AICPA® Forensic and Valuation Services Section

Valuation and Transactional Issues Associated

With Employee Stock Ownership Plans

October 2013

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The Forensic and Valuation Services team and the authors thank the members of the 2012-2013 AICPA Forensic and Valuation Services Executive Committee and AICPA Business Valuations Committee for reviewing this white paper.

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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. ESOPs have increasingly come to occupy a more prominent position in the business community as their financial benefits are realized. The recent renaissance in ESOP attractiveness is magnified with the passage of significant federal legislation permitting S corporations to sponsor ESOPs.

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 obligations. With these fundamentals, readers are encouraged to more fully explore the employee ownership community for further insights.

OVERVIEW OF ESOPS AND TRUSTS

History

The first major federal legislation embracing the concept of employee ownership was the Employee Retirement Income Security Act (ERISA) of 1974. 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, the ERISA included ESOPs in the definition of a qualified employee benefit plan under the Internal Revenue Code (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 have to be primarily invested in employer securities. These provisions are significant because most other qualified retirement plans contain specific restrictions against the inclusion of more than 10% in employer securities. ERISA established both the Department of Labor (DOL) and the Internal Revenue Service (IRS) as federal oversight agencies for ERISA.

- **Revenue Act of 1978**. This act requires that stock, not publicly traded, in an ESOP must offer participating employees a "put" option back to the employer and the employer and/or the ESOP must repurchase the stock. The mandated repurchase of the employer stock is generally referred to as the repurchase obligation. Full pass through voting rights on allocated shares in public companies was required, and closely held companies were required to extend voting rights on major issues.

- **The Economic Recovery Act of 1981**. This act increased the tax deductible covered payroll contribution limit for C corporations from 15% to 25% in an ESOP for principal payments and provides for an unlimited tax deduction for interest payments. This act also requires that employees departing an ESOP accept cash for the fair market value ("FMV") of their stock rather than the stock.

- **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 include 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, as long as the proceeds are reinvested in Qualified Replacement Property (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%. 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 ESOPs**. Congress has embraced ESOPs with a series of legislation 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 most commonly associated with 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.

Every Trustee is bound by applicable fiduciary responsibilities, and, in certain instances, fiduciary responsibilities may extend to other parties that **are not Trustees**.

ERISA established the requirement that all qualified plans must have an ESOP Trustee ("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 the review areas for both the DOL and IRS may overlap, in practice, the DOL is most commonly concentrated on fiduciary issues and prohibited transactions. The DOL is looking for self-dealing and conflicted relationships between the parties-in-interest.

Prohibited transactions typically focus on the relationships between parties-in-interest and the ESOP and any self-dealing and conflicts of interest. Parties-in-interest include members of this non-exclusive list: 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 ownership interests in the plan sponsor, and relatives of the owners, including lineal descendants. Prohibited transactions may be 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 reviewing fiduciary responsibilities of the various parties-in-interest. Fiduciary responsibilities generally are considered to be very high standards of conduct in the business community.

Trustee. 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 the 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 make sure that there is no prohibited transaction.

Major Fiduciary Duties

- **Duty of Loyalty**. The fiduciary must act solely in the interest of the participants and beneficiaries. This often is 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. 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.

- **Following 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 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 be aware of the range of conflicts that could lead to challenges.

Tax Regulations Overseen by the IRS (Generally Title 2 of ERISA)

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. First, common tax attributes are considered with all corporations; followed by C corporation attributes and finally S corporation attributes. Since many of the contribution limits are indexed to inflation, those regulations are continually evolving, and this paper does not address such details. Differences between public company tax attributes and private company attributes, if any, will be indicated.

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. Similar to 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, similar to 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)). This has 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 2012 is about $250,000. There are regulations that distinguish the contribution limit and the maximum allocation limit (which includes forfeitures). Generally, allocation limits are the lesser of $50,000 (in 2012) or 100% of the participant's salary, indexed to inflation in $1,000 increments (IRC Section 415(c)(1)).

Deductible Dividends. Dividends are typically taxed to the receiving owners. Dividends paid to an ESOP in privately held corporations are tax deductible as long as 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 capital gain to the seller. This is the case in public corporations. For owners in 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 between 3 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 as long as 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 (both 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 a number of 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 has to 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). This has 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 contribution limit in 2012 is approximately $250,000. There are regulations that distinguish the contribution limit and the maximum allocation limit (which includes forfeitures). Generally allocation limits are the lesser of $50,000 (in 2012) 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 in that 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. 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) is in excess of 50% of the total, the company is subject to significant financial and tax penalties. If circumstances dictate the incurrence of tax penalties, this 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

Our 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 an applicable wait for a holding period (often 5 years). 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.

Changing from an S corporation back to a C corporation typically involves an applicable wait for a holding period (often 5 years).

ESOP VALUATION STANDARDS OVERSEEN BY THE DOL AND IRS

ESOPs are unusual in that the valuation of stock in private companies is subject to standards of both the DOL and the IRS. Publicly held companies with ESOPs generally 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 Fair Market Value (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 of the parameters of FMV apply to the valuation of stock for the purposes of an ESOP. The DOL has articulated additional understandings in the determination of the value of privately held stock for ESOP purposes in: "Proposed Regulation Relating to the Definition of Adequate Consideration," 29 CFR Part 2510 as published in the Federal Register on May 17, 1988 (Adequate Consideration). The definition of Adequate Consideration contains a number of sections that are specific to the requirements of an ESOP valuation. 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.
- **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 it at its FMV.

DOCUMENT REQUESTS FROM THE DOL AND THE IRS

The DOL and the IRS have oversight responsibility with the enactment of ERISA. These two federal agencies have the primary responsibility for compliance with ESOP regulations. ERISA and the IRC give the DOL and the IRS 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 in connection with the investigation.

Requests for information are often broad, covering multiple years and including documents related to the ESOP. Additional information of the plan sponsor is often requested such as corporate tax returns, financial statements and Board minutes. There is some overlap in the areas subject to review by both the DOL and the IRS, 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 on a timely basis and within limits; testing allocations to determine proper accounting; verify that the plan is updated with current regulations; review eligibility requirements; 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 often is 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 is in part focused on matters of a qualitative assessment of behavior. 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.

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 all of 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.

It is recommended that the company designates **one knowledgeable spokesperson** to work with legal counsel and other service providers in response to document requests.

Audit Resolution

The IRS will provide a closing letter with any required changes relating to a review of the IRC issues and if there is 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.

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 in place 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 a number of 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 purposes. Arrangements are made for the ESOP to borrow the funding to acquire stock from 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 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 x 40%). This is also referred to as a capital creation ESOP in that the company is able to 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 are also 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 also generates 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.

> **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).

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 a number of 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 in that 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 not in excess of 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. It is recommended, by some parties, that an independent Trustee be engaged for the sale of stock to an ESOP.

- **Legal Counsel.** ESOP and ERISA legal counsel will have to be retained for the production of the legal documents including such things as the ESOP, the trust agreement, a stock purchase agreement 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.

The valuation firm should demonstrate experience with ESOP valuations and familiarity with all applicable regulations from the DOL and IRS.

- **Independent Valuation Professional.** The Trustee will typically retain the services of a valuation firm to provide the report that recommends 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 a number of 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 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 is able to 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 first to the company and thereby securing a collateral interest in all the assets of the company (the "outside" loan). Second, the company 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 when lending money directly to the ESOP. Loan documents have to be drawn with a thorough knowledge of the applicable rules or the sale could be reclassified as a prohibited transaction with substantial penalties. Many ESOP transactions today 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, 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 the transaction price for 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.

- **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 selling a control position to the ESOP, significant amount of debt from banks or owners, management agreements, and other material provisions.

Documentation Related to the ESOP Valuation

The preparation of the valuation report requires the valuation analyst to consider virtually 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 forecasts, 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. Since historical financial results may not be indicative of future prospects, the forecast provided by the company must be carefully analyzed by the valuation analyst. 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 forecast 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.

One common development for valuation firms is to provide the financial analysis while some of the key information is not finalized. This 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 in light of 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 is typically negative for the employer's balance sheet since the net worth of the company is reduced by the contra-equity account (Unearned ESOP Shares). This 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.

There typically are two types of valuations performed for a Trustee: one, for proposed transactions involving the ESOP (either buy-side or sale-side); and two, 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.

Additional Services Provided by the Valuation Analyst to the Trustee

The independent financial adviser, or valuation analyst, may be called upon to render an opinion as to whether the debt design in a proposed ESOP transaction is fair to the ESOP participants from a financial perspective. Typically, this analysis will form part of a "fairness opinion" that the valuation analyst is asked to prepare for the Trustee.

The Trustee typically will hire the valuation analyst to render one of two types of opinions in the context of an ESOP transaction:

1. **An adequate consideration opinion**
2. **A fairness opinion**

- **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 in the sense that 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.

  Essentially, the valuation analyst's opinion will attempt to answer the following 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." Essentially, 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. His or her opinion that the transaction is "fair to the ESOP from a financial point of view" involves a relative statement.

- **Fairness Opinion.** As mentioned earlier, the difference between an adequate consideration opinion and a fairness opinion is that in addition to opining on whether the amount paid for or received in an ESOP transaction qualifies as "adequate consideration," a fairness opinion will include the valuation analyst's opinion as to 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 such elements as the 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.

  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, in particular, 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.

The transactional fairness opinion is an important legal 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 the transaction to withstand the scrutiny of the DOL, the IRS, and/or ESOP plan participants.

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Communications between the Valuation Analyst, the Trustee and the Company

There are few guidelines on exactly what kinds of communications a valuation analyst can have with a sponsor company without involving, in some manner, the Trustee. Generally speaking, a Trustee will ask 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, although not exhaustive, of common "do's" when it comes to the ESOP valuation analyst communicating with the sponsor company without the involvement of the Trustee: send Requests For Information (RFIs) including the request for financial statements and records; coordinate 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 "don'ts" in communications between the ESOP valuation analyst and the sponsor company, at least among institutional Trustees: conduct management interviews without the Trustee being present physically or via telephone; discuss any issue directly related to the share price — for example, discussing a preliminary share value, which may invite unwanted influence and/or 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 may be instances when the ESOP is no longer desirable or feasible, the sponsor is sold 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 for any number of reasons the plan is no longer seen as worth continuing.
- The company becomes insolvent or files for bankruptcy.

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 similar to 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 a number of 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 of the 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 a number of 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 there is stock value in excess of 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 involved, and the failure to follow prudent procedures may expose the fiduciary to financial penalties.

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 of the 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. Generally 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 at a later date when 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 be in compliance 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

The valuation report prepared as part of the documentation for the sale of stock to an ESOP is addressed to the Trustee. The Trustee determines the FMV of the stock, and that responsibility is typically discharged by the Trustee engaging an independent valuation analyst (or firm) to recommend the value of the stock. The Trustee will use the valuation report as one source of information in determining the FMV of the stock. It is the responsibility of the Trustee to understand the contents of the valuation report, including the underlying assumptions, valuation methodologies and other material factors.

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's 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 all of 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, a leveraged ESOP will have a negative entry in equity for 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. Other candidates for adjustment 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 report and/or valuation 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 various interested parties.

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.

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. Typically an ESOP formation, including all aspects, will 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.

While the role of the valuation analyst is not to act as the ESOP attorney or a fiduciary, the analyst should make a determination with the information he or she has as to 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 VALUATION 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 in the event that 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. But generally speaking, the plan participants are 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. This is 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 ISSUES

Applicable Standards

- **AICPA.** The type of report used should be carefully selected in compliance with AICPA Statement on Standards for Valuation Services No. 1 ("SSVS No. 1"). While SSVS No. 1 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 all of these topics that are reviewed with the Trustee, notes must be kept in the work paper file 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 forecast, 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 a Bring Forward Letter for the valuation as of the date of a stock transaction with the ESOP. If the valuation report was prepared within a reasonable period of time before a stock transaction, a Bring Forward 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 a longer period of time 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 a Bring Forward Letter is adequate or whether more extensive work should be performed to bring the conclusion of value current with the actual transaction date.

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.

Control Versus Minority

The issue of premiums and discounts is always affected by the ESOP structure. The control versus minority adjustment is considered in the light of the current trend 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 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, in light of 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 preferred, non-voting shares to prevent the ESOP participants or the Trustee from voting on 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 actually 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.

The fairness opinion is not a conclusion of value and is not covered by SSVS No. 1. The best practices for the preparation of fairness opinions are beyond the scope of this white paper on ESOP valuations.

Reviewing Opposing Expert Reports

It is typical on larger sales of stock to an ESOP for the seller and the ESOP to retain separate valuation analysts. 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 Forecasts 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. Typically a selling shareholder, who previously earned high levels of compensation, will adjust those downward when contemplating a sale of all or part of the company stock to an ESOP. Thus, the earnings of the company and the future plan participants would effectively 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.

MERGER AND ACQUISITION ACTIVITY IN COMPANIES WITH ESOP TRUSTS

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 can be facilitated by either having the target company sell its stock to its own ESOP, then replacing the stock of the target company with stock of the acquiring company, or the acquiring company may purchase the assets or stock directly of the target company. Similar to 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 assumptions not consistent between the reports can be considered. Then the Trustee for each side will 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.

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 there are stable cash flows, quality management and a means to finance the transaction. The types of valuation services needed are similar to the acquisition of a company using an ESOP as discussed above.

AICPA RESOURCES

- *Journal of Accountancy*
- AICPA Prospective Financial Information Guide
- Employee Stock Ownership Plans Resource Center
- Primer on Employee Stock Ownership Plans
- AICPA Audit & Accounting Guide, *Employee Benefit Plans*
- AICPA *Accounting Trends & Techniques — Employee Benefit Plans*
- ESOPs: Savvy Strategy for Tax Management, Succession, and Continuity
- Webcast: Valuation for Employee Stock Ownership Plans (archived)
- Forensic and Valuation Services Membership Section
- Forensic and Valuation Services Webcast Library

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