial perspective and does not extend to matters such as legal aspects of the transaction. The structure of the transaction typically considers all the material financial aspects of the transaction, including management incentive and retention agreements, relationships between related entities (such as between the company and the owner of real estate leased to the company), and any other material aspects of the transaction. Debt structures will be reviewed. The likely demand on corporate resources for the future repurchase obligation and the risk of the ESOP transaction, as compared to market transactions not involving an ESOP, must be considered.

The fairness opinion addresses whether the proposed transaction is “fair to the ESOP, from a financial point of view.” Acquisition financing is examined to determine if the interest rate and terms of the financing are reasonable in the given economic environment. The valuation analyst should perform a comparison of the ESOP debt terms with empirical debt market evidence. The valuation analyst’s analysis of current market interest rates should indicate whether the interest rate on the ESOP acquisition debt is a market interest rate. In addition, the valuation analyst should opine on whether the term of the proposed acquisition debt is reasonable and prudent. An overly aggressive repayment schedule that might lead to a debt service coverage ratio which is problematic from the average lender’s perspective would be an example of when the valuation analyst might advise the trustee that a term modification is in order.

The target audience for a fairness opinion is very narrow. The fairness opinion solely reflects the fairness of the proposed transaction to a specific party, in most cases, the trustee or a Special Fiduciary to the trustee responsible for assuring financial fairness of the ESOP transaction.

The transactional fairness opinion is an important analysis tool in the trustee’s toolkit, providing evidence that the trustee used reasonable business judgment in the evaluation and assessment of the proposed transaction. While fairness opinions are not required, they do serve to help to

support the thoroughness of the analysis of the transaction to meet expectations of the DOL, the IRS, and ESOP plan participants.

Communications between the Valuation Analyst, the trustee and the Company

The trustee will expect to be involved in most discussions between the valuation analyst and the sponsor company that deal with substantive financial issues.

The following is a list of examples when it comes to the ESOP valuation analyst communications with the sponsor company that should include the trustee: Requests For Information (RFIs) including the request for financial statements and records; coordination of site visits and management interviews; and follow up with calls and emails after the management interview, in which the valuation analyst seeks clarification on issues not directly relating to the setting of the share price.

The following are some examples of common errors in communications between the ESOP valuation analyst and the sponsor company: conduct management interviews without the trustee being present physically or via telephone (as required by the trustee); discuss any issue directly related to the share price — for example, discussing a preliminary share value, which may invite unwanted influence and opinions from sponsor company management; field virtually any question about the draft report outside of incidental company structure or history; and transmit the final share price directly to the sponsor company or its third-party administrator without the trustee's permission.

ESOP terminations

When an ESOP is installed, the presumption is that the plan will have an indefinite life into the future. Circumstances change, and there will be instances when ownership of stock by the ESOP is no longer desirable or feasible, such as the plan sponsor is sold, the corporation can no longer afford the cash flow demands of the ESOP, or files for bankruptcy. In such instances, the ESOP may be terminated. Terminating an ESOP must be accomplished within the rules and regulations regarding such action; and the assistance of knowledgeable legal counsel is highly recommended.

Common reasons for terminating an ESOP

The most commonly cited reason for a plan termination is the sale or merger of the company. When the company is sold or merged, the new or succeeding owner does not wish to continue the ESOP and it is terminated. Poor financial results by the company and subsequent unacceptable stock performance are other reasons for termination. The company may not be able to meet acquisition debt obligations if the plan is still leveraged, or poor financial results impose too great a burden relating to the repurchase obligation. The ESOP may have served an original purpose and objectives change over time. The ESOP may have been intended to be an employee benefit, but over time the plan becomes a disincentive for employees.

Voluntary termination of the ESOP

The decision to terminate the ESOP is made by the company board of directors. The process of terminating the ESOP is like terminating other qualified plans; however, the termination of an ESOP with outstanding securities acquisition debt is handled differently.

In most cases, the termination of the ESOP is a proactive decision reached by the board of directors. When an ESOP is terminated, all account balances become fully vested. The sponsor company will have to plan for this requirement and ensure that there is adequate liquidity to redeem the stock from the plan. In certain circumstances where the ESOP is terminated, the plan participants may be subject to a pass-through vote on the shares allocated to their accounts.

Unleveraged plans — Assuming the ESOP is unleveraged, there are several appropriate steps that need to be completed. First, the ESOP documents must be updated to current regulatory

requirements, if not already current. Often the ESOP will be amended to specifically accommodate the termination in such matters as asset distributions, account allocations and other regulatory requirements. It is a recommended practice to obtain a favorable determination letter before assets are distributed and the plan is officially terminated. Obtaining a determination ruling will likely slow the process; however, it is protection for those overseeing the termination of the plan. Distributing assets in the absence of a favorable determination letter may expose the plan fiduciary to possible financial penalties.

Assuming the first steps have been completed, the next obligation is to distribute plan benefits to participants as soon as administratively feasible. The adherence to administrative procedures will be determined by the facts and circumstances of each application. Generally, most plans are effectively terminated within one year. When a plan is terminated, all account balances become fully vested, so this financial obligation must be planned.

If termination matters are not finalized on a timely basis, the plan remains open and is subject to such ongoing administrative obligations, such as annual valuations and administration reporting requirements. The last step in the termination process is to ensure that final returns are filed, most typically Form 5500.

Vesting of account balances may also happen when a partial plan termination occurs. A partial plan termination happens when the workforce is significantly reduced or loses its rights to benefits under the plan. The most common example is a labor reduction due to financial stress or a recession. Generally, when at least 20% of the participants are terminated, a partial plan termination occurs. There are issues with vesting for participants in a plan after voluntary or involuntary terminations that impact repurchase obligations.

There are additional considerations that may be involved in the voluntary termination of an ESOP that must be specifically addressed. A few such instances include: if the ESOP contains a money purchase pension plan feature (more common in older plans when contribution limits were substantially lower than today); if the seller elected the IRC Section 1042 tax deferral, certain holding periods may apply to the plan sponsor or there may be the imposition of an excise tax; and the existence of acquisition debt related to the ESOP.

Leveraged plans — When the plan is terminated and there is outstanding debt, the problem arises regarding what to do with the unallocated shares of stock (typically shares of stock held in a suspense account waiting to be allocated as the debt is repaid). The most common situation is that the outstanding debt is offset against the FMV of the unallocated stock.

If the stock value is more than the outstanding debt, the residual will be allocated to the ESOP beneficiaries according to applicable regulations. If there is a deficit, the termination of the plan may be delayed, or the shortfall is compensated by the company as an additional contribution. The key point to emphasize is that the termination process may become complicated, and the failure to follow prudent procedures may expose the fiduciary to financial penalties.

Alternative valuation approach — For most ESOP valuations, the value of the stock will decline following a leveraged transaction. This is because the debt incurred to purchase the ESOP stock is a deduction from the enterprise value. The reason that the debt is deducted from the value is because the company has an obligation to repay the debt to the lender (bank or selling shareholder). At the same time, the ESOP has an obligation to repay its loan to the company. Therefore, upon the sale of an ESOP company, the debt can be repaid by cancelling the unallocated shares or reducing the proceeds received by the ESOP in the transaction. In effect, unallocated shares are like shares held in treasury. The unallocated shares are only released when the debt is repaid.

In some cases, the value of the ESOP stock will not include a deduction for the ESOP debt. It is important that this assumption is clearly stated in the ESOP valuation report along with the reasoning behind the treatment of the debt. Additionally, an increased emphasis on the repurchase liability is important to be assured that future cash flows will be available to service the ESOP debt. The use of the alternative valuation approach is a plan design issue that will require approval by the trustee.

Floor put — A floor put is a method of price protection that is like the alternative valuation approach. It is often implemented in second stage transactions so that participants that are close to retirement will not experience a post transaction price decline in their shares due to the new ESOP debt. The stock is valued without reducing the price by the new ESOP debt. Generally, there is a limited time for the price protection to remain in place and not all participants are granted the protection.

Practical considerations

The repurchase obligation may become a significant issue for a company wishing to terminate its ESOP. The repurchase obligation combined with the full vesting in all participant's accounts may pose too much of an obligation on the company. An option for the Board of Directors to consider is to freeze the plan. Under such circumstances, the company makes no further contributions to the plan, and will redeem the stock of exiting participants into the company treasury. With time, the amount of stock in the ESOP will decline, and the percentage of ownership by the ESOP will correspondingly drop. When the ownership percentage is reduced, the ESOP is frequently terminated after the company has the liquidity to redeem the remaining stock. Until the ESOP is formally terminated, the company will still have the obligation of annual valuations, account administration, and full compliance with plan documents and applicable regulations.

Rather than terminating the ESOP, the company may authorize the merging of the ESOP with another qualified plan. Often the ESOP is merged with a 401(k) plan, but there are other qualified plan options. The ESOP enjoys specific exemptions from some ERISA-based obligations such as an exemption from a concentration of investment in the company stock and a reasonable rate of return on plan assets. The purpose of the ESOP is to be primarily invested in the stock of the employer. If the ESOP is merged into another plan, care must be taken to ensure full regulatory compliance with the succeeding combined plan. For example, stock in the plan sponsor is typically limited to no more than 10% of the combined plan's assets. Additionally, the combined plan may have to honor redemption attributes applicable to the assets transferred from the ESOP. This requirement to track former ESOP assets separately may impose substantial administrative record keeping requirements on the company. Merging plans may be an option worth considering, but there are potentially complex compliance rules to keep in mind.

When the ESOP is being terminated it is recommended that the plan sponsor retain an independent trustee (if one is not already engaged) to negotiate the termination on behalf of the plan beneficiaries. When the plan is terminated, there is one last opportunity for the beneficiaries to participate in this benefit plan. Having an independent trustee helps ensure that the plan beneficiaries are receiving the best financial consideration through active negotiations.

Involuntary ESOP termination

When the plan sponsor is bankrupt or insolvent and operations cease, there is often no value in the stock of the company. The ESOP, however, may own additional assets such as cash and other liquid investments. Those assets inside the ESOP remain in the plan and may not be attached by creditors. Those assets will have to be distributed, and in such circumstances the ESOP must be terminated with great care to comply with all applicable regulations. An involuntary termination carries the same administrative obligations as a voluntary termination. Failure to do so will expose the trustee to potential fines.

Preparation of the valuation report

Preparation of a valuation report for the stock held or to be sold to an ESOP requires special analysis and disclosures not found in the typical valuation report. A valuation for ESOP purposes must satisfy the requirements of the DOL. From the viewpoint of both the DOL and the IRS, an ESOP may not pay more than “adequate consideration” for the shares acquired. The IRS’ concern is that a company should not be allowed to take a tax deduction for an ESOP contribution unless that ESOP has received securities worth a similar amount. The term “adequate consideration,” other than securities for which there is a generally recognized market, means the FMV of the asset as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary of Labor.

The valuation analyst will want to read, at a minimum, the ESOP plan document, the ESOP trust document, the ESOP loan documents, the agreement to sell stock to the ESOP and any Form 5500s available for the ESOP in addition to the usual records required for a valuation engagement. The valuation analyst should ask if a repurchase obligation study has been performed for the ESOP, obtain a copy of the summary plan document, and possibly review a summary report of the participants’ statements, including allocation testing and testing for compliance with anti-discrimination rules for ERISA plans.

The valuation analyst should consider what normalization adjustments should be made for the activity of the ESOP. Often, ESOP benefits may be higher than a normal retirement benefit. This excess benefit should be examined to determine if compensation expense should be reduced to a normal market level of benefit. Additionally, generally accepted accounting principles require that a leveraged ESOP must record the debt on the balance sheet of the plan sponsor as negative equity in an account titled “Unearned ESOP Shares”. The valuation analyst should consider adjusting the Unearned ESOP Shares to more fairly present owners’ equity, particularly if an asset approach is used in the valuation report. When an asset approach is used, typically the Unearned ESOP Shares balance is ignored. Other adjustments could be normalizing entries for discretionary costs and non-recurring items.

The valuation analyst should discuss the assumptions used in the report with the trustee. The valuation analyst will explain the positions assumed in the normalization entries, how the post-transaction debt was treated for the purposes of estimating the value of the stock held by the ESOP, whether the company can afford the potential repurchase liability of the ESOP and, finally, whether the estimate of value represents adequate consideration as defined by the DOL.

Communication of the assumptions made and the results of the analysis are extensive for ESOP purposes. These discussions may include the presentation of the valuation report to the management of the company after the report is approved by the trustee, owners outside the ESOP, the Board of Directors, the ESOP Administrative Committee, the outside accountants, the record keeper for the ESOP plan, and the ESOP. Time should be allowed for these additional reviews with interested parties.

The estimate of value will be included on the Form 5500 filed for the ESOP trust for that year, and the report may be audited by the DOL or IRS. Newly formed ESOPs will often be audited by the DOL or the IRS at least once after the implementation of an ESOP, normally within five years of the transaction. In addition, the review of the transaction will examine whether the valuation analyst has considered whether the company can afford the repurchase obligation of the ESOP at the estimate of value in the report. The valuation analyst should consider adding a schedule for testing the future cash flows of the ESOP both for the debt service, if the ESOP is leveraged, and the repurchase obligation. This focus on cash flows helps underpin the concept of adequate consideration, which requires that the ESOP be considered a financial buyer who is reliant on the future cash flows of the company for the payment of benefits to plan participants.

The role of the valuation analyst is not to act as the ESOP attorney or a fiduciary, however, the analyst should decide with the information he or she has whether the administration of the plan is in accordance with the plan, loan and trust agreements. Common problems with ESOP plans include the discriminatory selection of how benefit payments are made to terminated plan participants and the possible involuntary termination of the plan if it has had no activity for five years or more.

Uses and limitations of the valuation analyst's report

The trustee has specific fiduciary obligations that prevent it from widely distributing the valuation analyst's report. In addition, the trustee is bound by certain professional ethics constraints that dictate it allow the valuation analyst some input on how and to whom the report is distributed.

In the context of an ESOP transaction, the trustee will typically share the report with ERISA counsel. However, there are circumstances where the trustee will not share the report with the selling owner(s), even though the latter may have a seat on the sponsor company's Board of Directors and/or is effectively the party that retained the trustee for the ESOP transaction.

In the context of an annual valuation update, the trustee will normally share the valuation report with a very limited group, comprised of the sponsor company's ESOP Plan committee, the trustee's counsel, and the third-party ESOP administrator, if requested.

It is common practice for the trustee to seek the valuation analyst's permission when a third party, other than those listed above, requests a copy of the valuation report. For example, it is increasingly common for the sponsor company's outside audit firm to request a copy of the valuation report. When this happens, a trustee will often request that the valuation analyst co-sign a release form that is counter-signed by the audit firm. This document serves to protect the dissemination of the valuation report beyond the close circle of advisers connected with the ESOP transaction or annual administrative functions and to prevent misuse of the valuation report.

Employee communications of valuation results

Valuation analysts frequently present the results of the valuation report to the participants of the ESOP plan. The plan trustee will guide the valuation analyst on what he/she can and cannot disclose. The plan participants are mostly interested in learning why their employer stock values went up or down, and what role the employees can play in improving those values. The valuation analyst may explain which approaches were selected, which methods were used, and how data to use those methods was obtained. Showing overall trends in the market and showing trends in the financial statements (with approval by the trustee) can be helpful in explaining to the plan participants how the value is estimated.

At these presentations to plan participants, it is not advisable to estimate how much their accounts will be worth when they retire since that is too speculative and may lead to potential claims of liability in the future. However, the analyst may want to explain some of the features of the plan, for instance how much debt was paid down, whether dividends were paid to participants, the diversification election for certain plan participants and how benefits are paid once the plan participant terminates his or her employment. Some clients want the valuation analyst to attend employee events such as picnics, annual employee appreciation events, or use broadcast media to reach as many of the plan participants as possible. These events are a great opportunity for the valuation analyst to be reminded of who they represent when they estimate the value of a qualifying employer security for ESOP purposes.

Other valuation topics

Applicable standards

AICPA — The type of report used should be carefully selected in compliance with [AICPA Statement on Standards for Valuation Services No. 1](#) (“VS Section 100”). While VS Section 100 allows the use for oral, calculation or valuation reports, it is likely that an oral report or calculation report would not meet the requirements of the DOL or the IRS. The valuation analyst may prepare a preliminary report based on a proposed ESOP transaction structure with a final report prepared as the terms of the ESOP transaction are finalized. In short, the content and assumptions used in an ESOP report must be reviewed with the trustee, and possibly others, prior to preparing the report.

DOL and IRS — The DOL’s proposed regulations, “§2510.3-18 Adequate Consideration” should be included in their entirety in the written report. While it is typical and often advisable to let the trustee review the report in draft form, the valuation analyst must be careful not to let plan participants know the conclusion of value until any review comments and suggested edits have been resolved. Complying with the spirit of the proposed regulations of the DOL and being able to prove that compliance has been met for many years after the report has been released is critical to the success of a valuation practice that performs valuation engagements for ESOP purposes.

The preparation of a detailed valuation report is required annually for plan administration and at any time the ESOP buys stock or sells stock other than in payment of participant benefits. A valuation analyst should be cautious if asked to perform an ESOP valuation if they cannot examine prior valuation reports, if transactions have been conducted without a valuation, or if the annual valuation has not been prepared for more than one year. These circumstances may be an opportunity for the sponsor of the ESOP plan to perform a voluntary self-correction of errors in the administration of the plan. While helping a company with a determination of value is acceptable, the valuation analyst should not allow himself/herself to be used to achieve a goal of adding legitimacy to an ESOP plan that has been mismanaged.

Another situation unique to companies that sponsor an ESOP plan is that the sale or exchange of bonus stock, stock appreciation rights, preferred stock, and stock sold under a restriction in a shareholders’ agreement stipulates how value is determined. This is a facts and circumstances determination that must be reviewed with the trustee and assumptions used must be disclosed in the report. For any topic reviewed with the trustee, notes must be kept in the work paper file of the valuation expert for the report being prepared.

There may be interactions between the valuation analyst and the fiduciaries of the ESOP outside of the annual valuation report. In addition to the valuations required for the sale or purchase of stock by the ESOP, there may be requests of the valuation analyst to assist with other consulting and analytical work for the sponsor company. These assignments outside of the routine ESOP valuation work should be documented by an engagement letter for the specific assignment and should be undertaken with the approval of the trustee. The independence of the valuation analyst must be maintained through proper documentation of these assignments outside of the normal ESOP valuation work. Examples that may lead to the impairment of independence would be the preparation of a financial PFI, compilation, review or

audit of the financial statements, ownership of any interests or membership on the Board of Directors of the subject company.

There typically will be a need for an update letter for the valuation as of the date of a stock transaction with the ESOP. If the valuation report was prepared within a reasonable time before a stock transaction, an update letter may be used to confirm the previously determined estimate of value. This letter may analyze changes in market values since the report was issued, re-confirm the financial condition of the company and update any other factors that may have changed since the original report was issued. If it has been longer than 90 to 120 days since the report was issued, a full report may be required. The valuation analyst will need to consider the facts and circumstances to determine whether an update letter is adequate or whether more extensive work should be performed to bring the conclusion of value current with the actual transaction date.

Control versus minority

The issue of premiums and discounts is always affected by the ESOP structure. The control versus minority adjustment must be considered in the light of the current best practice to adjust cash flows to reflect control or minority cash flows. The DOL will expect a discount for lack of marketability based on the time it takes for benefits to be paid to the participant after being earned. Most ESOP plans will take at least two years after termination of the participant before the benefits can be paid to the participant. When compared to the three days for the settlement of a publicly traded stock, it would suggest that a discount for lack of marketability (a discount for the illiquid nature of the ESOP stock-based benefit payments) should be deducted to calculate the estimate of value under the adequate consideration standard as required by the DOL and IRS.

There is a problematic situation related to control versus minority value regarding ESOP activities. While a controlling interest is often sold to the ESOP, when benefits are paid, should a minority value be used? This would appear to be a prohibited transaction, knowingly selling to the ESOP at a higher value than a participant could be paid for their benefits on the same stock. Some practitioners take a position that as the stock continues to rise in value this issue becomes moot over time since the participants will eventually get a value higher than what the selling owners received for a controlling interest. However, considering the probability of economic downturns over the years the plan will be in place, this is a risky assumption. This issue should be discussed with the trustee.

Another common concern with control versus minority is whether the ESOP is to be devalued when its shares fall below 50% of the outstanding shares. Sometimes the ESOP owns convertible preferred (the ESOP shares must have the highest voting rights), where voting can be restricted to prevent the ESOP participants or the trustee from voting on routine corporate governance issues. The terms of the ESOP transaction must be studied to determine whether those preferred shares should be discounted. Lastly, if the control does rest with the ESOP trust, how are the prerogatives of control exercised by the ESOP? Does the trustee vote for the control held by the ESOP, except in the instances where regulations require that the participants must be allowed to vote or does the company simply ask the participants to vote on all corporate governance issues? Those who have the prerogatives of control may affect the estimate of value.

Financial fairness concerns

Today, many private companies implementing an ESOP are having initial transactions that exceed 50% of the outstanding stock and often include 100% of the stock. Such transactions are almost always heavily leveraged and relatively complex in structure. It is common for such transactions to encompass a wide range of consideration such as: the purchase price for the stock, complex financial structure (often with a significant amount of seller or owner debt), financial incentive and retention program for senior management, analysis of a control price, lease of facilities controlled by the selling owner, employment or consulting agreement with the selling owner, and other issues. The ESOP transaction may span so many issues that the fiduciary often requests a fairness opinion from an independent valuation firm.

The analysis of the transaction in a fairness opinion looks at the totality of all the major terms of the sale of stock to the ESOP, not just the purchase price. The intent of the examination is to be able to submit a fairness opinion that stipulates the transaction is fair to the ESOP, from a financial perspective. This means an in-depth examination of the major provisions has been conducted to determine that those financial provisions are fair and reasonable to the ESOP.

It is used to avoid the disguised purchase price situations. The fairness opinion looks at the entire process related to the ESOP transaction, including all documents thereto, to determine if the transaction fair to the trustee from a financial point of view.

Reviewing buying and seller reports

It is typical on larger sales of stock to an ESOP for the seller and the ESOP to retain separate valuation analysts. Think of the transaction as a negotiation between buyer and seller, with both sides having equal representation as best practice. Frequently, a valuation analyst will be asked to review the valuation report prepared by the opposing side of the ESOP transaction. In this situation, the valuation analyst will prepare his or her report and then review the report prepared by the opposing expert.

Any discrepancies will need to be addressed by the valuation analysts, and any differences not resolved by the valuation analysts will need to be addressed by the trustee. The review of the opposing side's ESOP valuation must be documented in writing and filed for any future requests for information by the IRS or the DOL.

Failure to meet the PFIs used in the report

If an ESOP plan has financial distress due to falling stock prices, a cash flow shortage, a failure to comply with debt covenants or any other related issues that may arise, a valuation analyst may be engaged to assist with a valuation based on the proposed corrections to the ESOP. The assumptions used and the reasons for those assumptions must be discussed in the report. If an error is found in the report after the report has been issued, the valuation analyst must discuss the impact of the error on the conclusion of value and an acceptable approach must be used to report the corrected value. This may include preparing new participant statements, amending the form 5500, and changing benefit payments already made to the participants.

Additional valuation issues

Several additional considerations apply to the valuation analyst's work related to an ESOP valuation. The compensation paid to the top executives of the subject company should be reviewed to determine if the compensation is fair to the ESOP. A common failing in ESOP structures is to channel an inordinate amount of the subject company's earnings into executive compensation at the expense of the participants of the ESOP. Often a selling shareholder, who before the ESOP purchase of the company's stock earned high levels of compensation, will

adjust their compensation downward when contemplating a sale of all or part of the company stock to an ESOP. Thus, the earnings of the company and cash flows to the future plan participants gain the benefit of said reduced compensation. Another concern that should be addressed by the valuation analyst is the need to maintain files for as long as it takes to pay off any leverage plus seven years. This can cause files to be kept well over 25 years on a valuation report prepared for ESOP purposes.

There is an increased level of activity by plaintiffs' attorneys looking for price dips in Employee Stock Ownership Plan ("ESOP") owned stock. The technique often employed is to pay a law firm to compare form 5500's submitted by ESOP Trusts, looking for a drop in the value of the stock held by the Trust. Most often, these price drops are found after an ESOP stock purchase with debt, where the debt from the stock purchase reduces the value of the sponsoring company's equity and thus reduces the value of the shares held by the ESOP.

I often think of what my friend Bob Smiley, an editor of the book *Employee Stock Ownership Plans: ESOP Planning, Financing, Implementation, Law & Taxation*, Robert W. Smiley Jr., Ronald J. Gilbert, David M. Binns, Ronald L. Ludwig and Corey M. Rosen, editors, would say:

"Say you buy a house for \$400,000, and you put down 25%, financing the remaining \$300,000. The house is still worth \$400,000 after the purchase, but if you sold the home, you would only realize \$100,000, which is your equity in the house. The same principle works for an ESOP purchasing stock with debt. The total value of debt and equity still equals the transaction price for the stock purchase, but the equity portion of that total value is the purchase price less debt."

We have clients that have found advertisements placed in local newspapers that start off with an attorney firm name, then ask the reader if they have an "investment" in the XYZ Employee Stock Ownership Plan. The advertisement goes on to say who the trustee of the Plan is, and that the attorney firm is "investigating" the stock purchase by the ESOP, including the valuation of the XYZ stock at that time (presumably the time of the stock purchase by the ESOP trustee). There are several problems with this advertisement, not the least of which is that an ESOP plan is not a contributory plan, plan participants do not make "investments" in the plan. It appears that the attorney firm is looking for a volunteer from the plan participants to file a class-action lawsuit on their behalf.

One such plaintiff's attorney was successful in getting a judgment in a lower court last year in the case *Swain v. Wilmington Trust* (D.Del., 1:17-cv-00071, Aug. 14, 2017). In this case, the plaintiffs alleged that the purchase price that the trustee approved was above fair market value, in violation of ERISA regulations.

The original purchase price of 100% of the sponsoring company's outstanding stock was \$98,000,000, but on a form 5500 filed shortly after the stock purchase transaction by the trustee, the stock value had fallen to \$39,000,000. The price drop was related to the debt assumed by the ESOP used to finance the purchase of the stock. The plaintiff's attorney made the claim that the trustee approved a purchase price for the stock that was above fair market value, and that the stock was only worth \$39,000,000.

Shareholders' equity in a company is different than the total value (sometimes referred to as "enterprise value") of a company which includes both equity and debt. This concept is something that valuation experts must explain to shareholders on almost every valuation engagement performed. While the total company value may be \$100, if there is \$40 of long-

term debt that is part of the capital structure of the enterprise, then the shareholders' equity value normally would be \$60. The company is still worth \$100, it is just that upon sale or liquidation of the company, the equity holders will get \$60 and the debt holders will get \$40. The company is not worth \$60, it is still worth \$100, it is just that the equity holders will get \$60, after the debt holders have been paid.

The case mentioned above is an example where a lower court agreed with the plaintiff's attorney and issued a judgment against the ESOP trustee. This case has been appealed and in August 2017 a U.S. magistrate judge issued a report and recommendation that was in favor of the trustee, recommending that the case against the trustee be dismissed. The outcome of the recommendation is yet to be decided, so stay tuned!

As valuation experts, there are things we can do when we are retained by the trustee of the ESOP to assure the best possible outcomes for the participants of the ESOP. An experienced ESOP valuation expert knows that they are retained by an ESOP trustee as a FA, not just a valuation expert. In this role, there are several topics related to providing the trustee with a reliable estimate of the value of the stock held by an ESOP that must withstand scrutiny from outside interests, but more importantly, be fair and in the best interests for the participants of the ESOP. These additional procedures as the FA to the trustee include:

1. Comply with the DOL guidelines for valuation documentation and review found in the "Agreement Concerning Fiduciary Engagements and Process Requirements for Employer Stock Transactions"³ (the "GreatBanc process agreement"). We now must also assure compliance with the second process agreement with First Bankers Trust Services from Sept. 21, 2017 (the "First Bankers process agreement").
2. Document: your independence, your consideration of alternative PFI outcomes, consideration of different growth rates, consider alternative discount rates and most importantly what was done to test projected cash flows, including considering the repurchase obligation. In many ways, this requirement to document your work parallels the Mandatory Performance Framework for the new Certified in Entity and Intangible Valuations™ (CEIV) credential. Talk with the ESOP trustee about what work was done to test the assumptions used to develop the conclusion of value for the stock held by the ESOP. Whether the trustee is a committee, an individual, an independent professional or a "directed" independent professional, document your conversations.
3. Explain to the trustee that the client should be informed about the impact of the post-transaction stock price dip due to the treatment of debt. The sponsoring company should know that there may be attempts to get a plan participant to agree to be a party to a class action law suit claiming the stock was purchased by the trustee at an inflated price.
4. Lastly, suggest that employee communications include an overview of the issue of enterprise value and shareholders' equity value so that the participants in the plan know what to expect. A positive outcome is when participants learn how rapidly their stock values grow as debt is paid down is positive for the participants.

The key concept for valuation experts is that we are the FA to the trustee of the ESOP. We must work only for the trustee, always representing the best interests of the ESOP and able to

³ Perez v. GreatBanc Trust Company, C.D. Cal., case number 5:12-CV-01648-R(DTBx), settled June 1, 2014.

provide supporting financial analysis and advice to the trustee so that the trustee can document that the best interests of the participants of the ESOP have been considered in every action of the trustee. Our relationship is one of the trusted FA advisors. As such, we must recognize that the DOL is watching to be sure that we are performing that adviser role within the guidelines of the process agreement, so it is our responsibility to document independence, analytical skepticism, documentation of our work and presentation of our conclusions.

The DOL and First Bankers entered into a settlement agreement filed in U.S. District Court for the Southern District of New York resolving a case challenging First Bankers’ performance as trustee in a transaction where the common stock of a private label denim manufacturer was sold to an employee stock ownership plan (ESOP).⁴ This settlement agreement closely parallels the process agreement entered into between the DOL and GreatBanc Trust Company in 2014.⁵

These agreements provide a great deal of information about the expectations of the DOL regarding the valuation expert retained as an FA to the trustee of an ESOP. The DOL attempted to make a regulation that defined “adequate consideration”, which is a price that cannot be exceeded by an ESOP trustee when purchasing stock on behalf of the ESOP trust.⁶ This proposed regulation was published in 1988, and has until recently served as the best definition of how adequate consideration would be evaluated by the DOL.

With the GreatBanc (2014) and the First Bankers (2017) process agreements, the valuation expert is on notice as to what the standards the audit and enforcement teams of the DOL will expect when they review a valuation report prepared by a CPA acting as an FA to an ESOP trustee. Last fall, Christopher K. Burch, Gregory K. Brown and Louis L. Joseph of the Holland & Knight law firm prepared a side- by- side comparison of the two process agreements. We received permission to provide that chart for your use with ESOP valuation reports. The comparison chart is included by permission of Greg Brown of Holland & Knight.

Comparison of the GreatBanc Trust Company (GB) and First Bankers Trust Services (FBTS) process agreements

Note: The blue text indicates areas where the language between the two agreements differs. The green text shows language that appears in one agreement but not the other.

GB process agreement	FBTS settlement agreement
Selection and use of valuation advisor (VA) — general	
Prudently investigate VA's qualifications.	Prudently investigate VA's qualifications.

⁴ Acosta v. First Bankers Trust Services, Inc., S.D.N.Y., case number 1:12-CV-08648-GBD, settled Sept. 21, 2017.

⁵ Perez v. GreatBanc Trust Company, C.D. Cal., case number 5:12-CV-01648-R(DTBx), settled June 1, 2014.

⁶ David M. Walker, *Assistant Secretary, Pension and Welfare Benefits Administration, U.S. Department of Labor*. [FR Doc. 88-10934 Filed 5-16-88; 8:45am]

<p>Take reasonable steps to determine that the VA receives complete, accurate and current information necessary to value employer securities.</p>	<p>Take reasonable steps to determine that the VA receives complete, accurate and current information necessary to value ESOP sponsor's securities.</p>
	<p>Document steps trustee took, including who at trustee took those steps, to determine that the VA received complete, accurate and current information, and to ensure that the trustee understood the advice of the VA.</p>
<p>Prudently determine that its reliance on the VA's advice is reasonable before entering into any transaction in reliance on the advice.</p>	<p>Prudently determine that its reliance on the VA's advice is reasonable before entering into any transaction in reliance on the advice.</p>
<p>Selection of VA — conflicts of interest</p>	
<p>Not use a VA for a transaction that has previously performed work, including but not limited to, a "preliminary valuation," for or on behalf of the ESOP sponsor (as distinguished from the ESOP), any counterparty to the ESOP involved in the transaction, or any other entity that is structuring the transaction (such as an investment bank) for any party other than the ESOP or its trustee. The trustee shall not use a VA for a transaction that has a familial or corporate relationship (such as a parent-subsidiary relationship) to any of the</p>	<p>Not use a VA for a transaction that has previously performed work for any party to the transaction other than the ESOP or its trustee, including but not limited to, a "preliminary valuation" for or on behalf of the ESOP sponsor (as distinguished from the ESOP), a committee of employees of the ESOP sponsor, any counterparty to the ESOP involved in the transaction, or any other entity that is structuring the transaction (such as an investment bank) for any party other than the ESOP or its trustee. Trustee</p>

GB process agreement	FBTS settlement agreement
<p>aforementioned persons or entities. The trustee shall obtain written confirmation from the VA selected that none of the above-referenced relations exist.</p>	<p>shall not use a VA for a transaction that has a familial or corporate relationship (such as a parent-subsidiary relationship) to any of the aforementioned persons or entities. The trustee shall obtain written confirmation from the VA selected that none of the above-referenced relations exist.</p>
<p>Selection of VA — process</p>	
<p>In selecting a VA for a transaction, the trustee shall prepare a written analysis addressing the following topics:</p> <ul style="list-style-type: none"> • the reason for selecting the VA • a list of all the VAs the trustee considered • a discussion of the qualifications of the VAs that the trustee considered • a list of references checked and discussion of the references' views on the VA • whether the VA was the subject of prior criminal or civil proceedings • a full explanation of the bases for concluding that the trustee's selection of the VA was prudent 	<p>In selecting a VA for a transaction, the trustee shall prepare a written analysis addressing the following topics:</p> <ul style="list-style-type: none"> • the reason for selecting the VA • a list of all the VAs the trustee considered • a discussion of the qualifications of the VAs that the trustee considered • a list of at least three references checked and discussion of the references' views on the VA • whether the VA was the subject of prior criminal, civil or regulatory proceedings/investigations related to its previous valuation work and the outcome of such proceedings or investigations • a full explanation of the bases for concluding that the trustee's selection of the VA was prudent
<p>If the trustee selects a VA from a roster of VAs that it has previously used, the trustee need not undertake anew the analysis outlined above if the following conditions are satisfied:</p>	<p>If the trustee selects a VA from a roster of VAs that it has previously used or who has been previously approved in connection with the trustee's vendor risk management program, the trustee need not undertake</p>

GB process agreement	FBTS settlement agreement
<ul style="list-style-type: none"> the trustee previously performed the analysis in connection with a prior engagement of the VA the previous analysis was completed within the 15-month period immediately preceding the VA's selection for a specific transaction the trustee documents in writing that it previously performed the analysis, the date(s) on which the trustee performed the analysis, and the results of the analysis the VA certifies that the information it previously provided related to whether it was subject to criminal and or civil proceedings is still accurate 	<p>anew the analysis outlined above if the following conditions are satisfied:</p> <ul style="list-style-type: none"> the trustee previously performed the analysis in connection with a prior engagement of the VA or in connection with the trustee's vendor risk management program the previous analysis was completed within the prior calendar year immediately preceding the VA's selection for a specific transaction the trustee documents in writing that it previously performed the analysis, the date(s) on which the trustee performed the analysis, and the results of the analysis the VA certifies that the information it previously provided related to whether it was subject to any proceedings is still accurate
<p style="text-align: center;">Oversight of VA — required analysis</p> <p style="text-align: center;">The following items must be documented in a valuation report or in supplemental documentation:</p>	
<p>Identify in writing the individuals responsible for providing any projections reflected in the valuation report, and as to those individuals, conduct a reasonable inquiry as to:</p> <ul style="list-style-type: none"> whether those individuals have or reasonably may be determined to have any conflicts of interest in regard to the ESOP (including but not limited to any interest in the purchase or sale of the ESOP sponsor's stock being considered) 	<p>Identify in writing the individuals responsible for providing any projections reflected in the valuation report, and as to those individuals, conduct a reasonable inquiry as to, and record in writing:</p> <ul style="list-style-type: none"> whether those individuals have or reasonably may be determined to have any conflicts of interest in regard to the ESOP (including but not limited to any interest in the purchase or sale of the ESOP sponsor's stock being considered)

GB process agreement	FBTS settlement agreement
<ul style="list-style-type: none"> • whether those individuals serve as agents or employees of persons with such conflicts, and the precise nature of any such conflicts • record in writing how the trustee and the VA considered such conflicts in determining the value of the ESOP sponsor's securities 	<ul style="list-style-type: none"> • whether those individuals serve as agents or employees of persons with such conflicts, and the precise nature of any such conflicts • how the trustee and the VA considered such conflicts in determining the value of the ESOP sponsor's securities
<p>Document in writing an opinion as to the reasonableness of any projections considered in connection with the transaction and explain why and to what extent the projections are or are not reasonable. At a minimum, the analysis shall consider how the projections compare to — and whether they are reasonable in light of — the ESOP sponsor's five-year historical averages and/or medians, and the five-year historical averages and/or medians of a group of comparable public companies (if any exist) for the following metrics, unless five— year data are unavailable (in which case, the analyses shall use averages extending as far back as possible):</p> <ul style="list-style-type: none"> • return on assets • return on equity • EBIT margins • EBITDA margins • ratio of capital expenditures to sales • revenue growth rate • ratio of free cash flows (of the enterprise) to sales 	<p>Document in writing an opinion as to the reasonableness of any projections considered in connection with the transaction that explains why and to what extent the projections are or are not reasonable. At a minimum, the analysis shall consider how the projections compare to — and whether they are reasonable in light of — the ESOP sponsor's five-year historical averages and/or medians, and the five-year historical averages and/or medians of a group of comparable public companies (if any exist) for the following metrics, unless five— year data are unavailable (in which case, the analyses shall use averages extending as far back as possible):</p> <ul style="list-style-type: none"> • return on assets • return on equity • EBIT margins • EBITDA margins • ratio of capital expenditures to sales • revenue growth rate; and • ratio of free cash flows (of the enterprise) to sales
<p>If it is determined that any of these metrics should be disregarded in assessing the</p>	<p>If it is determined that any of these metrics should be disregarded in assessing the</p>

GB Process Agreement	FBTS Settlement Agreement
<p>reasonableness of the projections, document in writing both the calculations of the metric (unless calculation is impossible) and the basis for the conclusion that the metric should be disregarded. The use of additional metrics to evaluate the reasonableness of projections other than those listed above is not precluded, as long as the appropriateness of those metrics is documented in writing.</p>	<p>reasonableness of the projections, document in writing both the calculations of the metric (unless calculation is impossible) and the basis for the conclusion that the metric should be disregarded. The use of additional metrics to evaluate the reasonableness of projections other than those listed above is not precluded, as long as the appropriateness of those metrics is documented in writing.</p>
<p>If comparable companies are used for any part of a valuation — whether as part of a Guideline Public Company method, to gauge the reasonableness of projections, or for any other purpose – explain in writing the bases for concluding that the comparable companies are actually comparable to the company being valued, including on the basis of size, customer concentration (if such information is publicly available) and volatility of earnings. If a Guideline Public Company analysis is performed, explain in writing any discounts applied to the multiples selected, and if no discount is applied to any given multiple, explain in significant detail the reasons.</p>	<p>If comparable companies are used for any part of a valuation — whether as part of a guideline company method of valuation, to gauge the reasonableness of projections, or for any other purpose, explain in writing the bases for concluding that the comparable companies are actually comparable to the company being valued, including on the basis of size, customer concentration (if such information is publicly available) and volatility of earnings. If a guideline company analysis is performed, explain in writing any discounts applied to the multiples selected, and if no discount is applied to any given multiple, explain in significant detail the reasons.</p>
<p>If the ESOP sponsor is projected to meet or exceed its historical performance or the historical performance of the group of comparable public companies on any of the metrics described above, document in writing all material assumptions supporting such projections and why those assumptions are reasonable.</p>	<p>If the ESOP sponsor is projected to meet or exceed its historical performance or the historical performance of the group of comparable public companies on any of the metrics described above, document in writing all material assumptions supporting such projections and why those assumptions are reasonable.</p>
<p>To the extent that the trustee or its VA considers any of the projections provided by the ESOP sponsor to be unreasonable, document in writing any adjustments made to the projections.</p>	<p>To the extent that the trustee or its VA considers any of the projections provided by the ESOP sponsor to be unreasonable, document in writing any adjustments made to the projections.</p>

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<p>If adjustments are applied to the ESOP sponsor's historical or projected financial metrics in a valuation analysis, determine and explain in writing why such adjustments are reasonable.</p>	<p>If adjustments are applied to the ESOP sponsor's historical or projected financial metrics in a valuation analysis, determine and explain in writing why such adjustments are reasonable.</p>
	<p>Describe the risks facing the ESOP sponsor that could cause the ESOP sponsor's financial performance to fall materially below the projections relied upon by the VA.</p>
<p>If greater weight is assigned to some valuation methods than to others, explain in writing the weighting assigned to each valuation method and the basis for the weightings assigned.</p>	<p>If greater weight is assigned to some valuation methods than to others, explain in writing the weighting assigned to each valuation method and the basis for the weightings assigned.</p>
<p>Consider, as appropriate, how the plan document provisions regarding stock distributions, the duration of the ESOP loan, and the age and tenure of the ESOP participants may affect the ESOP sponsor's prospective repurchase obligation, the prudence of the transaction or the fair market value of the stock.</p>	<p>Consider, as appropriate, how the plan document provisions regarding stock distributions, the duration of the ESOP loan, and the age and tenure of the ESOP participants may affect the ESOP sponsor's prospective repurchase obligation, the prudence of the transaction or the fair market value of the stock.</p>
<p>Analyze and document in writing:</p> <ul style="list-style-type: none"> • whether the ESOP sponsor will be able to service the debt taken on in connection with the transaction (including the ability to service the debt in the event that the ESOP sponsor fails to meet the projections relied upon in valuing the stock) • whether the transaction is fair to the ESOP from a financial point of view 	<p>Analyze and document in writing:</p> <ul style="list-style-type: none"> • whether the ESOP sponsor will be able to service the debt taken on in connection with the transaction (including the ability to service the debt in the event that the ESOP sponsor fails to meet the projections relied upon in valuing the stock) • whether the transaction is fair to the ESOP participants from a financial point of view

GB process agreement	FBTS settlement agreement
<ul style="list-style-type: none"> • whether the transaction is fair to the ESOP relative to all the other parties to the proposed transaction • whether the terms of the financing of the proposed transaction are market-based, commercially reasonable and in the best interests of the ESOP • the financial impact of the proposed transaction on the ESOP sponsor, and document in writing the factors considered in such analysis and conclusions drawn therefrom 	<ul style="list-style-type: none"> □ whether the transaction is fair to the ESOP participants relative to all the other parties to the proposed transaction □ whether the terms of the financing of the proposed transaction are market-based, commercially reasonable and in the best interests of the ESOP participants □ whether the terms of any loan the ESOP receives in connection with the transaction are as favorable as the terms of any loans between the ESOP sponsor and any executive of the ESOP sponsor made within the two years preceding the transaction □ the financial impact of the proposed transaction on the ESOP sponsor, and document in writing the factors considered in such analysis and conclusions drawn therefrom
	<p>Explain any material differences between the present valuation and the most recent prior valuation of the ESOP sponsor performed within the past 24 months by any valuation firm for any purpose (if any exist).</p>
<p>Financial statements</p>	
<p>The trustee will request that the ESOP sponsor provide the trustee and its VA with audited unqualified financial statements prepared by a CPA for the preceding five fiscal years, unless such financial statements extending back five years are unavailable (in which case, the trustee will request audited unqualified financial statements extending as far back as possible).</p>	<p>The trustee will request that the ESOP sponsor provide the trustee and its VA with audited unqualified financial statements prepared by a CPA for the preceding five fiscal years, unless such financial statements extending back five years are unavailable (in which case, the trustee will request audited unqualified financial statements extending as far back as possible).</p>

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<p>If the ESOP sponsor provides to the trustee or its VA unaudited or qualified financial statements prepared by a CPA for any of the preceding five fiscal years (including interim financial statements that update or supplement the last available audited statements), the trustee will determine whether it is prudent to rely on the unaudited or qualified financial statements notwithstanding the risk posed by using unaudited or qualified financial statements.</p>	<p>If the ESOP sponsor provides to the trustee or its VA unaudited or qualified financial statements prepared by a CPA for any of the preceding five fiscal years (including interim financial statements that update or supplement the last available audited statements), the trustee will determine whether it is prudent to rely on the unaudited or qualified financial statements notwithstanding the risk posed by using unaudited or qualified financial statements.</p>
<p>If the trustee proceeds with the transaction notwithstanding the lack of audited unqualified financial statements prepared by a CPA (including interim financial statements that update or supplement the last available audited statements), the trustee shall document the bases for its reasonable belief that it is prudent to rely on the financial statements, and explain in writing how it accounted for any risk posed by using qualified or unaudited statements. If the trustee does not believe that it can reasonably conclude that it would be prudent to rely on the financial statements used in the valuation report, the trustee shall not proceed with the transaction. While the trustee need not audit the financial statements itself, it must carefully consider the reliability of those statements in the manner set forth herein.</p>	<p>If the trustee proceeds with the transaction notwithstanding the lack of audited unqualified financial statements prepared by a CPA (including interim financial statements that update or supplement the last available audited statements), the trustee shall document the bases for its reasonable belief that it is prudent to rely on the financial statements, and explain in writing how it accounted for any risk posed by using qualified or unaudited statements. If the trustee does not believe that it can reasonably conclude that it would be prudent to rely on the financial statements used in the valuation report, the trustee shall not proceed with the transaction. While the trustee need not audit the financial statements itself, it must carefully consider the reliability of those statements in the manner set forth herein.</p>
	<p>The trustee may approve a transaction notwithstanding the lack of unqualified financial statements (including interim financial statements that update or supplement the last unqualified financial statement) only if the stock purchase agreement includes a provision requiring the selling or purchasing shareholder(s) who is (are) an officer, manager or member of the board of directors of the ESOP sponsor to compensate the ESOP for any losses or</p>

GB process agreement	FBTS settlement agreement
	other harms caused by or related to financial statements that did not accurately reflect the ESOP sponsor's financial condition.
<p style="text-align: center;">Fiduciary review process — general</p> <p style="text-align: center;">In connection with any transaction, the trustee agrees to do the following:</p>	
Take reasonable steps necessary to determine the prudence of relying on the ESOP sponsor's financial statements provided to the VA, as set out more fully above.	Take reasonable steps necessary to determine the prudence of relying on the ESOP sponsor's financial statements provided to the VA, as set out more fully above.
Critically assess the reasonableness of any projections (particularly management projections), and if the valuation report does not document in writing the reasonableness of such projections to the trustee's satisfaction, the trustee will prepare supplemental documentation explaining why and to what extent the projections are or are not reasonable.	Critically assess the reasonableness of any projections (particularly management projections), and if the valuation report does not document in writing the reasonableness of such projections to the trustee's satisfaction, the trustee will prepare supplemental documentation explaining why and to what extent the projections are or are not reasonable.
Document in writing its bases for concluding that the information supplied to the VA, whether directly from the ESOP sponsor or otherwise, was current, complete and accurate.	
	If the trustee believes the projections are unreasonable, the trustee shall ask the VA to account for the unreasonable projections in its valuation, request new and reasonable projections from management, or reject the transaction. The trustee must document the bases for its decision.
	Ensure that the information the VA obtains from the ESOP sponsor and purchasing or

GB process agreement	FBTS settlement agreement
	<p>selling shareholder(s) includes the following, to the extent it exists:</p> <ul style="list-style-type: none"> • any prior attempts by the purchasing or selling shareholder(s) to purchase or sell their stock in the ESOP sponsor within the preceding two years • any prior defaults within the past five years by the ESOP sponsor under any lending or financing agreement • any management letters provided to the ESOP sponsor by its accountants within the past five years • any information related to a valuation of the ESOP sponsor provided to the IRS within the past five years
Fiduciary review process — documentation of valuation analysis	
<p>The trustee shall document in writing its analysis of any final valuation report relating to a transaction. The trustee's documentation will specifically address each of the following topics, will include the trustee's conclusions regarding the final valuation report's treatment of each topic and explain in writing the bases for its conclusions:</p> <ul style="list-style-type: none"> • marketability discounts • minority interests and control premiums • projections of the ESOP sponsor's future economic performance and the reasonableness or unreasonableness of such projections, including, if applicable, the bases for assuming that the ESOP sponsor's future financial performance will meet or 	<p>The trustee shall document in writing its analysis of any final valuation report relating to a transaction. The trustee's documentation will specifically address each of the following topics, will include the trustee's conclusions regarding the final valuation report's treatment of each topic and explain in writing the bases for its conclusions:</p> <ul style="list-style-type: none"> • marketability discounts • minority interests and control premiums • projections of the ESOP sponsor's future economic performance and the reasonableness or unreasonableness of such projections, including, if applicable, the bases for assuming that the ESOP sponsor's future financial performance will meet or

GB process agreement	FBTS settlement agreement
<p>exceed historical performance or the expected performance of the relevant industry generally</p> <ul style="list-style-type: none"> • analysis of the ESOP sponsor’s strengths and weaknesses, which may include, as appropriate, personnel, plant and equipment, capacity, research and development, marketing strategy, business planning, financial condition and any other factors that reasonably could be expected to affect future performance • specific discount rates are chosen, including whether any weighted average cost of capital used by the VA was based on the ESOP sponsor’s actual capital structure or that of the relevant industry and why the chosen capital structure weighting was reasonable • all adjustments to the ESOP sponsor’s historical financial statements • consistency of the general economic and industry-specific narrative in the valuation report with the quantitative aspects of the valuation report • reliability and timeliness of the historical financial data considered, including a discussion of whether the financial statements used by the VA were the subject of unqualified audit opinions, and if not, why it would nevertheless be prudent to rely on them • the comparability of the companies chosen as part of any analysis based on comparable companies 	<p>exceed historical performance or the expected performance of the relevant industry generally</p> <ul style="list-style-type: none"> • analysis of the ESOP sponsor’s strengths and weaknesses, which may include, as appropriate, personnel, plant and equipment, capacity, research and development, marketing strategy, business planning, financial condition and any other factors that reasonably could be expected to affect future performance • specific discount rates are chosen, including whether any weighted average cost of capital used by the VA was based on the ESOP sponsor’s actual capital structure or that of the relevant industry and why the chosen capital structure weighting was reasonable • all adjustments to the ESOP sponsor’s historical financial statements • consistency of the general economic and industry-specific narrative in the valuation report with the quantitative aspects of the valuation report • reliability and timeliness of the historical financial data considered, including a discussion of whether the financial statements used by the VA were the subject of unqualified audit opinions, and if not, why it would nevertheless be prudent to rely on them • the comparability of the companies chosen as part of any analysis based on comparable companies

GB process agreement	FBTS settlement agreement
<ul style="list-style-type: none"> • material assumptions underlying the valuation report and any testing and analyses of these assumptions • where the valuation report made choices between averages, medians and outliers (e.g., in determining the multiple(s) used under the “guideline company method” of valuation), the reasons for the choices • treatment of corporate debt • whether the methodologies employed were standard and accepted methodologies and the bases for any departures from standard and accepted methodologies • the ESOP sponsor’s ability to service any debt or liabilities to be taken on in connection with the proposed transaction • the proposed transaction’s reasonably foreseeable risks as of the date of the transaction • any other material considerations or variables that could have a significant effect on the price of the employer securities 	<ul style="list-style-type: none"> • material assumptions underlying the valuation report and any testing and analyses of these assumptions • where the valuation report made choices between averages, medians and outliers (e.g., in determining the multiple(s) used under the “guideline company method” of valuation), the reasons for the choices • treatment of corporate debt • whether the methodologies employed were standard and accepted methodologies and the bases for any departures from standard and accepted methodologies • the ESOP sponsor’s ability to service any debt or liabilities to be taken on in connection with the proposed transaction • the proposed transaction’s reasonably foreseeable risks as of the date of the transaction • any other material considerations or variables that could have a significant effect on the price of the employer securities
<p>Fiduciary review process — reliance on valuation report</p>	
<p>The trustee, through its personnel who are responsible for the proposed transaction, will do the following and document in writing its work with respect to each:</p>	<p>The trustee, through its employees who are responsible for the proposed transaction, including any employee who participated in decisions on whether to proceed with the transaction or the price of the transaction, will do the following and document in writing its work with respect to each:</p>

GB process agreement	FBTS settlement agreement
<ul style="list-style-type: none"> • read and understand the valuation report • identify and question the valuation report's underlying assumptions • make reasonable inquiry as to whether the information in the valuation report is materially consistent with information in the trustee's possession • analyze whether the valuation report's conclusions are consistent with the data and analyses • analyze whether the valuation report is internally consistent in material aspects 	<ul style="list-style-type: none"> • read and understand the valuation report • identify and question the valuation report's underlying assumptions • make reasonable inquiry as to whether the information in the valuation report is materially consistent with information in the trustee's possession • analyze whether the valuation report's conclusions are consistent with the data and analyses • analyze whether the valuation report is internally consistent in material aspects
<p>The trustee will document in writing the following:</p> <ul style="list-style-type: none"> • the identities of its personnel who were primarily responsible for the proposed transaction, including any person who participated in decisions on whether to proceed with the transaction or the price of the transaction • any material points as to which such personnel disagreed and why • whether any such personnel concluded or expressed the belief prior to the trustee's approval of the transaction that the valuation report's conclusions were inconsistent with the data and analysis therein or that the valuation report was internally inconsistent in material aspects 	<p>The trustee will document in writing the following:</p> <ul style="list-style-type: none"> • the identities of its employees who were primarily responsible for the proposed transaction, including any employee who participated in decisions on whether to proceed with the transaction or the price of the transaction • any material points as to which such employee disagreed and why • whether any such employee concluded or expressed the belief prior to the trustee's approval of the transaction that the valuation report's conclusions were inconsistent with the data and analysis therein or that the valuation report was internally inconsistent in material aspects

GB process agreement	FBTS settlement agreement
<p>If the individuals responsible for performing the analysis believe that the valuation report's conclusions are not consistent with the data and analysis or that the valuation report is internally inconsistent in material respects, the trustee shall not proceed with the transaction.</p>	<p>If the employees who were primarily responsible for the transaction, including any employee who participated in decisions on whether to proceed with the transaction or the price of the transaction, believe that the valuation report's conclusions are not consistent with the data and analysis or that the valuation report is internally inconsistent in material respects, the trustee shall not proceed with the transaction.</p>
<p>Preservation of documents</p>	
<p>In connection with any completed transaction, must create and preserve for six years notes and records documenting:</p> <ul style="list-style-type: none"> • the full name, business address, telephone number and email address at the time of the trustee's consideration of the proposed transaction of each member of the trustee's fiduciary committee (whether or not he or she voted on the transaction) and any other trustee personnel who made any material decision(s) on behalf of the trustee in connection with the proposed transaction, including any of the persons identified above • all notes and records created by the trustee in connection with its consideration of the transaction, including all documentation required by the Agreement with the DOL • the vote (yes or no) of each member of the trustee's fiduciary committee who voted on the proposed transaction and a signed certification by each of the voting committee 	<p>In connection with any completed transaction, must create and preserve for six years notes and records documenting:</p> <ul style="list-style-type: none"> • the full name, business address, telephone number and email address at the time of the trustee's consideration of the proposed transaction of each employee who was primarily responsible for the transaction, including any employee who participated in decisions on whether to proceed with the transaction or the price of the transaction, and any other employee who made any material decision(s) on behalf of the trustee in connection with the transaction • all relevant notes and records created by the trustee in connection with its consideration of the transaction, including all documentation required by the Agreement with the DOL • the vote (yes or no) of each employee who voted on the proposed transaction and a signed certification by each of the voting employees, in his or her representative capacity, and

GB process agreement	FBTS settlement agreement
<p>members and any other trustee personnel who made any material decision(s) on behalf of the trustee in connection with the proposed transaction that they have read the valuation report, identified its underlying assumptions, and considered the reasonableness of the valuation report's assumptions and conclusions</p> <ul style="list-style-type: none"> all documents the trustee and the persons identified in the first bullet above relied on in making their decisions all electronic or other written communications the trustee and the persons identified in the first bullet above had with service providers (including any VA), the ESOP sponsor, any non-ESOP counterparties, and any advisors retained by the ESOP sponsor or non-ESOP counterparties 	<p>any other trustee employee who made any material decision(s) on behalf of the trustee in connection with the proposed transaction that they have read the valuation report, identified its underlying assumptions, and considered the reasonableness of the valuation report's assumptions and conclusions</p> <ul style="list-style-type: none"> all relevant documents the trustee and the persons identified in the first bullet above relied on in making their decisions all relevant electronic or other written communications the trustee and the persons identified in the first bullet above had with service providers (including any VA), the ESOP sponsor, any non-ESOP counterparties, and any advisors retained by the ESOP sponsor or non-ESOP counterparties
<p>Fair market value</p>	
<p>The trustee shall not cause an ESOP to purchase employer securities for more than their fair market value or sell employer securities for less than their fair market value. The DOL states that the principal amount of the debt financing the transaction, irrespective of the interest rate, cannot exceed the ESOP sponsor's securities' fair market value. Accordingly, the trustee shall not cause an ESOP to engage in a leveraged stock purchase transaction in which the principal amount of the debt financing the transaction exceeds the fair market value of the stock acquired with that debt, irrespective</p>	<p>The principal amount of the debt financing the transaction, irrespective of interest rate, cannot exceed the ESOP sponsor's securities fair market value. Accordingly, the trustee shall not cause an ESOP to engage in a leveraged stock purchase transaction in which the principal amount of the debt financing the transaction exceeds the fair market value of the stock acquired with that debt, irrespective of the interest rate or other terms of the debt used to finance the transaction.</p>

GB process agreement	FBTS settlement agreement
of the interest rate or other terms of the debt used to finance the transaction.	
Control	
	<p>If the trustee approves a transaction in which the ESOP cedes any degree of control to which it would otherwise be entitled based on its ownership interest, including but not limited to the unencumbered ability to vote its shares (for example, by electing members of the board of directors), the trustee must document any consideration received in exchange for such limitation on the ESOP's control (or how the limitation on control is otherwise reflected in the purchase price) and why it is fair to the ESOP. If the trustee approves a transaction in which the ESOP pays a control premium, the trustee must document why it believes that the ESOP is obtaining voting control, and control in fact, and identify any limitations on such control as well as the specific amount of consideration the ESOP received for such limitation(s).</p>
Consideration of claw-back	
<p>In evaluating proposed stock transactions, the trustee shall consider whether it is appropriate to request a claw-back arrangement or other purchase price adjustment(s) to protect the ESOP against the possibility of adverse consequences in the event of significant corporate events or changed circumstances. The trustee shall document in writing its consideration of the appropriateness of a claw-back or other purchase price adjustment(s).</p>	<p>In evaluating proposed stock transactions, the trustee shall consider whether it is appropriate to request a claw-back arrangement or other purchase price adjustment(s) to protect the ESOP against the possibility of adverse consequences in the event of significant corporate events or changed circumstances. The trustee shall document in writing its consideration of the appropriateness of a claw-back or other purchase price adjustment(s).</p>

Other professionals	
The trustee may, consistent with its fiduciary responsibilities under ERISA, employ, or delegate fiduciary authority to, qualified professionals to aid the trustee in the exercise of its powers, duties and responsibilities as long as it is prudent to do so.	The trustee may, consistent with its fiduciary responsibilities under ERISA, employ, or delegate fiduciary authority to, qualified professionals to aid the trustee in the exercise of its powers, duties and responsibilities as long as it is prudent to do so.
Not entirety of obligations	
This agreement is not intended to specify all of the trustee's obligations as an ERISA fiduciary with respect to the purchase or sale of employer stock under ERISA, and in no way supersedes any of the trustee's obligations under ERISA or its implementing regulations.	

While the process agreements let the valuation expert know what the DOL thinks, they are not law, nor regulation. Also, the process agreements pertain to transactions in ESOP stock purchases, not the annual administration and operation of the ESOP trust. Without clear regulation, it is up to the valuation expert to communicate with the ESOP trustee to discuss expectations regarding whether these standards will be followed for annual valuation reports. Included in that discussion is how, and who, will document compliance with the guidelines provided in the process agreements. Where the process agreements differ, the trustee must suggest which approach will be used for that valuation report. As valuation experts and FAs to the trustee, we should document that such a conversation took place and we should document how we addressed the guidelines found in the process agreements for which we accepted responsibility.

In addition to requiring adequate documentation of the conclusions of the valuation expert, tied to some level of market data as it is available, there is a desire for the financial statements of the sponsoring company of the ESOP to be audited. If not audited, then reviewed.

Unaudited statements

If the financial statements relied upon by the valuation expert are not audited or reviewed, then there are alternative procedures that can be applied by the valuation expert that do not put the valuation expert in a position of auditing the internally prepared statements but provide assurance that the cash flows are reliably verified. These alternative procedures may include the following steps:

- Compare the bank statements to the cash flows reported by the sponsoring company.
- Perform an analysis comparing year over year changes by major account, confirming the

- causes of any changes noted.
- Compare the internally prepared financial statements to what is reported on the federal tax return and reconcile any differences.
- Document why the valuation expert felt there was enough evidence of cash flows to support the conclusion of value so that the trustee knows what was done to compensate for the lack of audited or reviewed financial statements.

Another concern for the valuation expert performing ESOP valuations is the inaccuracy of the financial statements, either because they do not conform with GAAP, or because the statements omit activity found when the valuation expert reviews related documentation. Such documentation can include the ESOP form 5500, the record keepers' statements for the ESOP or transactions in the sponsoring company's stock that are not properly recorded in the financial statements. There are many examples of ESOP owned companies with financial statements that do not comply at all or comply fully, with accounting standards codification topic 718-40, accounting for ESOPs. This non-compliance lead to misstated goodwill, misstated long term debt, misstated shareholders' equity and incorrect income statement costs for employee compensation and debt service expenses. The valuation expert will need to consider adjusting for these misstatements and explaining the adjustments in the valuation report. The valuation expert should disclose findings of incorrect accounting entries to the ESOP trustee. Lastly, the valuation expert must analyze the impact of incorrect accounting on the past and projected cash flows used to develop the conclusion of value. Accounting errors can also impact the sponsoring company's estimates of the repurchase obligation, which can further cloud the ability of the valuation expert to determine cash flows available to debt holders and shareholders in an ESOP-owned company.

Merger and acquisition activity in companies with ESOP ownership

There are several possible ways to use an ESOP in merger and acquisition transactions that must be known by the valuation analysts. A company that already sponsors an ESOP plan may use the assets of that plan to acquire the stock, or assets, of a target company. This type of acquisition can be facilitated by either having the target company sell its stock to its own ESOP and replacing the stock of the target company with stock of the acquiring company, or the acquiring company may directly purchase the assets or stock of the target company. Like a traditional transaction, the use of an ESOP trust to facilitate an acquisition can be financed with cash, seller financing or third-party debt. These types of transactions generally require a trustee or trustees, since all parties to the transaction are conflicted. In addition, there normally will be two valuations prepared for ESOP purposes, one for the selling side and one for the buying side. Often these valuation reports will be compared by the valuation analysts so that any inconsistent assumptions between the reports can be considered. The trustee for each side will then negotiate the most favorable transaction terms for the participants of the ESOP, within the range of values found in the valuation report for each side.

Once the transaction is complete, the employees retained by the acquiring company will become participants in the ESOP trust of the surviving company. If the acquired company was purchased in an asset sale, the ESOP Trust will wind down the operations of the stock company that was replaced by the acquiring company. This wind down will include the settlement of debt of the ESOP and distributions of cash received at the time of sale. The acquired company may

possibly remain in place during the escrow period, while some sale proceeds are held (pending the resolution of the responsibilities of the representations and warranties of the selling company), possibly. In this case, the trustee will accept an earnout on behalf of the beneficiaries of the ESOP and discharge any remaining corporate responsibilities before the corporation is terminated. The abandoned ESOP may need to be operated for several years past the sale of the assets of the company that sponsored the ESOP.

An ESOP can also be a very effective way to spin off an operating unit of a company. Many times, there will not be a ready market for a unit within a company so that the company is faced with either selling to a competitor, from whom there is a loss of significant competitive information and employee skill sets, or the business unit would have to be closed. To avoid these outcomes, the use of an ESOP can provide a tax-advantaged method to allow for an employee buyout of the operating unit. Again, the financing can come from either cash within the operating unit, financing from the seller (the soon to be former parent company) or from third parties. This method of spinning off an operating unit can be very effective when it has stable cash flows, quality management and a means to finance the transaction. The types of valuation services needed are similar to those services needed for the acquisition of a company using an ESOP as discussed above.

Summary notes

The CPA is in a unique situation to provide FA services to an ESOP trustee. Not only does the CPA enjoy a reputation for independence and thoroughness, the CPA possess the analytical tools and experience that the trustee requires. While the valuation work associated with ESOPs can be a valuable source of repeat business for the CPA, there are some critical requirements for this work.

The CPA must be independent from all other activities and services for the sponsoring company of the ESOP. The report must document the analytical work performed completely, so that the trustee has adequate documentation of compliance with the expectations of the DOL. Finally, the CPA must demonstrate professional skepticism in his or her analysis that supports the requirement that the CPA work on behalf of the best interests of the participants in the ESOP Trust.



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