Willamette Management Associates

Insights

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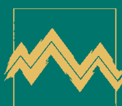
Spring 2020

Business Valuation, Forensic Analysis, and Financial Opinion Insights

Thought Leadership in Employee Stock Ownership Plan Employer Stock Valuations



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Insights

Insights, the thought leadership journal of applied microeconomics, is published on a quarterly basis, with periodic special interest issues. *Insights* is distributed to the friends and clients of Willamette Management Associates.

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We welcome reader comments, suggestions, and questions. We welcome reader recommendations with regard to thought leadership topics for future *Insights* issues. In particular, we welcome unsolicited manuscripts from legal counsel, accountants, bankers, and other thought leaders involved in the valuation and forensic services community. Please address your comments or suggestions to the editor.

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Insights Editors and Staff

Robert Schweihs
Managing Editor
rpschweihs@willamette.com

Charlene Blalock
Editor
cmblalock@willamette.com

Mary McCallister
Production Editor
mmccallister@willamette.com

Mark Abbey
Business Manager
mfabbey@willamette.com

Debi Quinlivan
Accountant
dlquinlivan@willamette.com

Michael Amoroso
Financial Analyst
mcamoroso@willamette.com

Editorial Board

Business Valuation Services—*valuations of businesses, business interests, securities, and intangible assets*

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tgwhitehead@willamette.com

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Editors for This Issue: Kyle J. Wishing and Scott R. Miller

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Forethoughts

This *Insights* issue continues the Willamette Management Associates tradition of thought leadership in the employee stock ownership plan ("ESOP") community. In our 50-plus years of providing valuation services, we have performed thousands of ESOP-related engagements. These engagements include ESOP feasibility analyses financial advisory services for the ESOP trustee regarding ESOP implementation, second stage employer stock purchases, and sponsor company sale transactions; valuations performed for ESOP administration and ERISA compliance purposes; and testifying expert services related to ESOP valuation disputes.

The concept of employee ownership is easy to get behind. If implemented and administered correctly, an ESOP can benefit the private company selling shareholders, the sponsor company employees, and the sponsor company itself.

However, the benefits offered by an ESOP come with their own set of challenges. The discussions featured in this *Insights* issue should help business owners, ESOP trustees, valuation professionals, and other ESOP professionals promote successful employee ownership through ESOPs.

The first discussion in this *Insights* issue addresses the questions that private company business owners have when considering the sale of their shares to an ESOP. That discussion is followed by thought leadership discussions on financial feasibility and plan structure options that provide pertinent information for companies considering, or in the process of, an ESOP implementation.

Valuation is central to the ESOP (and to the ESOP sponsor company) at all stages—feasibility, installation transaction, ongoing administration, and sponsor company sale/termination. This *Insights* issue features specific discussions on financial statement normalization adjustments, the valuation treatment of the repurchase obligation, and valuation considerations related to synthetic equity plans. These discussions are followed by an overview discussion of the ESOP administration valuation update process from the ESOP trustee's perspective.

The final discussion in this *Insights* issue addresses the specific procedures and analysis performed by the ESOP trustee and the trustee's financial adviser when a sponsor company sale transaction is contemplated. These discussions are particularly relevant for ESOP fiduciaries and sponsor company board members.

With this *Insights* issue, our analysts and guest contributors have authored more than 200 discussions on ESOP-related topics. We are proud of the thought leadership that our firm's professionals have contributed to the ESOP community.

About the Editors

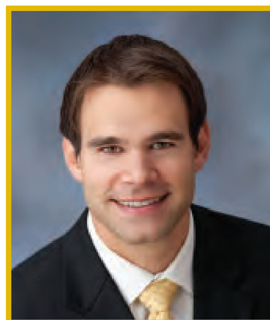
Kyle J. Wishing

Kyle Wishing is a director of our ESOP financial advisory services practice in our Atlanta office.

Kyle routinely provides a broad range of business and stock valuation, damages measurement, and transfer pricing analysis services.

Kyle is particularly proud of the services that he performs related to ESOPs. These services include ESOP feasibility analyses, transactional fairness and solvency opinion analyses, sponsor company valuations performed for ESOP administration purposes, and ERISA litigation disputes.

Kyle is an active member of the ESOP Association and the National Center for Employee Ownership. Kyle is also a member of the ESOP Association's valuation advisory committee, and he has served as a vice president and executive member of the New South chapter of the ESOP Association.



Scott R. Miller

Scott Miller is a director of our ESOP financial advisory services practice in our Portland, Oregon, office.

Scott's practice focuses on valuation and financial advisory services for ESOP transactions and administration, gift and estate taxation planning and compliance, transaction opinions, forensic analysis and dispute resolution, and corporate strategic information and planning. Scott also performs valuations and economic analyses for purposes of property tax compliance, transfer pricing, and regulatory compliance.

Scott values the long-term relationships he has formed with his ESOP clients over his 12-year tenure at Willamette. He strongly believes in the benefits of employee ownership and enjoys assisting ESOP companies and trustees with any valuation-related needs.

Introduction to ESOPs for Business Owners

Emily Rickard, Esq., and Erin Turley, Esq.

All private company business owners eventually have to address the issue of ownership transition. For business owners of private companies, viable opportunities to liquidate their business interests are often (1) limited and/or (2) suboptimal. Many business owners have some level of familiarity with the employee stock ownership plan ("ESOP") structure. They may have heard of ESOP sponsor companies through the local or national media, from a trusted adviser, or from a friend who works for an ESOP sponsor company. For many business owners, the ESOP concept can sound either (1) too good to be true or (2) too complicated and burdensome to implement. This discussion addresses questions that business owners typically have related to an ESOP. The answers to these questions may allow these business owners to make an informed decision regarding their business ownership interests.

Introduction

This discussion provides an overview of an employee stock ownership plan ("ESOP") for private company business owners.

This discussion specifically addresses the following questions that such business owners may have with regard to an ESOP:

- What is an ESOP?
- What are the benefits of selling my private company shares to an ESOP?
- How will my business operate after an ESOP stock purchase transaction?
- What are the legal and regulatory requirements for an ESOP formation?

What Is an ESOP?

An ESOP is an employee benefit plan that is uniquely positioned to:

1. use the shares of employer corporation stock to fund tax-preferred employee retirement benefits and
2. serve as a corporate financing vehicle.

Though similar in many ways to both Internal Revenue Code ("Code") Section 401(k) plans and profit sharing plans, an ESOP differs from most retirement plans in that it:

1. is designed to invest primarily in shares of employer corporation stock and
2. may borrow money from the sponsor company to finance its investment—so long as certain legal standards are met.

According to the latest-available data from the National Center for Employee Ownership ("NCEO"), there are approximately 6,460 ESOP sponsor companies in the U.S.[1]

What Are the Benefits of Selling Shares to an ESOP?

While an ESOP is not appropriate for every private company, sponsoring an ESOP is worth consideration by any private company business owner. ESOPs are

often used by private company business owners who wish to:

1. give back to the employees who helped build the business,
2. secure the business a place in the community, and
3. bolster their legacy while securing a succession plan and equity strategy for the business.

Accordingly, the most typical application of an ESOP is to sell all—or part—of the ownership interest in a closely held corporation on a tax-advantaged basis.

Several of the advantages of this application of an ESOP include the following:

- An ESOP can provide a market for the employer corporation stock, particularly when a market otherwise does not exist.
- An ESOP can be funded by a company with pretax dollars, as long as Internal Revenue Service ("Service") deduction limits are met.
- An ESOP can enable a business owner to sell his or her interest in a private company while continuing his or her involvement in both the company's management and operations.
- An ESOP can present a private company business owner with significant income, estate, and gift tax advantages.

ESOPs provide a great deal of flexibility for shareholder liquidity, ownership succession, and employee incentives. For instance, the ESOP may initially acquire either:

1. a small, noncontrolling ownership interest or
2. a 100 percent ownership interest of the outstanding equity.

Some of the benefits available to business owners and to the ESOP sponsor company vary depending on:

1. the structure of the ESOP and
2. the corporate organization of the sponsor company.

Leveraged ESOPs

There are countless ways in which an ESOP may buy sponsor company stock. The most common transactional structure results in a "leveraged ESOP."

The leveraged ESOP structure is often used because it provides a means for employers to fund ESOP stock acquisitions with tax-favored capital. If used properly, the sponsor company can use a leveraged ESOP to simultaneously provide:

1. significant corporate income tax savings and
2. substantial benefits for employees.

To form a leveraged ESOP, the sponsor company generally will borrow money—using the credit of the sponsor company itself or that of its corporate officers—to purchase the employer stock for the ESOP. While there are many permutations of this transaction, the basic transaction structure requires the following components:

- The sponsor company, in consultation with legal counsel, drafts the documents necessary to create an ESOP. These generally consist of a written ESOP plan document and a written ESOP trust document.

  As part of this process, the sponsor company must identify one or more named Employee Retirement Income Security Act ("ERISA") fiduciaries to control and manage the operation and administration of the ESOP and its assets.
- The sponsor company appoints the trustee (the "Trustee") to manage the ESOP.
- The Trustee, on behalf of the newly created ESOP, either borrows money from a bank, with the sponsor company guaranteeing the loan, or borrows money from the sponsor company.

  Often, bank lenders prefer to lend money directly to the sponsor company. In these situations, the sponsor company will obtain a bank loan and then lend the proceeds of that loan to the ESOP. The loan from the sponsor company to the ESOP does not have to be on the same terms as the loan from the bank to the sponsor company.

  However, any loan from the sponsor company to the ESOP should be as fair to the ESOP as an equivalent "arm's-length" financing transaction.
- Using the loan proceeds, the Trustee authorizes the ESOP trust to purchase the employer corporation stock either from an existing business owner or directly from the sponsor company.
- Once the ESOP trust purchases shares of employer stock, the purchased shares

are held in a suspense account within the ESOP trust as security for the stock acquisition loan.

- The ESOP trust will repay the loan using tax-deductible annual contributions from the sponsor company. As the loan is repaid, shares of the employer corporation stock are periodically released into employee accounts within the ESOP trust.

C Corporation ESOP Sponsor Companies

An important motivation for many ESOP transactions in private companies taxed under subchapter C of the Code is the ability of the business owner to defer capital gains tax on the sale of his or her shares to the ESOP. This tax deferral is available under Code Section 1042.

In order for a business owner to enjoy this capital gains tax deferral opportunity, the following requirements in Section 1042 must be met:

- The sponsor company is a C corporation.
- The business owner holds the employer corporation stock for at least three years prior to his or her sale to the ESOP.
- The employer corporation stock sold has not been acquired through options or another employee benefit plan.
- Upon completion of the sale, the ESOP trust owns at least (1) 30 percent of the outstanding shares of each class of sponsor company stock or (2) stock representing 30 percent of the value of all of the sponsor company stock.
- The shares acquired by the ESOP trust may not be allocated to accounts of the business owner's children, spouses, parents, or brothers and sisters.
- The shares acquired by the ESOP trust may not be allocated to the accounts of over 25 percent shareholders.

S Corporation ESOP Sponsor Companies

An ESOP also has income tax benefits for businesses structured as S corporations. As a tax deferred retirement plan, an ESOP-owned S corporation is not subject to federal income taxes (and possibly state income taxes, depending on the state).

Often, S corporations make distributions to shareholders so as to meet their income tax liability. Distributions received by the ESOP may be used to repay the ESOP loan or to purchase additional shares of employer stock. If an ESOP owns 100 percent of the stock of an S corporation, then the sponsor company is exempt from federal income taxation.

Business owners should be aware that some of the tax incentives that are provided for C corporations do not apply to S corporations. For example, S corporations are not allowed to deduct cash dividends paid on stock held by an ESOP.

S corporations also do not benefit from the increased limits for tax deductions for contributions to a leveraged ESOP when those contributions are used to pay interest on an ESOP loan. S corporation business owners are ineligible for the capital gains tax deferral under Code Section 1042.

What Qualities Make for a Good ESOP Sponsor Company?

In general, companies that are good candidates to successfully implement an ESOP and to sponsor a sustainable ESOP have the following characteristics:

- Employ more than 25 full-time employees
- Have an established record of consistent profitability and cash flow
- Have at least 10 years of operating history
- Have one or more owners who are interested in investment liquidity and in a diversification of personal wealth
- Have one or more owners who are interested in ownership/management succession planning and in transitioning the ownership of the company to the employees
- Report at least $10 million in company annual revenue
- Have one or more owners who are open to accepting a reasonably conservative stock value (i.e., a fair market value price)
- Have a strong management team that supports the concept of an ESOP formation (and of the employee ownership of the sponsor company)[2]

An ESOP can be an important tool to increase performance at private companies that have a strong management team and an ownership culture. The ESOP can promote employee productivity, job satisfaction, job stability, and employee tenure.

How Will My Business Operate after an ESOP Installation?

Who Runs the Sponsor Company?

The Trustee will act as shareholder of record of the shares owned by the ESOP. Although the Trustee of a majority-ESOP-owned company will be responsible for electing and overseeing the sponsor company board of directors (the "board"), the Trustee will typically refrain from making business and governance decisions (with the exception of potentially bargaining for the addition of one or two independent board members).

The corporation's board of directors will continue to run the sponsor company following an ESOP transaction.

The following list provides some examples of typical board-level functions (before and after an ESOP is established):

- Approving budgets
- Enacting corporate policies and objectives
- Appointing officers
- Hiring management to run the day-to-day operations of the company

Ongoing ESOP Maintenance Expenses

An ESOP has annual expenses associated with sponsorship—just like any other employer sponsored benefit—that are borne by the sponsor company and/or the ESOP trust. Because the ESOP holds stock, however, most of those expenses will need to be funded by the employer (versus being paid for with plan assets).

These expenses often include the following:

- Sponsor company legal adviser fees
- Trustee fees
- Trustee valuation adviser fees
- Trustee counsel (limited involvement) fees
- Third-party administrator fees

Investment Planning Strategies

An ESOP implementation should not prohibit other investment planning strategies. An ESOP may co-invest with other investors willing to provide capital to the sponsor company. Such contribution may be at a lower-tier limited liability company ("LLC") level (i.e., below the sponsor company) or a direct investment in the sponsor company, alongside the ESOP trust.

There are certain structural design requirements that would require planning (e.g., how a corporation structure may be used within an LLC "blocker" structure and where each investment occurs). However, many ESOPs successfully own companies that include other forms of outside investment.

An ESOP also does not forestall other transaction considerations. To the extent that an ESOP-owned company is an attractive "takeover" target, ESOP ownership simply means that the ESOP participants will participate in the value paid for the sponsor company.

Compensation Structure

The sponsor company is permitted to provide appropriate and market-based compensation for its management and employees. To the extent a board determines that implementation of an equity-based program (or "synthetic" equity program, e.g., phantom stock) is appropriate, such a program may be

implemented and awarded as the board—or the board compensation committee—sees fit.

The appropriate standard for compensation remains a corporate decision, subject to corporate fiduciary judgment and related requirements. While a Trustee may request information on these matters, the Trustee typically will not vote on the compensation awards.

What Are the Legal and Regulatory Standards for an ESOP?

An employee's retirement benefit under an ESOP is the sum of contributions, forfeitures, and earnings during participation in the ESOP. Because an ESOP ties employees' retirement to the value of the sponsor company, an ESOP is governed by strict federal standards.

To take advantage of an ESOP's income tax benefits, a sponsor company must comply with process, valuation, written plan document, eligibility, contribution, allocation, vesting, voting, diversification, and distribution requirements prescribed by the Code and ERISA.

Process Requirements

ERISA standards and state-level corporate law influence the corporate governance of an ESOP-owned company. ERISA requires that any company that creates an ESOP, does so only in the best interest of its employees—the people who actually expect a portion of their retirement savings to consist of stock in the company for which they work.

ERISA requires that the ESOP be represented by a Trustee. The Trustee acts as the shareholder of record of all shares held by the ESOP.

ERISA mandates certain actions (i.e., fiduciary duties) that require that an ESOP's fiduciaries—which generally include the Trustee and the sponsor company—establish and operate the ESOP for the exclusive purpose of providing benefits to ESOP participants and beneficiaries.

ERISA provisions govern the board—to the extent of the board's responsibility to appoint, monitor, and remove the Trustee and/or where the board otherwise acts in an ERISA fiduciary capacity.

ERISA also prohibits certain actions ("prohibited transactions") by a fiduciary that may involve self-dealing and conflicts of interest.

To avoid a prohibited transaction, the ESOP must:

1. purchase sponsor company shares at a price that is no more than "adequate consideration" or
2. sell sponsor company shares at a price that is no less than "adequate consideration."

In the case of private company stock, the U.S. Department of Labor ("DOL") defines "adequate consideration" as the fair market value of the stock, as determined:

1. in good faith by the Trustee or named fiduciary pursuant to the terms of the ESOP and
2. in accordance with DOL regulations.

Generally, an ESOP must be established as a "permanent arrangement." While this *does not* mean the ESOP must exist "forever," it does mean that at the time of implementation there was not a short-term plan to terminate or eliminate the arrangement.

For example, if an ESOP is terminated within three years of its implementation, there should be

good facts indicating that such termination was in connection with an event not contemplated at the time the ESOP was established as a benefit form.

Valuation Requirements

The ERISA reporting and disclosure rules work in tandem with the Code qualification standards to require that an independent appraiser value a private sponsor company ESOP's stock holdings on at least an annual basis for the purpose of contributions and distributions made during that year (i.e., the "administrative valuation").

The Code requires that administrative valuations be performed by an independent appraiser who works for/responds to the Trustee (as defined below) only. The independent appraiser cannot provide any other services to—or otherwise be related to—the sponsor company.[3]

The Service, DOL, and federal court guidance make clear that reliance on a given ESOP valuation—for whatever purpose—is a fiduciary decision that must be exercised on a nondiscriminatory basis and in good faith.

Usually performed as of the end of the plan year, the valuation analysis typically is based on the fair market value standard of value. The administrative valuation is used to report benefits on benefit statements and to pay distributions to participants.

Written Plan Document Requirements

The Code requires that an ESOP be administered based on a written defined contribution plan that complies with Code qualification rules. To comply with these provisions of the Code, an ESOP document must contain certain specific terms (detailed below).

Eligibility Requirements

Employees over age 21 who work more than 1,000 hours per year must generally be eligible to participate in the ESOP. The ESOP document may provide eligibility criteria that are more favorable than this standard (e.g., employees over age 18; less onerous service requirements).

The ESOP document may exclude certain classes of employees, such as "union" employees, leased employees, nonresident aliens with no U.S. source income, temporary employees, or interns (provided that such designation is not intended to circumvent the maximum service requirement that may be imposed).

It is noteworthy that providing ESOP benefits to union employees outside of a collectively bargained agreement may cause a labor violation.

Contribution Requirements

An ESOP may accept sponsor company contributions similar to those made to other qualified retirement plans, including matching contributions and profit sharing contributions.

Code provisions permit sponsor companies to make an annual tax-deductible contribution—in shares of employer stock or cash—that is equal to 25 percent of the total eligible payroll of ESOP participants. Shares of sponsor company stock contributed to an ESOP are valued based on current fair market value (for purposes of determining the amount of the contribution and applying appropriate Code limits).

Amounts paid toward interest on an ESOP loan are not included in calculating the 25 percent limit for C corporations.

The Code also permits a C corporation to deduct reasonable dividends paid on sponsor company stock held by an ESOP.

In order to take advantage of the dividend deduction, the terms of the written ESOP document should provide that the dividends are paid in one of the following ways:

- In cash to participants
- To the ESOP trust and, within 90 days after the close of the plan year in which the payment was received, distributed in cash to the participants
- To the ESOP trust and used to purchase additional stock

If sponsor company contributions exceed the deduction limits, the Code imposes a 10 percent excise tax on the excess. This includes dividends as well as contributions to other defined contribution plans.[4]

Contributions are—regardless of the 25 percent deduction limit—limited in amount on a participant basis by the Code. The limitation is that no participant may receive more than the lower of $57,000 or 100 percent of compensation as a contribution in a plan year.[5]

The sponsor company can increase current cash flow by issuing new shares or treasury shares and contributing those shares to the ESOP. In other words, an ESOP can be fully funded by contributing

shares of employer stock to the plan which will delay the need for cash amounts to be paid to the ESOP/participants.

It is noteworthy that this provision will dilute existing business owners. Therefore, the sponsor company must have sufficient shares authorized.

Many employers opt to use stock contributed to an ESOP as a 401(k) plan match feature, which provides a cash flow neutral (subject to limits under the Code) tax deduction opportunity.

Allocation Requirements

Allocations of annual contributions must accumulate in an ESOP participant's account until the participant resigns, dies, retires, or is terminated. Code rules require that allocations be made generally at the end of the year either on the basis of relative pay or another equal, nondiscriminatory formula (i.e. per capita, seniority, or a combination thereof).

An ESOP may limit the ability to hold stock to active employees only. This is accomplished through terms of the ESOP document that require converting into cash the shares of employer stock held in the accounts of terminated employees and reallocating the shares amongst active employees.

ESOPs may condition participant eligibility for allocations on employment on the last day of the plan year and/or 1,000 hours of service.

The shares held by an ESOP should participate on a pro rata basis whenever the sponsor company declares a dividend payment.

Vesting Requirements

Vesting refers to the amount of time an employee must work before acquiring a nonforfeitable entitlement to his or her benefit. A participant begins to vest according to a schedule incorporated into the ESOP plan document, generally after one full year (1,000 hours) of service.

The Code requires that participants fully vest in their ESOP accounts on a three-year cliff schedule (no vesting at all for the first years, followed by 100 percent vesting after the third year of service) or a six-year graded vesting schedule (20 percent vesting after the second year of service, followed by 20 percent each year until full vesting occurs).

ESOP plan documents may contain vesting that is more generous than a three-year cliff or six-year graded schedule.

Voting Requirements

In general, the Trustee is only permitted to vote on matters reserved for a shareholder vote. On an annual basis, this would typically refer to board elections. If the ESOP holds private employer company stock, certain matters have to be "given" to participants who may direct the Trustee as to how to vote shares held in such participants' accounts.

These are limited matters including the voting of shares with respect to the approval or disapproval of any corporate merger or consolidation, recapitalization, reclassification, liquidation, dissolution, or sale of substantially all assets of a trade or business.

It is noteworthy that a direct stock sale of all corporation stock typically does not trigger a pass-through vote to ESOP participants, but such a sale is subject to the Trustee's approval.

Distribution Requirements

Employees pay no income tax on the contributions to an ESOP until distribution from their accounts. Participants can roll over their distributions to an individual retirement account or other retirement plan (and continue to defer taxes) or pay current tax on the distribution with any gains accumulated over time taxed as capital gains.

The income tax portion of the distribution is subject to a 10 percent penalty if made before normal retirement age.

Distributions from an ESOP are generally made at the election of the employee. Distributions may be made in lump sum or installments, and distributions may be immediate or deferred.

The Code generally requires that an ESOP begin the payment of benefits to a participant no later than one year after the end of the plan year in which the participant terminates employment because of normal retirement, disability, or death.

The Code provides that a participant that terminates employment for reasons other than death, disability, or retirement must begin to receive distributions within six years of his or her termination date.

The "repurchase obligation" triggered by distribution requirements is typically handled in one of the following ways:

- The sponsor company makes a tax deductible contribution to the ESOP in an amount equal to the distribution requirement owed in a given year. The ESOP allocates the cash among active, eligible employees.

"[ESOPs] provide a popular—and tax-effective—way to manage succession planning, business owner tax liability, employee retirement security, and employee retention."

The cash amounts are immediately used to buy the shares from the to-be-distributed employees (e.g., the terminated employees). The cash allocation made to the active participants is replaced with these shares. So, as an end result, the terminated individuals receive the cash value of their investment, and the active employees receive the purchased shares.

The shares of the sponsor company stock stay within the ESOP in this instance and are "recycled" to active participants. In this instance the ESOP retains the same share ownership and is not diluted as a result of this process.

- The sponsor company pays the terminated participant directly and the shares of employer stock are retired to treasury. The sponsor company may then retain such shares in treasury stock (lowering the number of shares held by the ESOP and diluting ownership vis-a-vis non-ESOP shareholders) or make contributions of such shares to the ESOP.

Diversification Requirements

When employees reach age 55 and have 10 years of participation in the ESOP, the Code requires that they be given the option of either:

1. diversifying 25 percent of their account balance in sponsor company shares among at least three other investment alternatives or
2. receiving cash distributions equal to 25 percent of their sponsor company share account balance.

At age 60, employees can elect to have 50 percent of their sponsor company share account balance diversified in other investments or distributed to them.

The Code states that diversification distributions must begin within 180 days—or six months—of the end of a given plan year. There is no similar timing rule with respect to distributions occurring at termination from service.

Summary and Conclusion

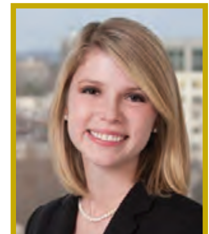
There are successful ESOPs in almost every industry—and in companies of all sizes. Though a business owner must be mindful of the complex legal and regulatory requirements associated with the ESOP structure, these specialty retirement plans provide a popular—and tax-effective—way to manage succession planning, business owner tax liability, employee retirement security, and employee retention.

This discussion provided a summary of considerations for a private company business owner curious about selling to an ESOP, and explained why an ESOP is worthy of consideration by private company business owners.

Notes:

1. https://www.nceo.org/articles/employee-ownership-by-the-numbers. For reference, the NCEO and the ESOP Association are two prominent nonprofit organizations that provide a variety of resources for the purpose of educating business owners regarding ESOPs and employee ownership.
2. See Robert F. Reilly and Robert P. Schweihs, *Best Practices—Thought Leadership in Valuation, Damages, and Transfer Price Analysis* (Ventnor, NJ: Valuation Products and Services, LLC, 2019), 684.
3. Code 401(a)(28)(C).
4. "Reasonable dividends" that are distributed to participants or reinvested in stock do not count toward this limit for C corporations.
5. This Code Section 415 limit is applied across all employer-sponsored plans. This means that the limit includes not only amounts paid to an ESOP, but also amounts paid to the sponsor company's 401(k) plan.

Emily Rickard is an associate at the law firm of McDermott Will & Emery and is based in its Washington, DC, office. She focuses her practice on ERISA compliance and has devoted a substantial portion of her practice to assisting employers in implementing and maintaining ESOPs. Emily can be reached at (202) 756-8370 or at erickard@mwe.com.



Erin Turley is a partner at the law firm of McDermott Will & Emery and is based in its Dallas, Texas, office. She focuses her practice on employee benefits matters, and has extensive experience handling issues pertaining to ERISA and ESOPs. Erin can be reached at (214) 295-8020 or at eturley@mwe.com.

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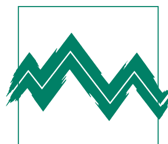

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Best Practices Discussion

Employee Stock Ownership Plan Financial Feasibility Analysis: Financial Considerations for Shareholders

Robert F. Reilly, CPA

The owners of a private company who are looking for an exit strategy may consider the sale of all (or part) of that company to an employee stock ownership plan ("ESOP"). Such an exit strategy may be particularly attractive to baby boomer private company owners who are seeking retirement and liquidity and who would prefer to see their loyal employees retain a stake in the company ownership. This discussion summarizes the factors that such private company owners should consider—and the feasibility analysis that their financial advisers should perform—to assess whether a sale of the private company stock to an ESOP makes sense as an ownership transition strategy.

Introduction

When it is time for the owners of a private company to consider an ownership transition (i.e., a sale of the company on the path to retirement), a sale to the company employees may be one option to consider. This particular ownership transition exit strategy is often implemented through the formation of an employee stock ownership plan ("ESOP").

The private company sponsors (i.e., arranges) the formation of the ESOP. And, the ESOP trust buys the private company stock, often through a leveraged stock acquisition transaction. As discussed below, the selling stockholders may or may not provide seller financing to make the stock acquisition transaction more attractive to the employees.

Through the ESOP's acquisition of the company stock, the selling stockholders receive liquidity—usually in a tax-advanced structure. The selling stockholders achieve the ownership transition objective that they are seeking. And, the loyal employees enjoy a stake in the ownership of the employer company on a going-forward basis.

Obviously, an ESOP formation and a leveraged stock acquisition is not the appropriate ownership transition strategy to satisfy every private company owner's exit plan. This discussion summarizes the financial factors that the current company shareholders should consider before the company sponsors an ESOP formation.

In addition, this discussion describes the ESOP financial feasibility analysis (and the other issues) that the company financial advisers should consider before the current owners implement a sale of the private company to an ESOP.

Before a private company proceeds with the formation of an ESOP, the company owners should participate in an ESOP formation feasibility analysis. The purpose of a feasibility analysis is to give both the selling shareholder(s) and the private company management/directors the information they will need to determine whether to move forward:

1. with the ESOP formation and
2. with the ESOP's purchase of the company stock.

The results of the feasibility analysis should enable the private company, the trustee of the to-be-formed ESOP, the selling shareholder(s), and the legal counsel to all parties to structure a transaction that is beneficial to all of the such parties.

Of course, in order to comply with the applicable federal laws, such a stock purchase transaction must be fair to the to-be-formed ESOP from a financial point of view.

This discussion summarizes the process of the ESOP financial feasibility analysis. And, this discussion summarizes how the parties to the ESOP formation may use the information developed in the financial feasibility analysis to decide if—and how—to structure the ownership transition transaction.

In the decision to implement an ESOP purchase of the private company stock, the selling shareholders have to consider whether (and at what price) to sell their company shares to the ESOP. The selling shareholders also have to decide whether they are willing to give up ownership control of the private company to a new owner—that is, to the ESOP.

This transfer of ownership control consideration is also relevant in an ESOP formation where the private company itself (and not the current shareholders) sells treasury shares to the ESOP.

The company managers and company directors have to consider whether the company can afford to finance the ESOP stock purchase transaction—particularly if the ESOP transaction is to be a leveraged stock purchase. The company managers and company directors also have to consider the other (nondebt service) ESOP-related costs—such as plan administration expenses, regulatory compliance expenses, and financial statement impact "costs."

The information developed during the ESOP financial feasibility analysis allows these parties to decide whether or not an ESOP stock purchase transaction is an effective strategy for achieving the current shareholders' ownership transition and liquidity objectives. Each ESOP feasibility analysis will be different—depending on each private company's situation.

However, most ESOP feasibility analyses include certain basic considerations in order to:

1. provide meaningful information to all of the parties involved in the ESOP formation and the private company sale decision and
2. avoid costly mistakes that could impair the long-term success of the ESOP (and of the private company itself).

The Employee Stock Ownership Plan

An ESOP is an employee benefit plan that provides employees with an equity ownership interest in the sponsor company. An ESOP is an employee retirement plan that in some ways is similar to (and governed by) the same statutory authority and administrative regulations as a 401(k) plan.

Through the ESOP, the sponsor company creates a trust for the company employees. Either the sponsor company contributes cash to the ESOP to allow the trust to purchase the sponsor company stock shares or the ESOP trust borrows funds from a financial institution (or from the selling stockholders) to purchase the sponsor company stock shares. Alternatively, the sponsor company may contribute shares of stock (from the company treasury stock) directly to the ESOP. In any event, the company employees obtain ownership in the employer company through the ESOP trust.

The sponsor company's contributions to the ESOP (to allow the ESOP trust to buy the employer shares or to pay back the stock acquisition loan) are tax deductible to the sponsor company. However, the employees do not recognize an income tax liability for the sponsor company contributions until the employees actually receive the shares of stock. That receipt typically occurs either when the employee leaves the company or retires.

ESOPs were created by, and are regulated by, the Employee Retirement Income Security Act of 1974 ("ERISA"). In addition, an ESOP is an Internal Revenue Code ("Code") Section 401(a) qualified defined contribution plan that is either a stock bonus plan or a stock bonus/money purchase plan.

The ESOP must be designed to invest primarily (although not exclusively) in qualifying employer company securities—as defined by Code Section 4975(e)(8). In addition, the ESOP must meet other qualifying requirements of the Code and the Regulations.

The Internal Revenue Service and the U.S. Department of Labor both have regulatory jurisdiction over ESOPs and ESOP sponsor companies.

The ESOP Financial Feasibility Analysis

In general, an ESOP feasibility analysis should address the following transaction pricing and structuring questions:

- What parties will actually sell the private company shares to the to-be-formed ESOP?

- How will the to-be-formed ESOP finance the purchase of the private company stock?
- How will this new stock acquisition financing (if any) affect the cash flow of the private company?
- What is the best plan design for the company? For example, should the company merge the to-be-formed ESOP with its existing 401(k) plan?
- What are the ERISA and the Code (and state securities law) requirements with respect to an ESOP that the company management and the selling shareholder(s) should know about?
- What if the company actual future results of operations vary—positively or negatively—from any financial projections prepared at the time of the company stock purchase transaction?
- How does the selling shareholders' desired sale price for the private company stock compare to the range of company stock fair market values estimated by the independent financial adviser or valuation analyst (hereinafter, collectively, the "analyst") working for the to-be-formed ESOP trustee?

Initial Considerations

The initial considerations regarding the ESOP feasibility analysis may be assessed by the company's selling shareholder(s)—with the help of the company management. That is, the ESOP feasibility initial considerations may be determined without the need to retain an independent analyst or legal counsel.

In general, private companies that are reasonable candidates to successfully implement an ESOP formation—and to sponsor a sustainable ESOP—have the following characteristics:

- Be a private U.S. company
- Employ more than 25 full-time employees
- Have an established track record of consistent profitability and earnings growth
- Have at least 10 years of company operating history
- Report at least $10 in company annual revenue
- Have one or more company owners who are interested in investment liquidity and in a diversification of their personal wealth
- Have one or more company owners who are interested in ownership/management succession planning and in the transition of the company ownership to the employees
- Have one or more company owners who would consider accepting a reasonably conservative stock value (i.e., a price that is at the lower end of the range of corporate acquirer transaction prices)
- Have a senior management team that supports the concept of an ESOP formation (and of the employee ownership of the private company)

The controlling shareholder(s) should assess the company relative to these benchmark characteristics in order to determine if the company is a reasonable candidate for an ESOP formation. This initial feasibility analysis may be performed internally within the private company—that is, without the company having to spend large amounts of time and money.

That is, if the private company, the selling shareholders, and the company management do not "pass" these threshold characteristic "tests," then the company may not be a particularly good candidate for an ESOP formation. The company stockholders and the company management do not need to proceed to the financial, valuation, or administrative "tests" associated with an ESOP formation.

The next procedure of the feasibility analysis is for the company shareholders and company management to become more familiar with the ESOP installation process. This procedure should include developing a familiarity with the financial, legal, administrative, and regulatory aspects of an ESOP

formation. The ESOP Association and the National Center for Employee Ownership are useful resources for this type of information.

This "process familiarity" procedure should allow the parties in interest to address questions such as the following:

- Can the differing goals and objectives of the various company shareholders—and of the other parties to the proposed stock sale transaction (e.g., the management team, employees, nonselling shareholders, etc.)—be achieved through the formation of an ESOP?
- Would a company merger or a sale to a strategic corporate acquirer—or some other type of company liquidity event—be better suited to achieve the objectives of the company shareholders, management, and other parties?
- What percentage of the private company stock will the to-be-formed ESOP own after the stock purchase transaction? And, which shareholders will sell or redeem their shares as part of the ESOP's stock purchase transaction?
- How will the current company management—and the current controlling shareholder(s)—react to the inevitable changes in voting/control rights and in corporate governance?
- How will the company's current management succession planning be addressed in relation to the stock ownership change transaction? How long will the selling shareholders (assuming they are also company managers or directors) remain in their current management roles? How will the successors to the current executive management or board of directors be identified and transitioned in order to maintain operational management continuity on a going-forward basis?
- Is it desirable for the private company to merge the to-be-formed ESOP with the company's existing 401(k)—or other employee benefit—plan?
- What happens to any existing management incentive (compensation) plans? Will a new management compensation plan be introduced at the same time as the ESOP stock purchase transaction?
- Which of the company's employees will (and will not) be eligible to participate in the to-be-formed ESOP?

Consideration of these questions may help to clarify the strategic objectives (and the personal objectives) of all interested parties to the private company ownership transition. In order for the ESOP formation to be successful, the means of achieving these strategic objectives (and these personal objectives) should be evaluated as part of the ESOP feasibility analysis.

If these initial procedures indicate that financing an ESOP stock purchase transaction is a reasonable alternative for achieving the objectives of most of the interested parties, then it may be time for the company to retain experienced ESOP advisers.

These ESOP advisers will address some of the more technical (and complex) ESOP formation feasibility issues. These ESOP advisers typically include a trustee, legal counsel, an independent financial adviser/analyst, and perhaps others.

Typical Components of an ESOP Financial Feasibility Analysis

A comprehensive ESOP feasibility analysis typically includes several transaction planning, pricing, structuring, administrative, and legal considerations. These considerations typically include the following:

- A preliminary valuation of the private company stock to estimate the approximate fair market value price that the to-be-formed ESOP could or may pay
- A quality of earnings (or sometimes called a stockholders' equity) analysis to determine how the to-be-formed ESOP would affect (1) the existing company shareholders and (2) the company's future financial performance
- A plan design study to determine the most beneficial stock ownership transition transaction structure and which plan features to incorporate in the to-be-formed ESOP
- A liquidity study to assess the future demands that the ESOP stock repurchase obligation may eventually make on the private company

A Preliminary Valuation Analysis

A preliminary valuation analysis of the company stock is an important component of the ESOP financial feasibility analysis. It is one of the

procedures that should be performed early in the process. Accordingly, this preliminary valuation analysis may be performed by an analyst without undertaking a comprehensive due diligence investigation.

Therefore, the analyst typically cannot provide a final opinion of the fair market value of the private company stock. Rather, the analyst provides an opinion of a reasonable—but not final—range of fair market value indications for the private company stock.

The estimation of the company stock value is a complex process—and it is important to the ESOP formation decision. Accordingly, the parties usually retain an analyst who is experienced in ESOP—and ERISA-related—stock valuations.

In fact, typically the selling shareholders (and/or the company) and the trustee to the to-be-formed ESOP typically each retain their own independent analyst at this stage of the feasibility analysis. Regardless of whether the analyst is retained by the company's selling shareholders or by the to-be-formed ESOP trustee, the analyst's preliminary value conclusion is typically expressed as a range of fair market values for the private company stock.

At this stage of the feasibility analysis, an analyst experienced in ESOP—or ERISA-related—stock valuations will typically estimate a reasonable range of stock values without preparing a narrative valuation report. Consequently, the expense associated with this preliminary valuation analysis is usually less than the expense associated with the analyst's final stock valuation analysis (and the preparation of a written narrative valuation report).

The estimation of the preliminary range of company stock fair market values is often considered on the "critical path" of the ESOP formation process. It is important for all of the parties to find out early if:

1. the preliminary stock value range is less than the per-share stock price desired by the company's selling stockholders and
2. transaction structuring alternatives, such as earn-outs or warrants, cannot be used to encourage the company's selling stockholders to accept the preliminary stock price.

In such an instance, other strategies may have to be considered to increase the ownership transition attractiveness to the company's selling shareholders. Such "other" strategies may include waiting until the company's financial performance improves, reducing company operating expenses, and the like. In other words, what can the selling shareholders do to increase the value (i.e., the selling price) of the private company?

If the company's principal shareholders are not willing to sell their stock to the ESOP, or to permit the company to issue new shares of stock at a price within the preliminary range of fair market values estimated by the analyst, then the ESOP formation process may be abandoned.

"The estimation of the preliminary range of company stock fair market values is often considered on the "critical path" of the ESOP formation process."

Therefore, the preliminary range of fair market values for the company stock should be concluded as early as possible in the ESOP feasibility process. That way, the selling shareholders can change direction and evaluate other liquidity alternatives—while still minimizing the expense incurred to pursue an ESOP formation strategy that will ultimately be unsuccessful.

The Quality of Earnings Analysis

Often, the following components of the financial feasibility analysis can all be performed concurrently:

1. The quality of earnings analysis (which includes what is often called a stockholders' equity analysis)
2. The company liquidity (or cash flow test) study
3. The ESOP plan design study

In fact, these financial and administrative analyses can be performed at the same time that the preliminary stock valuation analysis is being performed.

The quality of earnings analyses should address several of the important questions that are typically asked by the company's principal shareholders. These principal shareholders are typically interested in the following considerations, particularly for the time period during which the ESOP stock purchase loan will be outstanding:

- How will the ESOP affect the fair market value of their (retained) stock ownership?
- How will the ESOP affect the company's expected cash flow and the company's expected profitability?
- What dilution effect will the ESOP-owned shares have on the fair market value of the company stock?

If the private company already has an existing pension and/or profit-sharing plan, the quality of earnings analysis may also compare:

1. the effects of the ESOP stock ownership on the company's benefit plans—in contrast to
2. the effects of the current stock ownership (without the ESOP formation) on the company's existing plans.

The quality of earnings analysis typically applies management-prepared financial projections—projections with alternative growth and profitability assumptions and other ESOP transaction variables—to create several alternative scenarios.

The analyst typically performs this scenario analysis to illustrate the resulting impact of the to-be-formed ESOP on:

1. the private company cash flow and
2. the private company stock value.

The cash flow component of the quality of earnings analysis can also be used as a structuring tool to help evaluate a mixture of stock purchase financing options. The alternative ESOP stock purchase financing options may include varying levels of bank debt financing versus seller note financing—as well as the assorted terms and conditions of the proposed financing structure.

In the quality of earnings analysis, some of the analysis variables that may be typically adjusted (or "stress tested") in order to construct alternative scenarios include the following:

- Company revenue growth rates
- Company operating profit margins
- The amounts of the company's current operations-related bank financing

- The amounts of—and the terms of—the ESOP stock purchase bank financing
- The ESOP stock purchase bank financing terms (e.g., interest rates, covenants, maturity, required prepayments, guarantees, etc.)
- The amounts of any selling stockholder-provided financing
- The terms of any selling stockholder subordinated debt (e.g., interest rates, maturity, required prepayments, warrants, etc.)
- The refinancing of the company's existing bank debt
- Any expected future capital expenditure investment requirements
- Any expected future working capital investment requirements

Often, the analyst applies the management-prepared financial projections as a "base case" scenario in the quality of earnings analysis. The analyst then adjusts (or "stress tests") the revenue, expense, investment, and income projection variables in order to create alternative financial projected scenarios. These alternative scenarios may include financial projections that reflect prospective operations under optimistic, pessimistic, and zero growth conditions.

These alternative scenarios typically hold all of the other company operational variables constant across the various sets of conditions. The goal of stress testing the operational variables in these alternative scenarios is to analyze how the private company could fare under alternative future operating circumstances.

The Liquidity Analysis

The liquidity analysis component of the ESOP feasibility analysis is intended to estimate the amount of the ESOP stock repurchase obligation that the company may incur over the next, say, 10 to 15 years. This ESOP stock repurchase obligation results from the employees' expected future terminations of service due to death, disability, retirement, and so forth.

The liquidity analysis typically does not address the source of funding for the ESOP stock repurchase obligation. Nonetheless, this liquidity analysis is a valuable tool that can help the private company management to estimate the timing of—and the amount of—the funding that may be needed in the future for repurchasing the allocated shares from any departing employees.

This information allows the private company management to make the appropriate financing, insurance, or other liquidity plans.

The Plan Design Study

The greater the flexibility included into the design of the ESOP documents themselves, the more effectively the ESOP will be able to accomplish its objectives.

The ESOP plan design study will typically address the following issues:

- Plan participant eligibility
- Employee vesting schedules
- The timing of the benefit distributions
- Forfeitures of the departing employees
- Company contribution levels
- Employee account allocation formulas
- Past service credit
- Early retirement policies
- A corporate charter or bylaw provision that restricts the stock ownership to the employee group

The use of one or more special classes of stock (e.g., nonvoting stock, preferred or convertible preferred stock, etc.) may also be addressed in the ESOP plan design study.

Some of the other questions that may need to be considered in the ESOP plan design study include the following:

- Who will (and who will not) be able to participate in the to-be-formed ESOP?
- Must the private company distribute the shares of stock to employees at retirement—or at other required distribution dates—if the employees demand it, or can the company just limit the form of the distributions to cash?
- What company divisions or subsidiaries may be excluded from the plan?
- Who will (and who will not) be able to vote the shares of the ESOP-owned private company stock—and under what circumstances?
- Should the private company combine other benefit plans, such as a 401(k) plan, with the ESOP?
- What will happen to the company's existing pension or profit-sharing plan?
- Is the existing company pension plan overfunded, underfunded, or adequately funded?
- What about the selection of the ESOP fiduciary/trustee, and of any possible administrative and/or advisory committee(s)?

The consideration of income tax issues should also be part of the plan design phase of an ESOP feasibility analysis. The relevant income-tax-related issues may include the tax implications of ESOP-related legislation, regulations and administrative rulings, and judicial precedent.

"The greater the flexibility included into the design of the ESOP documents themselves, the more effectively the ESOP will be able to accomplish its objectives."

In addition, all of the interested parties should consider the implications of the following issues:

1. The "tax-deferred reinvestment" or "tax-free rollover" election available for the selling shareholders with regard to the sale proceeds of the private company stock to an ESOP
2. The tax deductibility to the employer company of dividend payments if paid to the ESOP participants or used to repay the ESOP stock purchase loan
3. Compliance considerations for an S corporation company that will be owned by an ESOP
4. Any new or currently proposed tax regulations or tax legislation

If a deferred profit sharing or money purchase pension plan already exists at the private company, it is normally "frozen." The assets of the existing benefit plan will typically remain invested in a diversified portfolio of publicly traded securities.

However, the employees can be given the option to invest a portion—or all—of their assets from a profit sharing, money purchase, or 401(k) plan into either (1) the company stock or (2) part of the ESOP stock purchase transaction.

Almost all ESOP sponsor companies either maintain or establish a diversified 401(k) plan that is not invested in the company stock. However, in some cases, the company may decide to merge its existing 401(k) plan with the newly formed ESOP.

In these situations, employees who are invested in the company's 401(k) plan are given the opportunity to invest their money into the ESOP. These funds are considered part of the stock purchase transaction financing. These funds are used to purchase the company's shares from the selling shareholder(s).

All federal and state securities laws should be complied with, and "full disclosure" should be

provided to the company employees. Full disclosure can be a fairly burdensome requirement for a private company.

As mentioned above, there are both expenses and risks associated with a new ESOP formation. For example, the private company that forms an ESOP will be required to create a disclosure memorandum.

The disclosure memorandum typically describes the following:

1. The nature of the company's business operations
2. The company's historical financial performance
3. Company management's expectations regarding the company's future financial performance
4. The risks associated with investing in the company stock
5. Other information that an investor may require in order to make an informed investment decision

The disclosure memorandum is then distributed to the company employees. The employees are typically given 20 to 30 days to make their decisions about investing in the company stock. The distribution of this disclosure memorandum may be considered a risk to the ESOP formation process. This is because, often, the company employees may not have the financial sophistication—or the desire—to evaluate all of the information provided in the disclosure memorandum.

Therefore, some employees may simply elect not to invest in the private company stock. As a result, the company may not receive the level of employee participation that was expected for the ESOP formation.

In some cases, the company may make financial advisers available at no cost to the employees. These financial advisers may be provided in an effort to give the company employees the resources they need to make an informed investment decision. However, due to the expense associated with giving employees the option to invest their 401(k) or profit-sharing assets in the company stock, the company management should carefully weigh the risks versus the probability of success before pursuing this option.

If the company management determines that this option will be pursued, then a temporary "floor price" may be attached to the private company stock acquired with assets from other benefit plans. This temporary floor price often remains in effect until the ESOP's stock purchase loan is completely repaid.

In most cases, this "floor price" is calculated as the fair market value of the company stock without taking into account the impact of the ESOP's stock purchase loan.

The ESOP plan design features should also allow for factors that will positively influence employee motivation. For example, an accelerated vesting schedule may serve to motivate employee participation in the ESOP. However, as a means to prevent vested employees from terminating their employment prematurely in order to receive large account balances, the ESOP sponsor company may postpone the distribution of accounts to terminated employees for a certain time period.

The transfer of voting rights is also a concern for many shareholders of a private company. However, this issue has not actually resulted in a problem for ESOP-owned sponsor companies. The requirement to "pass through" voting rights to employees of private sponsor companies is a function of state law.

However, the voting rights "pass through" is usually only required for major corporate issues such as mergers, consolidations, recapitalizations, sale of the business, liquidation, dissolutions, and similar types of transactions.

When a trusted, experienced management team has a proven track record of successfully operating the business to achieve growth and profitability, the employees are generally content to not be involved in the management of the ESOP sponsor company.

Illustrative ESOP Financial Feasibility Quality of Earnings Analyses

This discussion section presents certain components of a quality of earnings analysis for two hypothetical private company ESOP formations:

1. The illustrative Alpha Widget Manufacturing Company
2. The illustrative Beta Professional Services Company

In the first illustrative example, let's assume that the principal stockholders of the hypothetical Alpha Widget Manufacturing Company ("Alpha") are considering an ESOP formation with the ultimate objective of achieving an ownership transition.

Exhibit 1 presents an illustrative "base case" operating scenario for Alpha. This "base case" scenario applies the illustrative financial projections provided to the analyst by Alpha management.

Exhibit 1
Alpha Widget Manufacturing Company
ESOP Formation Financial Feasibility Analysis
Prospective Financial Results of Operations
(Management-Prepared Financial Projections of the "Base Case" Scenario)
As of January 1, 2019

Years Ended:	Projected 12/31/19 $000s	Projected 12/31/20 $000s	Projected 12/31/21 $000s	Projected 12/31/22 $000s	Projected 12/31/23 $000s	Projected 12/31/19 %	Projected 12/31/20 %	Projected 12/31/21 %	Projected 12/31/22 %	Projected 12/31/23 %	5-Year Average %
Company Revenue	9,000	9,900	10,692	11,227	11,788	100.0	100.0	100.0	100.0	100.0	100.0
Revenue Growth Rate		10%	8%	5%	5%						
Cost of Goods Sold	6,120	6,732	7,305	7,706	8,128	68.0	68.0	68.3	68.6	69.0	68.4
Gross Profit	2,880	3,168	3,387	3,521	3,660	32.0	32.0	31.7	31.4	31.0	31.6
Operating Expenses	(2,121)	(2,086)	(2,027)	(1,915)	(1,810)	(23.6)	(21.1)	(19.0)	(17.1)	(15.4)	(19.2)
Operating Income (EBIT)	759	1,082	1,360	1,606	1,851	8.4	10.9	12.7	14.3	15.7	12.4
Interest Expense	(90)	(60)	-	(1)	(2)	(1.0)	(0.6)	-	(0.0)	(0.0)	(0.3)
Other Income (Expense)	518	-	-	-	-	5.8	-	-	-	-	1.2
Pretax Income	1,187	1,022	1,360	1,605	1,849	13.2	10.3	12.7	14.3	15.7	13.2
Cash Flow Projection:											
Earnings before Interest and Taxes	759	1,082	1,360	1,606	1,851	8.4	10.9	12.7	14.3	15.7	12.4
+ Depreciation and Amortization Expense	2,974	3,004	3,064	3,063	3,061	33.0	30.3	28.7	27.3	26.0	29.1
= EBITDA	3,733	4,086	4,424	4,669	4,912	41.5	41.3	41.4	41.6	41.7	41.5

Exhibit 1 presents the Alpha prospective results of operations for the next five-year period.

Exhibit 2 presents the illustrative proposed financing of the Alpha ESOP purchase of the private company stock. This analysis considers the deal financing structure, the debt interest rates, the debt maturities, and the resulting (post-ESOP) sponsor company cash flow and covenant compliance.

In this illustrative example, the Alpha ESOP will pay $13 million for the purchase of the private company common stock. In this illustrative example, the Alpha ESOP will borrow $13 million in total, arranged as follows: (1) $10 million in a bank term loan and (2) $3 million in subordinated financing from the selling stockholders.

In particular, Exhibit 2 tests whether Alpha will be in compliance with all of its debt financing covenants—based on both (1) the terms of the ESOP stock acquisition debt and (2) the "base case" financial projections.

Exhibit 3 illustrates the impact of decreasing management's revenue projections on the Alpha expected profitability and expected cash flow. Exhibit 3 presents the management-prepared "downside case" scenario financial projections.

Exhibit 4 illustrates how the "downside case" scenario decrease in the Alpha profitability affects the expected Alpha cash flow—and the expected ESOP stock acquisition debt covenant compliance.

In particular, Exhibit 4 tests whether Alpha will still be in compliance with all of the financing covenants—given the impact of the "downside case" scenario financial projections on the Alpha cash flow.

From this illustrative quality of earnings analysis, the interested parties to the proposed ESOP leveraged stock purchase transaction can assess the impact that a decrease in the company's expected revenue/profitability would have on the company's expected cash flow. The interested parties can then develop a plan of action—or alter the proposed ESOP leveraged stock purchase deal structure.

The purpose of such strategic plan changes—or transaction structure alterations—is to ensure that the sponsor company (i.e., the hypothetical Alpha) has adequate capital in the event that the "base case" financial projections are not achieved.

In this hypothetical situation, Alpha management may make the stock purchase lender (i.e., the term loan financial institution) aware of the amount of stress that the sponsor company could expect during the first year of the loan—should the Alpha projected revenue decrease by 15 percent.

Certain components of a second illustrative quality of earnings analysis are presented in Exhibits 5 and 6. This illustrative quality of earnings analysis estimates the fair market value of the stock of the hypothetical Beta Professional Services Company ("Beta"). This illustrative quality of earnings analysis is based on the company financial projections prepared by Beta management and presented in Exhibit 6.

In this hypothetical ESOP formation and ESOP stock purchase transaction, the transaction is

Exhibit 2
Alpha Widget Manufacturing Company
ESOP Formation Financial Feasibility Analysis
ESOP Stock Purchase Debt Service Projections
(Management-Prepared Financial Projections of the "Base Case" Scenario)
As of January 1, 2019

Years Ended December 31:		2019 $000s	2020 $000s	2021 $000s	2022 $000s	2023 $000s	2024 $000s	2025 $000s	2026 $000s
Stock Purchase Term Loan:									
Loan Principal Amount ($000s)	10,000								
Loan Interest Rate	4.65%								
Loan Amortization Period (years)	7								
Loan Term (years)	3								
Beginning Principal Balance		10,000	7,356	5,955	4,080	2,916	1,655	289	-
Principal Payments		2,644	1,401	1,874	1,165	1,261	1,366	289	-
Interest Payments		380	312	379	284	188	83	3	-
Total Loan Payment		3,025	1,713	2,253	1,449	1,449	1,449	292	-
Ending Principal Balance		7,356	5,955	4,080	2,916	1,655	289	-	-
Total Principal Payments		2,644	1,401	1,874	1,165	1,261	-	-	-
Total Interest Payments		380	312	379	284	188	-	-	-
Total Transaction Debt Service		3,025	1,713	2,253	1,449	1,449	-	-	-
Cash Flow Available for Debt Service		3,452	3,757	3,998	4,207	4,418	4,638	4,870	5,114
Senior Debt Service Coverage (Deficit)		427	2,044	1,745	2,758	2,969	4,638	4,870	5,114
Selling Shareholder Subordinated Note 1:									
Seller Note Principal Amount ($000s)	3,000								
Note Interest Rate	10.00%								
Note Term (years)	3								
Beginning Principal Balance		3,000	3,000	3,000	3,000	3,000	3,000	3,000	3,000
Principal Payments		-	-	-	-	-	-	-	-
Interest Payments		300	300	300	300	300	300	300	300
Total Loan Payment		300	300	300	300	300	300	300	300
Ending Principal Balance		3,000	3,000	3,000	3,000	3,000	3,000	3,000	3,000
Cash Flow for Debt Service		427	2,044	1,745	2,758	2,969	4,638	4,870	5,114
Subordinated Note Payment		300	300	300	300	300	300	300	300
Debt Service Coverage (Deficit)		127	1,744	1,445	2,458	2,669	4,338	4,570	4,814
Excess Cash Flow Amount:									
EBITDA		4,086	4,424	4,669	4,912	5,157	5,415	5,686	5,970
Less: Cash Interest Expense		680	612	679	584	488	300	300	300
Cash Income Taxes (if any)		-	-	-	-	-	-	-	-
Required and Voluntary Debt Payments (principal)		2,644	1,401	1,874	1,165	1,261	-	-	-
Unfinanced Capital Expenditures		495	545	588	617	648	648	648	648
Dividend Distributions		194	258	305	351	369	387	407	427
Treasury Stock Purchases		-	-	-	-	-	-	-	-
		72	1,609	1,223	2,194	2,391	4,079	4,331	4,595
Mandatory Prepayment		(36)	(804)	-	-	-	-	-	-
Adjusted Cash Flow		36	804	1,223	2,194	2,391	4,079	4,331	4,595
Beginning Cash		1,348	1,384	2,189	3,412	5,606	7,997	12,076	16,407
Ending Cash		1,384	2,189	3,412	5,606	7,997	12,076	16,407	21,002
Selling Shareholder Personal Loan Guarantee		2,500	2,500	2,500	2,500	-	-	-	-
Debt Covenant Compliance:									
Letter of Credit		-	-	-	-	-	-	-	-
Capital Expenditures Loan		-	-	-	-	-	-	-	-
Stock Purchase Term Loan		7,356	5,955	4,080	2,916	1,655	289	-	-
Seller Subordinated Note 1		3,000	3,000	3,000	3,000	3,000	3,000	3,000	3,000
Seller Subordinated Note 2		-	-	-	-	-	-	-	-
Seller Personal Guarantee		2,500	2,500	2,500	2,500	-	-	-	-
Total Funded Debt		12,856	11,455	9,580	8,416	4,655	3,289	3,000	3,000
EBITDA		4,086	4,424	4,669	4,912	5,157	5,415	5,686	5,970
ESOP Contribution Expense		-	-	-	-	-	-	-	-
EBITDAE		4,086	4,424	4,669	4,912	5,157	5,415	5,686	5,970
Total Leverage Ratio		3.15x	2.59x	2.05x	1.71x	0.90x	0.61x	0.53x	0.50x
Maximum Leverage Ratio Allowed		3.25x	3.25x	3.25x	3.25x	3.25x	3.25x	3.25x	3.25x
Is the Sponsor Company in Compliance?		Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes

Exhibit 3
Alpha Widget Manufacturing Company
ESOP Formation Financial Feasibility Analysis
Prospective Financial Results of Operations
(Illustrating a Decreased Revenue Projection in the "Downside Case" Scenario)
As of January 1, 2019

Years Ended:	Projected 12/31/19 $000s	Projected 12/31/20 $000s	Projected 12/31/21 $000s	Projected 12/31/22 $000s	Projected 12/31/23 $000s	Projected 12/31/19 %	Projected 12/31/20 %	Projected 12/31/21 %	Projected 12/31/22 %	Projected 12/31/23 %	5-Year Average %
Company Revenue	9,000	7,650	6,503	5,527	4,698	100.0	100.0	100.0	100.0	100.0	100.0
Revenue Growth Rate		-15%	-15%	-15%	-15%						
Cost of Goods Sold	6,120	5,202	4,443	3,794	3,239	68.0	68.0	68.3	68.6	69.0	68.4
Gross Profit	2,880	2,448	2,060	1,733	1,459	32.0	32.0	31.7	31.4	31.0	31.6
Operating Expenses	(2,121)	(1,612)	(1,233)	(943)	(721)	(23.6)	(21.1)	(19.0)	(17.1)	(15.4)	(19.2)
Operating Income (EBIT)	759	836	827	791	738	8.4	10.9	12.7	14.3	15.7	12.4
Interest Expense	(90)	(60)	-	(1)	(2)	(1.0)	(0.8)	-	(0.0)	(0.0)	(0.4)
Other Income (Expense)	518	-	-	-	-	5.8	-	-	-	-	1.2
Pretax Income	1,187	776	827	790	736	13.2	10.1	12.7	14.3	15.7	13.2
Cash Flow Projection:											
Earnings before Interest and Taxes	759	836	827	791	738	8.4	10.9	12.7	14.3	15.7	12.4
+ Depreciation and Amortization Expense	2,974	3,004	3,064	3,063	3,061	33.0	39.3	47.1	55.4	65.2	48.0
= EBITDA	3,733	3,840	3,891	3,854	3,799	41.5	50.2	59.8	69.7	80.9	60.4

financed by seller financing (i.e., the company selling stockholders provide the stock acquisition financing). In partial compensation for this seller financing, the selling shareholders will receive warrants to buy some of the Beta stock at a future date, as indicated in Exhibit 6.

The Beta management-prepared financial projections will typically present the company's prospective results of operations projected out to at least the year that all of the seller financing matures.

In this illustrative analysis, the company's expected future market value of invested capital ("MVIC") is estimated by applying illustrative market-derived valuation pricing multiples for each future period. These illustrative market-derived valuation pricing multiples include valuation pricing multiples applied to both (1) revenue and (2) EBITDA (earnings before interest, taxes, depreciation, and amortization). The two value indications are then averaged in order to arrive at a single MVIC valuation synthesis and conclusion for Beta.

Next, both the sponsor company operations-related long-term debt and the ESOP stock acquisition debt are subtracted from the Beta MVIC. And, an illustrative discount for lack of marketability is applied in order to arrive at the estimated fair market value of the sponsor company total equity—on a nonmarketable, noncontrolling ownership interest basis) for each year in the projection period.

In the illustrative example presented in Exhibit 5, warrants are attached to the selling shareholder debt. Let's assume that these warrants provide the selling shareholder with the right to purchase 700,000 shares of stock at 90 percent of the December 31, 2018, fair market value of equity per share. Let's assume that the warrants are available in tranches that are exercisable based on the sponsor company achieving certain EBIT (earnings before interest and taxes) profit targets.

Exhibit 6 presents the cash flow implications of the additional debt arising from the selling shareholders' exercise of the Beta warrants. This component of the illustrative quality of earnings analysis may help to facilitate the discussions between the Beta selling shareholder(s), the legal counsel, and the ESOP financial advisers with regard to the following issues:

1. The total return on the debt and the warrants to be received by the Beta selling shareholder(s)
2. The resulting dilutive impact of the selling shareholder warrants on the sponsor company stock fair market value
3. The cash flow implications of the timing and the magnitude of the warrant cash out payments

Summary and Conclusion

Upon the completion of the ESOP financial feasibility analysis, the analyst typically presents the findings to the private company's board of directors or

Exhibit 4
Alpha Widget Manufacturing Company
Stock Purchase Debt Service Projections
Prospective Financial Results of Operations
(Illustrating a Decreased Revenue Projection in the “Downside Case” Scenario)
As of January 1, 2019

Year Ended December 31:		2019 $000s	2020 $000s	2021 $000s	2022 $000s	2023 $000s	2024 $000s	2025 $000s	2026 $000s
Stock Purchase Term Loan:									
Loan Principal Amount ($000s)	10,000								
Loan Interest Rate	4.65%								
Loan Amortization Period (years)	7								
Loan Term (years)	3								
Beginning Principal Balance		10,000	7,356	6,059	4,279	3,104	1,833	455	-
Principal Payments		2,644	1,297	1,780	1,174	1,272	1,377	455	-
Interest Payments		380	316	394	300	202	97	7	-
Total Loan Payment		3,025	1,613	2,174	1,474	1,474	1,474	463	-
Ending Principal Balance		7,356	6,059	4,279	3,104	1,833	455	-	-
Total Principal Payments		2,644	1,297	1,780	1,174	1,272	-	-	-
Total Interest Payments		380	316	394	300	202	-	-	-
Total Transaction Debt Service		3,025	1,613	2,174	1,474	1,474	-	-	-
Cash Flow for Debt Service		3,555	3,648	3,647	3,623	3,804	3,994	4,194	4,404
Senior Debt Service Coverage (Deficit)		530	2,035	1,473	2,149	2,330	3,994	4,194	4,404
Selling Shareholder Subordinated Note 1:									
Seller Note Principal Amount ($000s)	3,000								
Note Interest Rate	10.00%								
Note Term (years)	3								
Beginning Principal Balance		3,000	3,000	3,000	3,000	3,000	3,000	3,000	3,000
Principal Payments		-	-	-	-	-	-	-	-
Interest Payments		300	300	300	300	300	300	300	300
Total Loan Payment		300	300	300	300	300	300	300	300
Ending Principal Balance		3,000	3,000	3,000	3,000	3,000	3,000	3,000	3,000
Cash Flow for Debt Service		530	2,035	1,473	2,149	2,330	3,994	4,194	4,404
Subordinated Note Payment		300	300	300	300	300	300	300	300
Debt Service Coverage (Deficit)		230	1,735	1,173	1,849	2,030	3,694	3,894	4,104
Excess Cash Flow Amount:									
EBITDA		3,840	3,891	3,854	3,799	3,988	4,188	4,397	4,617
Less: Cash Interest Expense		680	616	694	600	502	300	300	300
Cash Income Taxes (if any)		-	-	-	-	-	-	-	-
Required and Voluntary Debt Payments (principal)		2,644	1,297	1,780	1,174	1,272	-	-	-
Unfinanced Capital Expenditures		495	421	358	304	258	258	258	258
Dividend Distributions		147	157	150	140	147	154	162	170
Treasury Stock Purchases		-	-	-	-	-	-	-	-
		(127)	1,400	872	1,581	1,809	3,475	3,677	3,889
Mandatory Prepayment		(63)	(700)	-	-	-	-	-	-
Adjusted Cash Flow		(190)	700	872	1,581	1,809	3,475	3,677	3,889
Beginning Cash		1,348	1,158	1,858	2,730	4,311	6,120	9,595	13,272
Ending Cash		1,158	1,858	2,730	4,311	6,120	9,595	13,272	17,161
Selling Shareholder Personal Loan Guarantee		2,500	2,500	2,500	2,500	-	-	-	-
Debt Covenant Compliance:									
Letter of Credit		-	-	-	-	-	-	-	-
Capital Expenditures Loan		-	-	-	-	-	-	-	-
Stock Purchase Term Loan		7,356	6,059	4,279	3,104	1,833	455	-	-
Seller Subordinated Note 1		3,000	3,000	3,000	3,000	3,000	3,000	3,000	3,000
Seller Subordinated Note 2		-	-	-	-	-	-	-	-
Seller Personal Guarantee		2,500	2,500	2,500	2,500	-	-	-	-
Total Funded Debt		12,856	11,559	9,779	8,604	4,833	3,455	3,000	3,000
EBITDA		3,840	3,891	3,854	3,799	3,988	4,188	4,397	4,617
ESOP Contribution Expense		-	-	-	-	-	-	-	-
EBITDAE		3,840	3,891	3,854	3,799	3,988	4,188	4,397	4,617
Total Leverage Ratio		3.35x	2.97x	2.54x	2.27x	1.21x	0.83x	0.68x	0.65x
Maximum Leverage Ratio Allowed		3.25x	3.25x	3.25x	3.25x	3.25x	3.25x	3.25x	3.25x
Is the Sponsor Company in Compliance?		No	Yes	Yes	Yes	Yes	Yes	Yes	Yes

Exhibit 5
Beta Professional Services Company
ESOP Formation Financial Feasibility Analysis
Selling-Shareholder-Provided Financing Analysis
Total Selling Shareholder Rate of Return Calculation
As of January 1, 2019

Years Ended:	12/31/18 $000s	12/31/19 $000s	12/31/20 $000s	12/31/21 $000s	12/31/22 $000s	12/31/23 $000s	12/31/24 $000s	12/31/25 $000s	12/31/26 $000s	12/31/27 $000s	12/31/28 $000s	12/31/29 $000s	12/31/30 $000s	12/31/31 $000s	12/31/32 $000s	12/31/33 $000s	12/31/34 $000s	12/31/35 $000s	12/31/36 $000s
Projected Company Revenue		40,000	37,000	42,000	46,000	49,000	51,450	54,023	56,724	59,560	62,538	65,665	68,948	72,395	76,015	79,816	83,807	87,997	92,397
Revenue Growth Rate			-8%	14%	10%	7%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%
EBITDA		1,500	2,373	4,471	5,999	7,500	7,875	8,269	8,682	9,116	9,572	10,051	10,553	11,081	11,635	12,217	12,828	13,469	14,142
EBITDA Growth Rate			58%	88%	34%	25%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%
EBITDA Margin			6%	11%	13%	15%	15%	15%	15%	15%	15%	15%	15%	15%	15%	15%	15%	15%	15%
Projected EBIT		1,200	2,273	4,371	5,899	7,999	8,398	8,818	9,259	9,722	10,208	10,719	11,255	11,817	12,408	13,029	13,680	14,364	15,082
EBIT Growth Rate			89%	92%	35%	36%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%
EBIT Margin			6%	10%	13%	16%	16%	16%	16%	16%	16%	16%	16%	16%	16%	16%	16%	16%	16%
Market Value of Invested Capital (MVIC) Analysis:																			
Projected MVIC Indication (based on market-derived revenue valuation pricing multiple)		28,000	25,900	25,200	27,600	29,400	30,870	32,414	34,034	35,736	37,523	39,399	41,369	43,437	45,609	47,890	50,284	52,798	55,438
Projected MVIC Indication (based on market-derived EBITDA valuation pricing multiple)		22,500	35,593	33,532	44,989	56,250	59,063	62,016	65,116	68,372	71,791	75,380	79,149	83,107	87,262	91,625	96,207	101,017	106,068
Projected MVIC Valuation Synthesis and Conclusion	35,000	25,250	30,746	29,366	36,295	42,825	44,966	47,215	49,575	52,054	54,657	57,390	60,259	63,272	66,436	69,757	73,245	76,908	80,753
Company Equity Value:																			
Projected MVIC Valuation Synthesis and Conclusion	35,000	25,250	30,746	29,366	36,295	42,825	44,966	47,215	49,575	52,054	54,657	57,390	60,259	63,272	66,436	69,757	73,245	76,908	80,753
- Long-Term Debt	11,943	3,030	3,690	2,000	1,500	1,200	1,200	1,200	1,200	1,200	1,200	1,200	1,201	1,202	1,203	1,204	1,205	1,205	1,205
+ Cash	1,176	800	740	840	920	980	1,029	1,080	1,134	1,191	1,251	1,313	1,379	1,448	1,520	1,596	1,676	1,760	1,760
- Seller Warrant Note 1	-	-	-	-	-	5,899	5,347	4,772	4,172	3,547	2,895	2,216	1,508	770	-	-	-	-	-
- Seller Warrant Note 2	-	-	-	-	-	-	4,985	4,519	4,033	3,526	2,998	2,447	1,873	1,275	651	-	-	-	-
- Seller Warrant Note 3	-	-	-	-	-	-	-	1,036	939	838	733	623	509	390	266	136	-	-	-
- Seller Warrant Note 4	-	-	-	-	-	-	-	-	623	565	504	441	375	306	234	159	81	-	-
- Seller Warrant Note 5	-	-	-	-	-	-	-	-	-	300	272	243	212	180	147	112	76	38	-
- ESOP Note	10,600	10,477	9,572	8,630	7,650	6,630	5,568	4,462	3,312	2,114	868	-	-	-	-	-	-	-	-
= Indicated Equity Value (rounded)	13,633	12,543	18,224	19,576	28,065	30,076	28,896	32,306	36,431	41,155	46,438	51,533	55,960	60,597	65,455	69,743	73,559	77,424	81,308
- Concluded Discount for Lack of Marketability -5%	(682)	(627)	(911)	(979)	(1,403)	(1,504)	(1,445)	(1,615)	(1,822)	(2,058)	(2,322)	(2,577)	(2,798)	(3,030)	(3,273)	(3,487)	(3,678)	(3,871)	(4,065)
= Concluded Total Fair Market Value of Equity (rounded) (on a nonmarketable, noncontrolling interest basis)	13,000	11,900	17,300	18,600	26,700	28,600	27,500	30,700	34,600	39,100	44,100	49,000	53,200	57,600	62,200	66,300	69,900	73,600	77,200
Number of ESOP Shares (000s)	700	700	700	700	700	700	700	700	700	700	700	700	700	700	700	700	700	700	700
Seller Warrant Shares Executed (000s)	-	-	-	-	-	300	225	50	25	10	-	-	-	-	-	-	-	-	-
Seller Warrant Price per Share ($)	18.57	17.00	24.71	26.57	38.14	40.86	39.29	43.86	49.43	55.86	63.00	70.00	76.00	82.29	88.86	94.71	99.86	105.14	110.29
Seller Warrant Shares Exercised (000s)		-	-	-	-	300	225	50	25	10	-	-	-	-	-	-	-	-	-
Market Value of the Warrant Exercised		-	-	-	-	11,443	9,193	1,964	1,096	494	-	-	-	-	-	-	-	-	-
Seller Warrant Exercise Price ($)	16.71	16.71	16.71	16.71	16.71	16.71	16.71	16.71	16.71	16.71	16.71	16.71	16.71	16.71	16.71	16.71	16.71	16.71	16.71
Total Warrant Exercise Value		-	-	-	-	5,014	3,761	836	418	167	-	-	-	-	-	-	-	-	-
Seller Warrant Cash-Out Value		-	-	-	-	6,429	5,432	1,129	679	327	-	-	-	-	-	-	-	-	-
Cumulative Warrant Value		-	-	-	-	6,429	11,861	12,989	13,668	13,995	13,995	13,995	13,995	13,995	13,995	13,995	13,995	13,995	13,995
Return to the Selling Shareholders		11,200	16,600	17,800	25,800	27,600	26,400	29,600	33,500	38,200	43,100	47,900	52,000	56,400	60,900	64,800	68,400	71,900	71,900
ESOP Note		16.00	23.71	25.43	36.86	39.43	37.71	42.29	47.86	54.57	61.57	68.43	74.29	80.57	87.00	92.57	97.71	102.71	102.71
Total Return to the Selling Shareholders:																			
ESOP Note	(10,600)	544	1,306	1,306	1,306	1,306	1,306	1,306	1,306	1,306	1,306	885	-	-	-	-	-	-	-
Seller Warrant Note 1	-	-	-	-	-	802	802	802	802	802	802	802	802	802	802	-	-	-	-
Seller Warrant Note 2	-	-	-	-	-	-	678	678	678	678	678	678	678	678	678	678	-	-	-
Seller Warrant Note 3	-	-	-	-	-	-	-	141	141	141	141	141	141	141	141	141	141	-	-
Seller Warrant Note 4	-	-	-	-	-	-	-	-	85	85	85	85	85	85	85	85	85	85	-
Seller Warrant Note 5	-	-	-	-	-	-	-	-	-	41	41	41	41	41	41	41	41	41	41
Total Return to the Selling Shareholders	(10,600)	544	1,306	1,306	1,306	2,108	2,787	2,927	3,012	3,053	3,053	2,632	1,747	1,747	1,747	945	266	126	41

Total Transaction Internal Rate of Return	15.0%
Transaction Internal Rate of Return with Mid-Period Discounting	16.3%

Exhibit 6
Beta Professional Services Company
ESOP Formation Financial Feasibility Analysis
Sponsor Company Cash Flow Analysis
As of January 1, 2019

Years Ended:	12/31/19 $000s	12/31/20 $000s	12/31/21 $000s	12/31/22 $000s	12/31/23 $000s	12/31/24 $000s	12/31/25 $000s	12/31/26 $000s	12/31/27 $000s
Company Revenue	40,000	37,000	42,000	46,000	49,000	51,450	54,023	56,724	59,560
EBITDA	1,500	2,373	4,471	5,999	7,500	7,875	8,269	8,682	9,116
Senior Bank Debt - Revolver	(120)	(111)	(126)	(138)	(147)	(154)	(162)	(170)	(179)
Cash Flow after Bank Debt Payments	1,380	2,262	4,345	5,861	7,353	7,721	8,107	8,512	8,938
Seller Subordinated Notes	(544)	(1,306)	(1,306)	(1,306)	(1,306)	(1,306)	(1,306)	(1,306)	(1,306)
Seller Warrant Note 1	-	-	-	-	(802)	(802)	(802)	(802)	(802)
Seller Warrant Note 2	-	-	-	-	-	(678)	(678)	(678)	(678)
Seller Warrant Note 3	-	-	-	-	-	-	(141)	(141)	(141)
Seller Warrant Note 4	-	-	-	-	-	-	-	(85)	(85)
Seller Warrant Note 5	-	-	-	-	-	-	-	-	(41)
Total Seller Subordinated Debt Service	(544)	(1,306)	(1,306)	(1,306)	(2,108)	(2,787)	(2,927)	(3,012)	(3,053)
Projected Capital Expenditures	(200)	(200)	(200)	(200)	(200)	(200)	(200)	(200)	(200)
Projected Working Capital Additions	4,983	270	(450)	(360)	(270)	(221)	(232)	(243)	(255)
Excess Cash Flow/(Deficit)	5,619	1,026	2,389	3,995	4,775	4,514	4,748	5,057	5,429

Years Ended:	12/31/28 $000s	12/31/29 $000s	12/31/30 $000s	12/31/31 $000s	12/31/32 $000s	12/31/33 $000s	12/31/34 $000s	12/31/35 $000s	12/31/36 $000s
Company Revenue	62,538	65,665	68,948	72,395	76,015	79,816	83,807	87,997	92,397
EBITDA	9,572	10,051	10,553	11,081	11,635	12,217	12,828	13,469	14,142
Senior Bank Debt - Revolver	(188)	(197)	(207)	(217)	(228)	(239)	(251)	(264)	(277)
Cash Flow after Bank Debt Payments	9,384	9,854	10,346	10,864	11,407	11,977	12,576	13,205	13,865
Seller Subordinated Notes	(1,306)	(885)	-	-	-	-	-	-	-
Seller Warrant Note 1	(802)	(802)	(802)	(802)	(802)	-	-	-	-
Seller Warrant Note 2	(678)	(678)	(678)	(678)	(678)	(678)	-	-	-
Seller Warrant Note 3	(141)	(141)	(141)	(141)	(141)	(141)	(141)	-	-
Seller Warrant Note 4	(85)	(85)	(85)	(85)	(85)	(85)	(85)	(85)	-
Seller Warrant Note 5	(41)	(41)	(41)	(41)	(41)	(41)	(41)	(41)	(41)
Total Seller Subordinated Debt Service	(3,053)	(2,632)	(1,747)	(1,747)	(1,747)	(945)	(266)	(126)	(41)
Projected Capital Expenditures	(200)	(200)	(200)	(200)	(200)	(200)	(200)	(200)	(200)
Projected Working Capital Additions	(268)	(281)	(295)	(310)	(326)	(342)	(359)	(377)	(396)
Excess Cash Flow/(Deficit)	5,863	6,740	8,104	8,606	9,134	10,491	11,751	12,502	13,228

to an ESOP formation committee. That ESOP formation committee may include board, management, and employee representatives.

The professionals involved in conducting the ESOP financial feasibility analysis may include the analyst, an ESOP consultant, investment bankers, lenders, the senior management team, legal counsel, and the company's selling shareholders. It is important for all of these parties to (1) anticipate potential ESOP formation obstacles and (2) consider reasonable solutions to each of these obstacles.

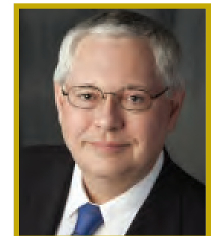
Based on such anticipatory consideration, any last-minute obstacles or issues can be evaluated as part of the decision-making process (1) of the private company's board of directors and (2) of the ESOP formation committee.

Further, the evaluation of the ESOP feasibility is an ongoing part of the ESOP formation process. As valuation, structuring, and financing decisions are made, circumstances (both for the employer company and for the selling shareholders) may change. In such instances, various alternative ownership transition opportunities may be considered.

As the consideration of the company sale transactions progress, the different aspects and considerations of the ESOP financial feasibility analysis may be updated. This updated feasibility analysis should reflect the most current set of facts related to the private company—in order to confirm the continued financial feasibility of the ESOP formation.

Finally, the decision to enter into a transaction to buy the private company's shares and to pay a fair market value price for those company shares is made (on behalf of the to-be-formed ESOP participants) by the ESOP fiduciary.

For private company owners considering a sale of all (or part) of the company, an ESOP formation is one possible ownership transition structure. However, a comprehensive ESOP formation and financial feasibility analysis would be appropriate to assess whether the sale of the private company stock to the ESOP makes sense (1) to the selling shareholders, (2) to the to-be-formed ESOP employee participants, and (3) to the private company itself.



Robert Reilly is a managing director of the firm and is resident in our Chicago practice office. Robert can be reached at (773) 399-4318 or at rfreilly@willamette.com.

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GUIDE TO ESOP VALUATION
and Financial Advisory Services

Second Edition

Robert F. Reilly and Robert P. Schweihs

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Who Should Buy This "Must-Have" Book

- ESOP independent financial advisers and business appraisers
- ESOP trustees and other plan fiduciaries
- ERISA lawyers and other ESOP professional advisers
- shareholder/executives of ESOP sponsor companies

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ESOP Implementation Considerations: A Leveraged ESOP versus a Nonleveraged ESOP

Ben R. Duffy

An employee stock ownership plan ("ESOP") is a qualified retirement plan that allows employees to hold equity in the sponsor company that employs them. There are various strategies that may be considered when the sponsor company forms an ESOP. One important structural decision regarding the ESOP formation is whether the ESOP will be leveraged or nonleveraged. This discussion compares the leveraged ESOP structure and the nonleveraged ESOP structure.

Introduction

There's a reason for the phrase, "no two ESOPs are alike." An employee stock ownership plan ("ESOP") can be structured to meet a variety of objectives—whether to promote employee ownership, provide employee retirement benefits, reduce sponsor company income taxes, provide shareholder liquidity, or transfer the ownership of the business. The ESOP can be structured to fit any of these needs.

This discussion focuses on one decision that the selling shareholders and company board will make when determining the appropriate structure for the ESOP—that is, whether the ESOP will be "leveraged" or "nonleveraged."

In short, a leveraged ESOP transaction involves the purchase of sponsor company stock with borrowed funds. These funds are typically borrowed from the sponsor company, which in turn borrows funds from an external lender.

In contrast, a nonleveraged ESOP transaction does not utilize debt to purchase the employer corporation securities. The nonleveraged ESOP typically acquires the employer securities through one of the following:

1. Tax deductible stock contributions
2. Tax deductible cash contributions from the sponsor company.

The sponsor company stock is purchased gradually each year based on the sponsor company's annual ESOP contribution amount. The ESOP ownership percentage of the sponsor company stock increases as the ESOP acquires additional shares.

If the parties to the ESOP elect to implement a nonleveraged ESOP stock purchase transaction, they may still implement a leveraged stock purchase transaction in the future. Alternatively, an ESOP can utilize leverage for the initial installation and also elect to acquire shares without leverage in the future.

An ESOP is not black and white, and it can be structured to fit the liquidity needs of the selling shareholders while simultaneously benefitting the employees and sponsor company.

Most of the ESOP professional literature and presentations at ESOP-related conferences focuses on the leveraged ESOP structure. As will be discussed later, there are a variety of reasons that

leveraged ESOPs are popular among the ESOP community in general and ESOP professional advisers in particular.

Despite their popularity in the ESOP community, the National Center of Employee Ownership ("NCEO") analysis of Department of Labor data reports that only 46 percent of ESOPs are leveraged.[1]

The following discussion provides a background of various characteristics and advantages associated with leveraged and nonleveraged ESOP structures. The following sections address the transaction structure, income tax considerations, and accounting for leveraged ESOPs and nonleveraged ESOPs.

Transaction Structure

Leveraged ESOP Structure

In a typical leveraged ESOP transaction, the sponsor company enters into a loan agreement with an outside lender and/or the selling shareholder(s) (the "external loan"). The sponsor company lends the proceeds from the bank loan to the ESOP trust (this is referred to as the "internal loan"). The ESOP trust uses the cash received from the sponsor company to purchase the sponsor company stock from the selling shareholder(s).

The typical leveraged ESOP transaction structure is presented in Figure 1.

A leveraged ESOP transaction allows the shareholder(s) to sell part or all of their interest in the sponsor company up front. This transaction is accomplished by utilizing debt (i.e., leverage).

The ESOP may acquire up to 100 percent of the outstanding equity in the business using a leveraged ESOP transaction. Typically, the acquisition of a 100 percent interest by the ESOP will consist of both cash and noncash consideration, such as a note issued from the seller to the sponsor company.

If the sponsor company obtains financing from a financial institution, then the seller note will likely be subordinated to the other debt and have a delayed payment schedule (often with payment in kind interest and/or warrants).

Often, the ESOP will acquire at least 30 percent of the equity in the sponsor company in the initial leveraged ESOP transaction to take advantage of the Internal Revenue Code ("Code") Section 1042 capital gains deferral. If the ESOP initially acquires less than 100 percent of the outstanding equity, then future purchases of equity by the ESOP can be on a leveraged or nonleveraged basis.

The sponsor company stock purchase/sale financing may also benefit from enhanced credit—if the selling shareholders pledge the qualified replacement property purchased by the selling shareholder in a Section 1042 rollover transaction.

After a leveraged transaction structure is implemented, shares are allocated to participant accounts based on the amortization of the internal loan (either based on principal payments or principal and interest payments on the internal loan, per the terms of the plan document).

The terms of the internal loan typically will not match the terms of the external loan. The terms of the internal loan are typically estimated to:

1. provide a target level of retirement benefits for participants and
2. manage the repurchase obligation relating to shares in participant accounts.

Figure 2 presents the typical repayment of the internal loan, using the principal and interest method.

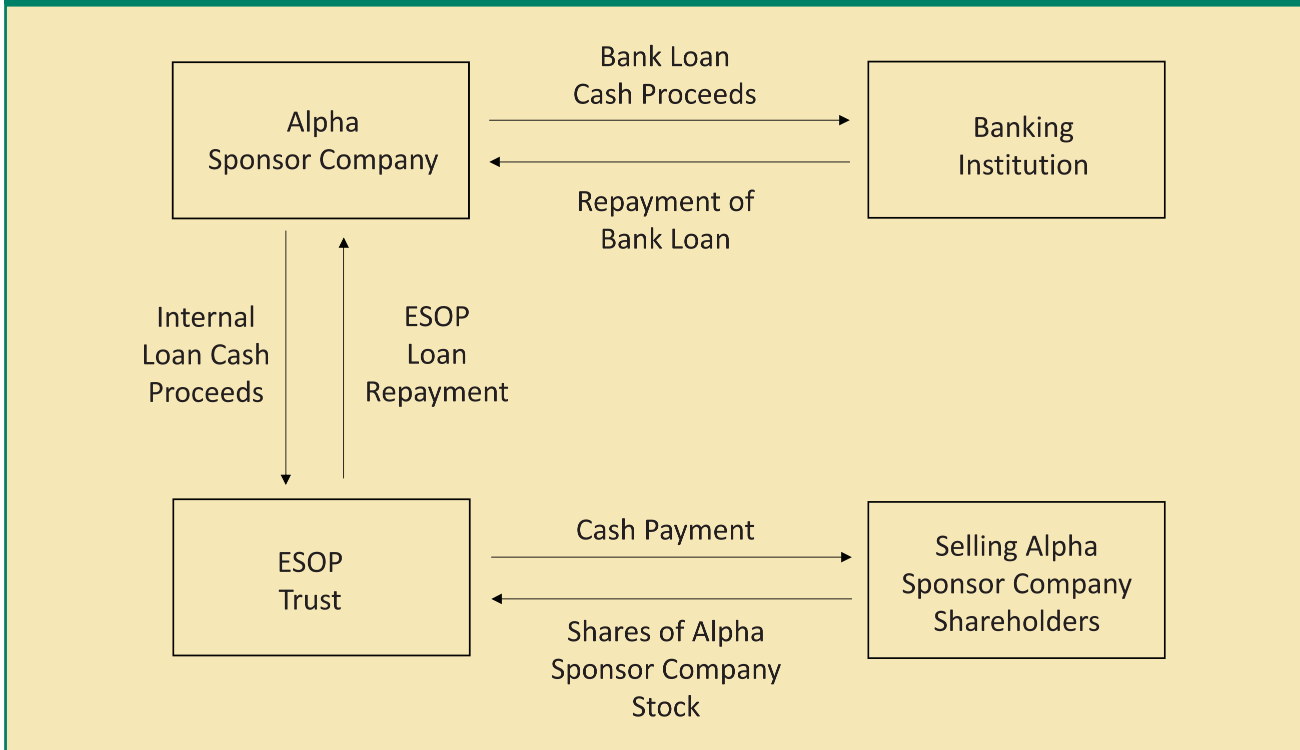


Figure 1
Typical Leveraged ESOP Structure for the Initial Purchase of the Sponsor Company Stock
Alpha
Sponsor Company
Bank Loan
Cash Proceeds
Banking
Institution
Repayment of
Bank Loan
Internal
Loan Cash
Proceeds
ESOP
Loan
Repayment
ESOP
Trust
Cash Payment
Selling Alpha
Sponsor Company
Shareholders
Shares of Alpha
Sponsor Company
Stock

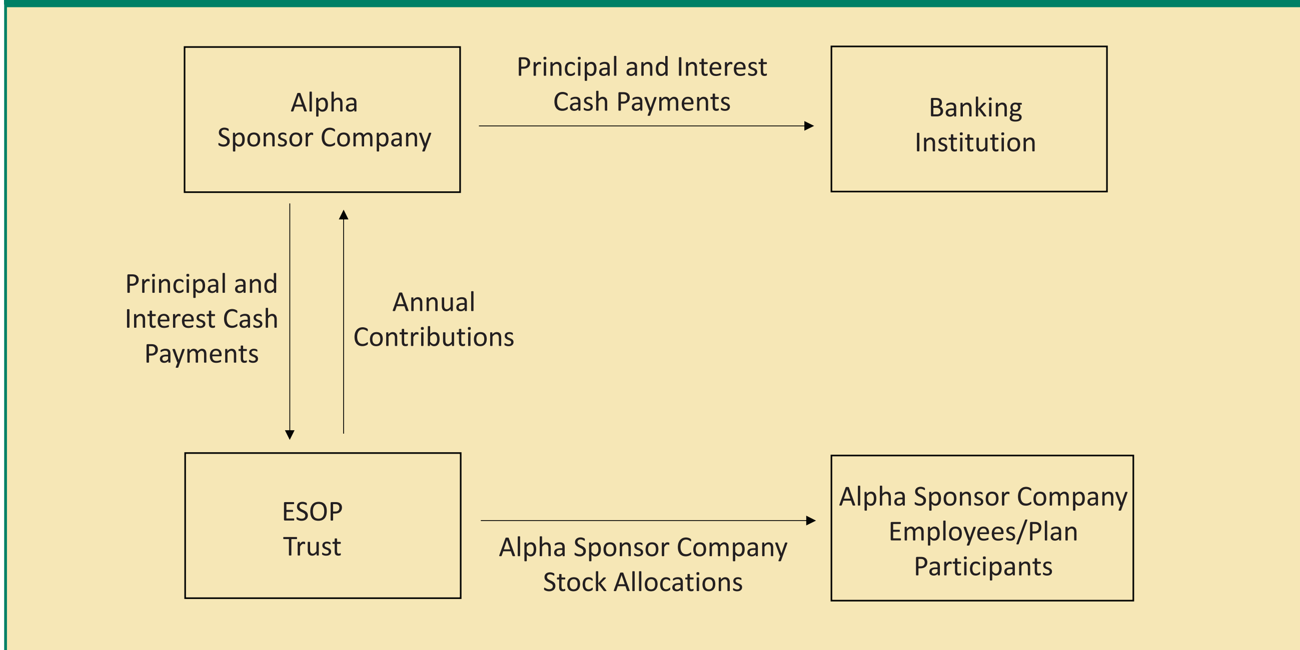


Figure 2
Typical Leveraged ESOP Structure for the Repayment of the ESOP Sponsor Company Stock Acquisition Loan
Alpha
Sponsor Company
Principal and Interest
Cash Payments
Banking
Institution
Principal and
Interest Cash
Payments
Annual
Contributions
ESOP
Trust
Alpha Sponsor Company
Stock Allocations
Alpha Sponsor Company
Employees/Plan
Participants

To calculate the number of shares released from treasury (that is, the shares allocated to the ESOP participant accounts) using the principal and interest method, the principal and interest paid is divided by the current and future principal and interest, multiplied by the total unreleased ESOP shares.

The number of released shares calculation is similar when using a principal only method, except the numerator and denominator do not include annual interest payment and current and future interest, respectively.

The principal only method is only allowed if the internal loan provides for annual payments of principal and interest at a cumulative rate, with payments at least equal to level annual payments for a period of 10 years.[2]

After the shares are released and allocated to participant accounts, they produce a repurchase obligation liability. A repurchase obligation is the obligation to repurchase shares from an ESOP participant in accordance with the plan documents. The repurchase obligation is typically triggered by a retirement, separation of service, or participant diversification election.

Although the stock repurchase liability is typically funded by the sponsor company, it is not recorded as a liability on the sponsor company's balance sheet. However, the sponsor company is required to bring attention to the liability in the notes to its audited financial statements.

Nonleveraged ESOP Structure

A nonleveraged ESOP transaction is often less complicated and involves fewer parties than a leveraged ESOP transaction. A nonleveraged ESOP transaction involves the contribution of cash or stock to the ESOP trust by the sponsor company.

If stock is contributed directly to the ESOP, then the stock can be allocated to participant accounts. If cash is contributed to the ESOP, then the ESOP will typically buy stock from the selling shareholders. Then, the stock will be allocated to the ESOP participant accounts.

The typical nonleveraged ESOP contribution structure is presented in Figure 3.

Alternatively, the sponsor company could redeem shares from the selling shareholders. The sponsor company would then contribute shares to the ESOP.

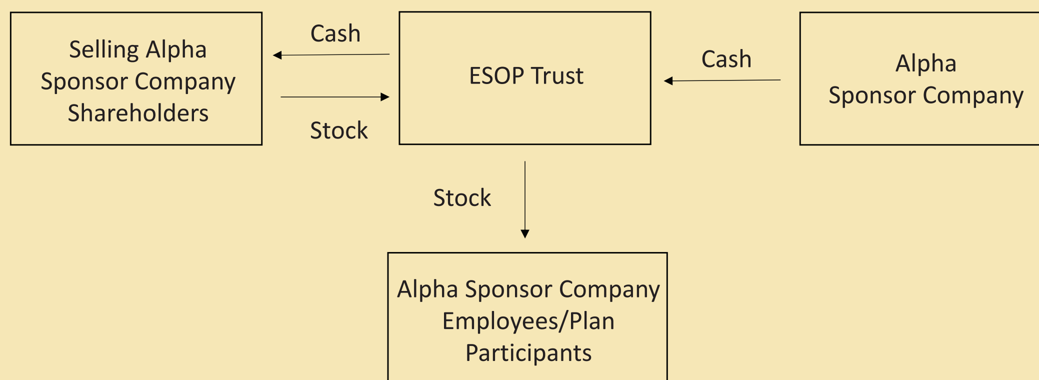
A nonleveraged ESOP typically results in a slower ownership transition than a leveraged ESOP. The ESOP acquisition of stock will be based on annual cash or stock contributions from the sponsor company, as opposed to debt financing. The annual cash or stock contributions are made on a pretax basis.

When purchasing stock from a shareholder using the nonleveraged ESOP transaction structure, the acquisition of the ESOP stock typically is based on the following:

1. The sponsor company's available cash flow in any given year, which may be limited by the annual tax deductible contribution limits equal to 25 percent of the payroll for eligible ESOP participants, as set forth in the Code
2. The value of the sponsor company stock

Mature sponsor companies that have ample cash flow will typically be able to acquire company stock at a faster rate than sponsor companies that require operating cash flow for growth.

Figure 3
Typical Nonleveraged ESOP Sponsor Company Acquisition Transaction Structure



If ownership transition is not an immediate objective, then the sponsor company may choose to issue the ESOP shares from treasury. This transaction would provide retirement benefits and employee ownership, while increasing current cash flow.

Income Tax Considerations

The income tax benefits associated with ESOP transactions may be one of the primary incentives for undergoing an ESOP transaction. There are various tax benefits available to ESOP sponsor companies and selling shareholders.

Many of the available income tax benefits depend on the following:

1. The structure of the ESOP sponsor company stock purchase transaction
2. The organization of the sponsor company

Leveraged ESOP

There are various economic and income tax advantages associated with a leveraged ESOP. These advantages are available to the sponsor company and the selling shareholders. A leveraged ESOP enjoys all of the income tax benefits of a nonleveraged ESOP— and several additional benefits.

Sponsor Company

If the ESOP sponsor company is structured as a C corporation, the sponsor company can deduct principal and interest payments on the internal loan for federal income tax purposes. The sponsor company may deduct additional contributions that are equal to or less than 25 percent of total eligible payroll of the ESOP participants.

S corporations pass income, losses, deductions, and credits through to the company shareholders for federal income tax purposes. Shareholders report the income, losses, deductions, and credits on their personal tax returns at their individual income tax rates. This procedure allows S corporations to avoid double taxation on corporate income.

The ownership interest held by the ESOP does not incur federal income taxes. Therefore, an S corporation that is wholly owned by an ESOP does not owe federal income taxes.

If the sponsor company has multiple investors, cash distributions that are made to cover the tax liability of non-ESOP shareholders are made on a pro rata basis. The cash is allocated to ESOP participants, and the cash may be used to fund future stock purchases or make other investments.

A leveraged ESOP transaction generally maximizes the tax benefits for C corporation and S corporation sponsor companies.

Selling Shareholders

The main benefit available to selling shareholders is the Code Section 1042 election. Section 1042 allows a selling shareholder to defer capital gains tax on the sale of the private company to the ESOP. All else equal, the seller would, therefore, realize greater net after-tax proceeds when selling the sponsor company stock to the ESOP.

The Section 1042 election eligibility requirements include the following:

1. The sponsor company should be a C corporation.
2. The selling shareholder(s) should hold the company stock for at least three years prior to the sale.
3. As a result of the transaction, the ESOP should own:
   a. at least 30 percent of the stock after the sale or
   b. at least 30 percent of the total value of the sponsor company.
4. The seller should reinvest the sale proceeds into a qualified replacement property within 12 months of the transaction.

Nonleveraged ESOP

Compared to the income tax benefits available to a leveraged ESOP, the income tax benefits of a nonleveraged ESOP are limited. The sponsor company receives an income tax deduction equal to the amount contributed to the ESOP (as long as the contributions are consistent with the deduction limits set forth in the Code).

S corporation nonleveraged ESOPs have the same benefits as leveraged ESOPs. However, the slower ownership transition means that the tax benefits will be realized over a longer period.

Financial Considerations

The board of directors may consider the impact that the ESOP structure could have on a company's financial statements. The ESOP assets are not included on a company's balance sheet, but they are included as assets within the ESOP trust.

Leveraged ESOP

If considering an ESOP transaction, especially a leveraged ESOP transaction, it is important to understand ESOP accounting policies and the impact the internal and external loans may have on the company's financial statements.

The receivable associated with the internal loan, made to the ESOP, is not to be recorded as an asset of the sponsor company. Instead, the loan is recorded against equity as unearned ESOP shares. Federal Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 718-40 provides accounting guidance for recording the earned and unearned ESOP shares.

A sponsor company will record compensation expense, as the sponsor company makes contributions to the ESOP. Contributions made to the ESOP trust are tax deductible up to 25 percent of the covered payroll.

The external loan receives the same financial statement treatment as normal external financing. The external loan is recorded as a liability on the sponsor company balance sheet and the interest payments made on the external loan are recorded as an expense.

C corporations may be eligible for additional income tax deductions associated with the internal loan. These C corporation income tax deductions include the following:

- Additional tax deduction of up to 25 percent of covered payroll expense for the repayment of the principal on the internal loan[3]
- Contributions applied for interest payments on the internal loan[4]

It is important to consider that the terms of the internal loan and the external loan will often be different. Often, the sponsor company will structure the internal loan with a longer term than the external loan. This structure allows the sponsor company to allocate shares to participate accounts over a longer period while the sponsor company services the external debt at an accelerated rate.

The share allocation creates a repurchase obligation liability for the sponsor company. However, the repurchase obligation liability is not a recorded liability, but it is mentioned within the notes of the company's financial statements.

The impact of the external loan on the sponsor company's financial statements may be a primary consideration when determining how to structure the ESOP. Typically, the external loan will decrease the value of the sponsor company equity. The leverage from the transaction may prevent the sponsor company from having the necessary capital for future growth initiatives.

Nonleveraged ESOP

The nonleveraged ESOP structure typically does not impact the sponsor company's financial statements as significantly as a leveraged ESOP transaction. The initial contribution to a nonleveraged ESOP is very similar to making an employer contribution to a 401(k) plan.

The sponsor company will record the contribution of cash or stock to the ESOP as a compensation expense on the income statement. This compensation expense figure will be equal to the total cash, or the fair market value of the shares, contributed to the ESOP.

The accounting impact of this contribution on the sponsor company's financial statements is summarized below:

Financial Statement Accounts	Debit	Credit
Cash or Common Stock		$100,000
ESOP Contributions	$100,000	

In accordance with the plan document of the ESOP, shares are then allocated to the participant accounts. This allocation creates a repurchase obligation for the company, which is mentioned in the notes to the financial statements. The magnitude of

the repurchase obligation liability will increase as the ESOP acquires more shares.

Since a nonleveraged ESOP transaction does not require external funding and the establishment of new debt obligations, the sponsor company is more likely to have available capital for growth initiatives.

A financial feasibility analysis can be performed to estimate the financial impact of the leveraged and nonleveraged ESOP structures. The considerations of the financial feasibility analysis with respect to the decision to use leverage are discussed below.

Fiduciary Considerations

Fiduciary liability concerns may be an additional consideration when determining which ESOP structure is the most appropriate. There are few litigation cases involving nonleveraged ESOP transactions.

However, there have been dozens of litigation cases associated with leveraged ESOP transactions. The allegations in these cases typically involve a trustee breach of fiduciary duties. The plaintiffs in the cases often argue that the ESOP trustee caused the ESOP to enter into a prohibited transaction by paying more than fair market value for the subject shares.

Leveraged ESOP transactions are often more expensive to implement than nonleveraged ESOP transactions. This is due to the size and complexity of a leveraged ESOP transaction.

Leveraged ESOP transactions often require several professionals with specific qualifications to be involved in the deal process. The professionals involved may include administrators, attorneys, trustees, valuation advisers, investment bankers, and other specialists. The higher audit risk and related fiduciary liability risk also could increase the total cost of installing a leveraged ESOP.

Nonleveraged ESOP transactions are typically smaller in size and complexity than leveraged ESOP transactions. The smaller size and complexity typically decreases the initial installation expense (in terms of professional fees).

In either transaction structure, it may be advisable for the sponsor company to obtain fiduciary liability insurance. The expense and necessary coverage, however, is likely to be significantly greater following a leveraged ESOP transaction.

Determining the Most Appropriate Structure

An ESOP can be an effective vehicle for structuring the sale of a private company business. Several specific factors may influence the decisions to undergo a leveraged or nonleveraged ESOP transaction.

Leveraged ESOP transaction structures are often selected by selling shareholders with the following attributes:

- Motivation to quickly liquidate their ownership
- Motivation to diversify their asset holdings
- Satisfaction with the current fair market value of the company

Leveraged ESOP transaction structures are often selected by sponsor companies with the following attributes:

- Financial ability to acquire a significant liability
- Financial ability to incur additional implementation expenses
- Financial ability to incur additional fiduciary liability insurance expenses

Nonleveraged ESOP transactions are often more appropriate for selling shareholders with the following attributes:

- No immediate liquidation needs
- Incentive to continue participating in the growth of the company

Nonleveraged ESOP transactions are often more appropriate for sponsor companies with the following attributes:

- Inability or lack of desire to acquire a significant liability
- Plans to incur major capital expenditures for growth initiatives
- Concern regarding the potential fiduciary liability risk associated with leverage ESOP transactions
- Multiple shareholders with the need for future liquidity

When determining which transaction structure is most appropriate, it is important to balance the needs of the various constituents of the transaction. It is also important to consider that selecting a specific transaction structure (leveraged or nonleveraged) does not prevent a company from undergoing the alternative transaction structure in the future.

Exhibit 1 summarizes many of the considerations related to a leveraged and a nonleveraged ESOP transaction.

Exhibit 1
Considerations of a Leveraged ESOP Stock Purchase Transaction versus a Nonleveraged ESOP Stock Purchase Transaction

ESOP Considerations	Leveraged Transaction	Nonleveraged Transaction
Level of Retirement Benefits	Function of internal note amortization and stock price; additional contributions	Flexible; can be different year to year
Employee Ownership Mentality	Yes	Yes
Creates a Market for Future Stock Purchases	Yes	Yes
Tax Benefits	1042 election for C corporations; principal and interest on internal loan is tax deductible; S corporations benefit from lack of income taxes due on ESOP ownership interest	Stock purchases are made with pretax dollars
Implementation Expenses	Typically higher	Typically lower
Audit Risk from the Department of Labor	Higher	Lower
Proceeds to the Selling Shareholders	Cash up front; do not participate in growth of company (unless warrants are issued with seller financing)	Slower transition of ownership; may continue to benefit in the growth of the company
Impact on the Sponsor Company	Equity value immediately decreased due to the use of leverage; could cause financial stress, or, at a minimum, limit growth opportunities due to cash flow requirements on the loan and other loan covenants	Equity value is stable; the sponsor company has flexibility with current cash flow for additional share purchases or future growth initiatives

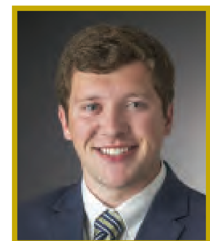
Summary and Conclusion

There is no "one size fits all" approach to structuring the installation of an ESOP at a sponsor company. By researching and understanding the impact of individual ESOP structures, an ESOP structure can be implemented that meets the needs of (1) the sponsor company, (2) the selling shareholders, and (3) the to-be-formed ESOP participants.

Notes:

1. NCEO analysis of the Department of Labor data, https://www.nceo.org/articles/employee-ownership-by-the-numbers. Some existing ESOPs may have utilized leverage previously.
2. Internal Revenue Service Technical Advice Memorandum 201425019.
3. See Code Section 404(a)(9)(A). This is in addition to the general tax deduction up to 25 percent of covered payroll. Therefore, a C corporation may be eligible for a tax deduction up to 50 percent of covered payroll.
4. See Code Section 404(a)(9)(B).

Ben Duffy is a manager in our Atlanta practice office. Ben can be reached at (404) 475-2326 or at brduffy@willamette.com.



Willamette Management Associates
Thought Leadership in Valuation, Damages, and Transfer Price Analyses

Willamette Management Associates consulting experts and testifying experts have achieved an impressive track record in a wide range of litigation matters. As independent analysts, we work for both plaintiffs and defendants and for both taxpayers and the taxing authorities. Our analysts have provided thought leadership in breach of contract, tort, bankruptcy, taxation, family law, shareholder rights, antitrust, fraud and misrepresentation, and other disputes. Our valuation, damages, and transfer price analysts are recognized for their rigorous expert analyses, comprehensive expert reports, and convincing expert testimony. This brochure provides descriptions of recent judicial decisions in which our analysts provided expert testimony on behalf of the prevailing party.

Dissenting Shareholder Testifying Expert Services

In the matter of the *Wayne L. Ryan Revocable Trust, Steven Ryan and First Nebraska Trust v. Constance "Connie" Ryan and Streck, Inc.* (Case No. Cl 14-1684), the District Court of Sarpy County, Nebraska, decided a matter described as one of the largest valuation disputes in Nebraska state court history. After the application of prejudgment interest, the fair value of the plaintiffs' ownership interest was estimated to be between $723 million and $804 million.

Willamette was retained to provide both consulting expert valuation services and testifying expert valuation services to the plaintiffs. Willamette managing director Kevin Zanni provided consulting expert services, and firm managing director Robert Reilly provided testifying expert services regarding the Streck fair value valuation.

In *Ryan*, Willamette and another well-known valuation advisory services firm applied the same valuation methodology, but reached significantly different opinions. In a 74-page published opinion, the court concluded that (1) the Willamette fair value conclusion of the subject equity interest was reasonable, and that value was accepted in full by the court, and (2) the defendants' testifying expert applied valuation variables designed to lower his fair value conclusion, and that value was rejected by the court.

In particular, the *Ryan* decision is representative of the Willamette thought leadership in fair value valuation matters related to statutory shareholder rights, dissenting shareholder appraisal rights, and shareholder oppression claims.

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Property Taxation Testifying Expert Services

In the matter of *Union Electric Company d/b/a Ameren Missouri v. Christopher Estes, Assessor, Cole County, Missouri*, No. 13-52002, 2019 WL 2369464 (Mo.St.Tax.Com. May 28, 2019), upon appeal and remand, the State Tax Commission of Missouri (the "STC"), found in favor of Ameren Missouri, the corporate taxpayer complainant. At issue in the matter was the need for STC to determine the appropriate amount of total depreciation to be applied to the Assessor's cost approach "market value" of the Ameren Missouri real property and tangible personal property.

The STC concluded that the taxpayer presented substantial and persuasive evidence to establish the correct amount of total property depreciation, including the identification and quantification of the taxpayer's economic obsolescence.

John Ramirez, Willamette director of property tax valuation services, provided consulting expert services—which included an economic obsolescence depreciation analysis and economic obsolescence depreciation report—on behalf of taxpayer Ameren Missouri. Robert Reilly, Willamette firm managing director, provided testifying expert services related to this public utility property tax valuation dispute.

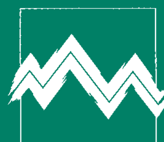
The Missouri STC accepted the economic obsolescence analysis and conclusion—and the total depreciation calculation—prepared by Willamette.

Estate Taxation Testifying Expert Services

In the matter of *Estate of Aaron U. Jones v. Commissioner,* T.C. Memo. 2019-101, the U.S. Tax Court adopted in full the value conclusions put forth by the Estate's valuation expert. In 2009, Aaron Jones gifted ownership interests in two companies: (1) Seneca Jones Timber Company ("SJTC"), a limited partnership that owned and harvested timberland, and (2) Seneca Sawmill Company ("SSC"), an S corporation that operated sawmills. In 2013, the Service issued a notice of deficiency for gift tax of approximately $45 million. The Estate brought this matter to the U.S. Tax Court.

Willamette was engaged by the Estate to provide valuation and testifying expert services. Scott Miller, Willamette vice president, provided valuation consulting services and Robert Reilly, a managing director of our firm, provided testifying expert services. Important issues in the dispute included (1) whether it was appropriate to tax affect the earnings of tax pass-through entities SSC and SJTC and (2) whether the income approach applied by the Estate's valuation expert was more appropriate for valuing the SJTC limited partnership units than the asset-based approach applied by the Service valuation expert.

In this important decision, the Tax Court adopted without adjustment the positions and value conclusions presented in the Willamette valuation expert reports.



Willamette Management Associates

Transfer Pricing Testifying Expert Services

In the matter of *Amazon.com, Inc. & Subsidiaries v. Commissioner,* 934 F.3d 976 (9th Cir. 2019), the Ninth Circuit affirmed the U.S. Tax Court 2017 decision in favor of taxpayer Amazon. The Tax Court case involved a 2005 cost sharing arrangement that Amazon entered into with its Luxembourg subsidiary. Amazon granted its subsidiary the right to use certain pre-existing intangible property in Europe, including the intangible property required to operate Amazon's European website business.

The Tax Court concluded that (1) the Service's determination with respect to the buy-in payment was arbitrary, capricious, and unreasonable; (2) Amazon's CUT transfer price method (with some upward adjustments) was the best method to determine the requisite buy-in payment; and (3) the Service abused its discretion in determining that 100% of the technology and content costs constitute intangible development costs. The Tax Court noted the Service's buy-in payment discounted cash flow analysis improperly included all contributions of value, including workforce in place, going-concern value, and goodwill.

On appeal, the Service argued that "residual business assets" (e.g., workforce in place, going-concern value, goodwill, and future growth options) satisfied the then applicable regulation's definition of "intangible." The Ninth Circuit concluded otherwise, accepting taxpayer Amazon's position that the then applicable regulation's definition of "intangible" was understood to exclude goodwill and going-concern value.

Willamette Management Associates managing director Robert Reilly provided expert testimony in the Tax Court on behalf of taxpayer Amazon in this Section 482 intercompany transfer pricing case.

Willamette Management Associates

Shareholder Litigation Consulting Expert Services

In many instances, an attractive settlement is as good, if not better, than a judicial victory. This was true in the matter of *In Re Legacy Reserves LP Preferred Unitholder Litigation*. In this particular matter, the Delaware Chancery Court approved a settlement between Legacy Reserves LP ("Legacy") and its preferred unit holders that resulted in the preferred unit holders realizing a significant increase in the transaction value.

The plaintiff preferred unit holders brought an action against defendant Legacy to remedy the defendant's alleged breach of contract and breach of the duty of good faith and fair dealing in connection with a proposed transaction in which Legacy would be converted from a partnership to a C corporation. The proposed transaction would result in Legacy and its general partner becoming subsidiaries of Legacy Reserves Inc. ("New Legacy") and Legacy's common and preferred unit holders becoming common stockholders of New Legacy. Pursuant to the terms of the proposed transaction, each outstanding Legacy limited partnership unit would be converted into the right to receive 1 share of New Legacy common stock, each outstanding Series A preferred unit would be converted into the right to receive 1.9620 shares of New Legacy common stock, and each outstanding Series B preferred unit would be converted into the right to receive 1.72236 shares of New Legacy common stock. Based on the announced terms, the preferred investors would receive 17.7 percent of the business, while the common holders would receive 82.3 percent of the business.

Lead counsel for plaintiffs in the litigation retained Willamette to assist and advise them regarding the fair value of the Legacy Series A preferred units and Series B preferred units. After extensive analysis and negotiations, Legacy management signed a memorandum of understanding. Legacy admitted to none of the allegations, and the plaintiffs agreed not to further pursue Legacy on any grounds surrounding the C corporation conversion and the preferred unit conversion. In exchange, the Series A preferred unit holders received 2.9203318 shares of common stock for each preferred unit, while the Series B preferred unit holders received 2.90650421 shares of common stock for each preferred unit. This settlement resulted in the preferred investors receiving approximately 26 percent of the restructured entity and the common holders receiving approximately 74 percent of the entity.

Willamette managing director Timothy Meinhart provided valuation consulting expert services to the preferred unit holder plaintiffs in this matter.

Willamette Management Associates

Synthetic Equity Plans for ESOP Sponsor Companies

Scott R. Miller and Lerry A. Suarez

Synthetic equity compensation practices—such as phantom stock plans and stock appreciation rights ("SARs") plans—are often used by employee stock ownership plan ("ESOP") sponsor companies to help retain and incentivize the sponsor company's key employees. These plans have become popular compliments to the ESOP sponsor company, and they offer additional compensation flexibility for the ESOP sponsor company. This discussion addresses (1) the definition of both phantom stock and SARs, (2) the development of an executive compensation plan, (3) the implementation of an executive compensation plan, and (4) the procedure for how phantom stock plans and SARs may be considered when valuing an ESOP sponsor company.

Introduction

Stock appreciation rights ("SARs") and phantom stock plans are often set up in conjunction with an employee stock ownership plan ("ESOP"). These compensation plans are usually promoted to both prospective and current employees—as part of a total benefits package to attract and retain talent. After their implementation, these compensation plans align the incentives of key employees and executives with the objectives of the ESOP shareholders (i.e., through the appreciation of the sponsor company stock).

Generally, SARs and phantom stock awards are designed to provide for the cash payment of a benefit—rather than for a payment in the form of shares of company stock. Phantom stock plans and SARs share certain pros and cons.

A major advantage of these compensation plans is flexibility in deciding who gets how much and under what rules. Additionally, these compensation plans do not dilute existing ownership interests and do not require existing shareholders to give up any control.

In order for SARs and phantom stock plans to be implemented appropriately, the private company should develop an executive compensation plan that suits the goals of the company. Once implemented, these compensation plans may have an impact on the value, or perceived value, of the sponsor company.

Valuation analysts ("analysts") should consider the value impact that these compensation plans have on an ESOP sponsor company when conducting a valuation analysis for ESOP administration or other purposes.

Definition of Phantom Stock

A phantom stock plan is defined as an employee benefit plan that gives selected employees many

of the benefits of stock ownership without actually giving them any company stock. Phantom stock is a reward paid to an individual for the value of a defined number of shares.

The award is not actually made in shares, but rather in a promise to pay the employee the value of the shares at some point in the future. The award is typically paid in cash.

These awards are subject to the requirements of the deferred compensation rules under Internal Revenue Code Section 409A.

Participants in a phantom stock program benefit from the underlying stock value, as well as the appreciation in the stock. The participants receive an award of hypothetical or "phantom" shares of company stock and are entitled to payment at a specified date in the future for the full value of the underlying shares.

There is typically no exercise price associated with phantom stock—except in the case of a deferred compensation plan investing in the phantom shares.

Definition of SARs

A SAR is a form of bonus compensation given to employees that is equal to the amount of appreciation in company stock over a previously agreed upon period of time. Due to this fact, SARs only provide value if the stock price rises.

This arrangement can be a benefit for the company as employees will benefit only if the company stock appreciates, which will entice employees to ensure that the company performs well.

As with phantom stock, benefits are normally paid out in cash, but could also be paid in shares. SARs may also be paid in a combination of cash and stock.

Participants generally have the right to exercise and realize the value of their SARs at their election or upon the occurrence of a payout event. This payout event can include the following:

1. A specified date in the future
2. Termination of employment
3. A change in control
4. A public offering[1]

Most agreements are structured so that SARs can be exercised any time after they vest.

SARs are different from stock options due to the fact that when the option is exercised, an employee does not have to pay to acquire the underlying security. It is a straight cash expense for the company. Payments are typically made in cash by the company and reported as compensation expense.

Compensation expense related to a SARs plan is reported on the sponsor company income statement based on:

1. the change in the fair value of the underlying stock and
2. the anticipated vesting schedule of the SARs.

Arguments for and against Phantom Stock Plans and SARs

Both phantom stock plans and SARs are considered synthetic equity. These types of equity plans are often favorable for S corporation ESOPs due to the fact that if the benefits are settled in cash, the ESOP's equity interest in the sponsor company is not diluted for income tax purposes.

Some other typical arguments for synthetic equity, and specifically for phantom stock plans and SARs, include the following:

1. Some private companies do not want employees to actually own shares or, in some cases, have no shares to make available. For instance, limited liability companies, partnerships, and sole proprietorships may not have stock, but they could give employees a right to a capital interest in the company.

   These private companies have equity value, and owners may want to share this in some way with employees without actually making them partners in the firm.
2. In companies that do have stock, owners may be concerned about employees owning actual shares. In some cases, this may be for fear of losing control, although, in practice, other kinds of stock plans (such as creating different classes of voting and nonvoting shares) can usually handle the control issue with little or no difficulty.
3. Private company owners may be concerned that there is no foreseeable market for actual shares given to employees. It may be simpler in these cases to give employees cash rather than to buy shares back from them or try to find other buyers. Such sales may also raise securities law compliance issues.

   Even the issuance of shares can trigger securities law compliance issues, although

it is usually a fairly simple process to obtain an exemption from these rules.[2]

4. When a company first implements an ESOP, before the sponsor company shares are released, these plans can help to incentivize and retain key executives (who are sometimes also the sellers to the ESOP) until the employee ownership interests are significant enough to promote retention and performance.
5. Phantom stock plans and SARs are flexible, and the issuing company can assign them to specific employees that they determine will have the greatest impact on company performance.

Some of the arguments against the use of the above-mentioned plans include the following:

1. They provide no significant income tax benefits to employers or employees, especially relative to such tax-qualified employee ownership plans as ESOPs, 401(k) plans, and incentive stock options.
2. They may be difficult to communicate to employees who are skeptical about whether the plans will deliver significant value.

   Whereas stock comes with specific contractual and general corporate law rights, and carries the same value as shares of the same class held by other owners of the private company, phantom stock or SARs are based only on a contractual agreement to pay out based on management's determination of what the private company is worth.
3. For ESOP sponsor companies, employee owners are already rewarded for appreciation in the value of the sponsor company stock through the ESOP shares that they own. Further, awarding additional synthetic equity to certain employees will create haves and have nots.
4. The value of SARs can fall to zero if the stock price of the issuing company is declining, thereby no longer providing a strong incentive to management when the current share price is significantly below the strike price.
5. When issuing phantom stock or SARs, the private company will need to determine the value of the shares on a regular basis. This could increase the administrative burden and cost, and lead to disputes regarding the determined value of the shares. However, this may be less of an issue for an ESOP sponsor company that already receives annual valuations for ESOP administration purposes.

Equity-Based Compensation Plans

The first procedure to figuring out which plan works best for the sponsor company looking to build an executive compensation plan is to figure out what the company intends to accomplish with this plan.

A philosophy statement is something that should be a part of all businesses that are looking to formulate an executive compensation plan.

A philosophy statement generally lays out:

1. how the company intends to recruit and retain employees,
2. how the company will pay employees, and
3. what the company will pay employees.

The philosophies will vary company to company based on how base pay compares to market-based compensation. Companies that set base pay below market price often will rely on benefits beyond base pay such as phantom stock plans or SARs plans to remain competitive.

One piece of information that many executive compensation programs rely on when planning is compensation survey data. This data is relied on for monitoring trends and to help formulate an equity compensation plan that works best for the specific company in question.

Keeping up with trends in order to offer competitive compensation packages is very important for attracting and retaining not only high-level executives, but employees at all levels of the company. Surveys are a great way to set a benchmark or provide a basis for formulating an ESOP company's executive compensation program.

Executive Compensation Surveys

Some executive compensation surveys gather a diverse sample of ESOP companies. One survey that is useful for ESOP companies is the National Center for Employee Ownership ("NCEO") *Survey of ESOP Company Executive Compensation*. The NCEO's most recent survey compiled 419 responses from various ESOP companies.[3]

The survey gathered compensation data for eight different executive positions. The survey goes into extreme detail in various tables detailing what different kinds of ESOP sponsor companies are doing for their executive compensation plans.

ESOP-specific compensation surveys are especially useful tools because such survey data from non-ESOP companies may not take into account the ownership benefits associated with being part of an ESOP.

Generally, executive compensation surveys are more useful for private companies, as public companies have a plethora of data at their disposal between publicly available SEC filings and discussions on executive pay philosophy among public companies.

Of course, executive compensation surveys may not take everything into account regarding a company's specific situation, but these surveys can be used as a good starting point for compensation discussions.

Implementing Executive Compensation Programs

Reasons for Implementing Executive Compensation Programs

Determining executive compensation is generally the responsibility of a company's board of directors or a compensation committee that is selected by the board of directors.

The objectives associated with an ESOP sponsor company implementing plans such as a phantom stock plan or SARs plan are to:

1. retain their key executives,
2. incentivize the growth of shareholder value, and
3. generally entice their executives to act and think like shareholders.

Newly hired executives may not have significant ownership in the ESOP early in their tenures. Likewise, newly created ESOPs may not have shares released yet.

Much like ownership through an ESOP, these synthetic equity plans are more of a benefit to executives if the share price of the company grows. By thinking and acting like shareholders, executives will most likely put the company in the best position to increase in value, which in turn will increase the compensation received by the executive.

The two most popular plans for ESOP companies to supplement the equity executives receive through an ESOP are:

1. phantom stock plans and
2. SARs.[4]

Phantom stock is often utilized to encourage employee retention. This is because phantom stock has value as long as the share price is greater than zero, regardless of the increase in share value. In order for phantom stock to be a useful retention tool, it is often granted with a multiyear vesting schedule.

If new phantom stock is continually granted with a multiyear vesting schedule, the recipient will continue to realize value from staying with the company as more shares will vest the longer they stay with the company.

If the primary goal of an executive compensation plan is to encourage growth in the value of the company, SARs can be an effective tool. Much like an at-the-money stock option, the recipient of a SAR will only realize value if the shareholder value of the company increases.

Scrutinizing Executive Compensation Programs

When implementing executive compensation plans, it is important for those in charge of the decision to consider potential conflicts of interest, particularly members of management who serve on the board.

This is why it is usually a best practice to have independent members who are not part of management be in charge of selecting the levels of executive compensation for the ESOP sponsor company.

It is important to be diligent in the selection of compensation as both the Internal Revenue Service ("Service") and the Department of Labor will be responsible for enforcing any rules that the ESOP is required to follow. Some of those requirements that the sponsor company will be subject to are laid out in the Employee Retirement Income Securities Act ("ERISA").

There are two types of analyses that are often used to assess the reasonableness of executive compensation:

1. A multifactor analysis
2. The independent investor test.

As mentioned previously, the Service will be scrutinizing any compensation plan that an ESOP sponsor company decides to implement.

According to the Service's *Job Aid for IRS Valuation Professionals*,[5] reasonable compensation is defined by Treasury Regulation § 1.162-7(b)(3) as the "[a]mount that would ordinarily be paid for like services by like organizations in like circumstances, and this standard is adopted in Treas. Reg. § 53.4958-4(b)(1)(ii)(A)."

The reasonableness of compensation concept has two prongs: (1) the amount test and (2) the purpose test. Generally, courts only need to examine the first reasonableness of compensation prong.

When analyzing the amount test, the courts are focusing on the reasonableness of the total amount paid. In order to satisfy the requirements of Section 162, there are 12 factors considered when assessing the reasonableness of any executive compensation.

The 12 reasonableness of compensation factors typically considered are as follows:

1. The employee's qualifications
2. The nature, extent, and scope of the employee's duties
3. The employee's background and experience
4. The employee's knowledge of the business;
5. The size and complexity of the business
6. The time devoted by the employee to the business
7. The economic conditions generally and locally
8. The character and amount of responsibility of the employee
9. Whether or not the compensation is predetermined based on activities to be performed or not determined until the end of the tax year
10. Amounts paid to the employee in prior years
11. The salary policy of the taxpayer as to all employees
12. The amounts paid by similar size businesses in the same area to equally qualified employees for similar services

"[T]he Service will be scrutinizing any compensation plan that an ESOP sponsor company decides to implement."

Different Ways SARs Are Utilized

For an ESOP sponsor company, SARs can be utilized to:

1. help retain management after an initial ESOP transaction and
2. incentivize management on an ongoing basis.

When an initial ESOP installation occurs, or when there is a large sale of equity to an ESOP, the selling shareholder(s) are often key members of management. To incentivize these selling shareholders (and other members of management) to continue their employment with the sponsor company, they are often granted SARs that vest over a defined period of time.

If the ESOP purchase was financed through debt (i.e., a leveraged ESOP), the equity value of the ESOP sponsor company may be depressed due to the significant debt burden. This situation presents issues with setting the strike price of the SARs at the current share value, which could be significantly below the pretransaction share value depending on the debt burden incurred by the sponsor company.

The assumption is that as the ESOP sponsor company pays down the debt, and the sponsor company continues to perform, the equity value and corresponding share price will increase significantly over time.

When SARs are used to incentivize key employees after a sponsor company is 100 percent owned by the ESOP, and all ESOP stock acquisition debt has been paid off, SARs are typically set at the current share price. This is typically the share price determined by an independent valuation adviser on an annual, semiannual, or quarterly basis for ESOP administration purposes.

In this scenario, the initial exercise value of the SARs will be zero but will become in the money after any increase in the value of the company shares. These SARs will often vest over a number of years, such as 20 percent annual vesting. The SARs plan may have special rules for employees at or nearing retirement age that allow for immediate vesting of the shares.

Valuation Considerations

Synthetic equity plans are typical in ESOP sponsor companies and are often adopted contemporaneously with the formation of an ESOP. SARs plans are one of the typical forms of incentive compensation implemented alongside an ESOP.

Assuming the value of a sponsor company is increasing, SARs create a real liability that analysts should consider when estimating the value of an ESOP sponsor company.

Knowing the Plan Documents and Plan Attributes

When determining the value impact of a synthetic equity plan such as SARs, the rights and characteristics of the plan, as outlined in the plan documents, may have a significant impact.

Therefore, the analyst should make sure he or she understands the attributes of the SARs plan including but not limited to the following:

1. What is the vesting schedule of the SARs?
2. Is the vesting schedule based on time of employment or company performance?
3. Is there a mandatory exercise of the SARs based on a date or event?
4. Is there an expiry date for the SARs plan?
5. How are the SARs treated in a change of control transaction or liquidity event?
6. How will the share value on which the SARs are based be determined?
7. Are the SARs settled in cash, stock, or both?
8. How many SARs are outstanding and how is this number expected to change over time?
9. What is the age of the employees that hold SARs and when will the payments associated with the SARs likely occur?
10. What are the strike price(s) of the various SARs outstanding?

Consideration of these attributes will help the analyst understand and, therefore, more accurately value, the SARs liability and associated valuation impact. Not knowing how these attributes will impact the value of the SARs and the associated liability may cause the analyst to overvalue or undervalue the ESOP shares.

Additionally, not understanding the liability associated with the SARs plan could create an unexpected liquidity problem for the sponsor company when the SARs come due.

Income Statement Impact of SARs

The accounting expense associated with a SARs plan is required to be measured on a fair value basis for financial statement reporting purposes at each reporting date. After the fair values of the grants are determined, the associated expense is recognized as a charge to the income statement.

The expense can be volatile, and it is affected by both the change in the fair value of the underlying shares and the change in the private company's expectation of the number of SARs expected to vest.

Given that SARs expense can be volatile, and not necessarily representative of the normalized cash flow impact of the SARs plan, it is typical for analysts to add back any SARs expense reported in the income statement and account for the SARs liability in other ways.

The analyst should interview members of the subject company accounting department to ensure that the analyst recognize how the SARs expense affects the income statement so that he or she can correctly adjust for the expense.

This procedure applies to adjusting both historical financial statement information, and projected financial statements that include management's expectations of future SARs-related accounting expense.

If the analyst excludes the SARs expense when determining normalized earnings, the value impact of the SARs liability should be addressed in another way. Assuming that the SARs liability will be settled in cash, it can be accounted for by one of the following procedures:

1. Estimating the actual cash flow impact in future years (for a discounted cash flow method analysis) and the normalized cash flow impact in historical years (for a market approach or direct capitalization method analysis)
2. Excluding the cash flow impact of the SARs plan for purposes of determining the unadjusted equity value of the private company and then subtracting the total SARs liability from the estimated equity value of the private company

Accurately estimating the timing of future cash flow payments as SARs are exercised can be difficult, so it is typical for analysts to account for the value impact of a SARs plan by subtracting the estimated SARs liability from the estimated equity value of the private company.

Determining the SARs Liability

The attributes of a SAR are similar to those of a stock option and may be treated in a similar manner for valuation purposes. Two ways to value the SARs liability are the intrinsic method and an option pricing model such as Black-Scholes.

The application of both models have advantages and disadvantages.

The Black-Scholes formula for pricing options or SARs is complex, the details of which are beyond the scope of this discussion. The Black-Scholes formula estimates the potential future value of a SAR based on inputs including the grant or strike price, a risk-free rate, the time to expiration, and the volatility factor.

One argument for applying the Black-Scholes formula to value a SAR is that even an out-of-the-money SAR has some level of value due to its potential to have value in the future. The Black-Scholes formula quantifies this future value potential.

However, the Black-Scholes model can be complicated to understand, and it relies heavily on one subjective input, the volatility factor of the share price. The higher the volatility factor in the Black-Scholes formula, the higher the estimated value of the SARs liability will be.

Volatility factors are typically estimated based on the price volatility in guideline publicly traded companies. However, the value of the ESOP shares, typically based on an annual valuation, may not have the same level of volatility as public company shares subject to dramatic swings from market duress or optimism.

The intrinsic method is a simpler and more intuitive way to estimate the value of the SARs liability. The intrinsic method calculates the value of a SAR based on the difference between the current value of the private company stock and the strike price of the SAR.

This method calculates what the cash outflow would be if each vested (or the vested portion) and exercisable SAR was exercised as of the valuation date. However, unlike the Black-Scholes model formula, the intrinsic method does not account for the time value of the option to hold onto the SAR, and any SAR not in the money as of the valuation date is assigned a value of zero.

Summary and Conclusion

When implemented correctly, executive compensation plans that utilize synthetic equity are a useful tool to attract, retain, and incentivize employees. Synthetic equity plans such as phantom stock and SARs have become popular tools for ESOP sponsor companies, both at the implementation of the ESOP and on an ongoing basis.

"[I]t is important for ESOP trustees to understand their fiduciary duties when it comes to executive compensation plans."

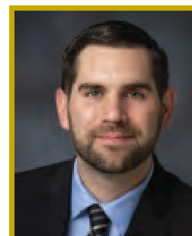
However, it is important that ESOP sponsor companies understand how and when to effectively utilize these plans. Further, it is important for ESOP trustees to understand their fiduciary duties when it comes to executive compensation plans.

Given the prevalence of SARs plans and other executive compensation plans in ESOP sponsor companies, analysts need to understand the impact that these plans have on the value of the sponsor company and the underlying ESOP shares.

Analysts should take care to understand the specific attributes of subject company synthetic equity plans and be comfortable with the valuation methods used to quantify them.

Notes:

1. *Beyond Stock Options* (Oakland: National Center for Employee Ownership, 2006).
2. Ibid., 13–14.
3. "2019 ESOP Executive and Board Director Compensation Survey Report," NCEO.org, 2019.
4. Aziz El-Tahch and Michael Ricaurte, "Executive Compensation Programs in ESOP Companies and Their Impact on Value," *The Journal of Employee Ownership Law and Finance* 21, no. 1 (Winter 2009).
5. "Reasonable Compensation: Job Aid for IRS Valuation Professionals," Internal Revenue Service (October 29, 2014).



Scott Miller is a vice president of our firm in our Portland, Oregon, practice office. Scott can be reached at (503) 243-7504 or at srmiller@willamette.com.

Lerry Suarez is an associate also in our Portland practice office. Lerry can be reached at (503) 243-7512 or at lasuarez@willamette.com.

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773 • 399 • 4310 (fax)

1355 Peachtree Street, NE
Suite 1470
Atlanta, GA 30309
404 • 475 • 2300
404 • 475 • 2310 (fax)

Financial Statement Normalization Adjustments for ESOP Sponsor Company Valuations

Charles A. Wilhoite, CPA, and Tia Hutton

Normalizing financial statements is the procedure for removing the impact that nonoperating assets and liabilities and nonrecurring or unusual income and expense items exert on the "normal"—or continuing—financial results of a company. Such a procedure is performed in order to establish a level of normal operations, and related operating results, that reasonably can be relied on to develop the valuation of an ESOP sponsor company.

Introduction

Recent estimates indicate that there are approximately 6,600 employee stock ownership plans ("ESOPs") covering approximately 14 million employee participants in the United States, and controlling approximately $1.4 trillion in corporate value (approximately 8 percent).[1]

ESOP regulations require that, at least annually, an ESOP sponsor company, representing the entity in which the ESOP participants own shares, must be appraised by an independent, qualified financial adviser to facilitate the administration of the ESOP.

While this discussion provides some general background regarding ESOPs, it is not intended to provide a detailed analysis regarding ESOP regulations, or the intricacies associated with forming and operating an ESOP. The valuation of an ESOP sponsor company should comply with generally accepted valuation practices and with business valuation standards. These practices and standards include the analyst's consideration and application of one or more valuation methods within the three generally accepted business valuation approaches:

1. The income approach
2. The market approach
3. The asset-based approach

This discussion assumes that the reader possesses a basic level of familiarity with the generally accepted business valuation approaches and underlying methods. Based on this premise, this discussion will not present a detailed analysis regarding the implementation of generally accepted business valuation approaches and methods.

Rather, this discussion focuses on financial statement normalization considerations that have the potential to exert a significant impact on the expected earning potential and, therefore, on the estimated value, of an ESOP sponsor company.

ESOP Background

An ESOP is a qualified, defined contribution employee benefit plan in which the sponsor company makes annual contributions. ESOPs were designed as a tax-advantaged mechanism for transferring ownership into the hands of American workers.

When establishing an ESOP, the sponsor company sets up a trust fund. There are two basic forms of an ESOP: (1) nonleveraged and (2) leveraged.

A nonleveraged ESOP trust, or ESOT, is funded without the use of debt, and the annual contributions are made in the form of sponsor company stock, or in cash to purchase existing sponsor company stock. The sponsor company shares held by a nonleveraged ESOP are allocated to individual participant accounts, generally on the basis of relative compensation.

A leveraged ESOP trust is funded through borrowing money to purchase shares in the sponsor company. The purchased shares are held in a suspense account and a proportionate number of shares are released as the ESOP loan is amortized. As the shares are released from the suspense account, they are allocated to individual participant accounts.

The sponsor company makes annual, tax-deductible contributions to the ESOP typically represented by the principal and interest payments made to pay down the underlying loan.

The Employment Retirement Income Security Act of 1974 ("ERISA") sets the minimum standards for many retirement and health plans, including ESOPs. ESOP fiduciaries must comply with the rules and standards of conduct set by ERISA. An ESOP fiduciary is considered to be anyone with authority or control over the assets of the ESOP, or anyone who participates in the management or administration of the plan.

ERISA established both the U.S. Department of Labor ("DOL") and the Internal Revenue Service ("Service") as federal oversight agencies for ERISA.

It is important for fiduciaries to ensure they comply with ERISA. Failure to comply can result in costly fines and penalties. The most important requirement provided by ERISA is that the fiduciary must act in the best interest of the beneficiaries and plan participants of the ESOP.

This requirement includes overseeing the acquisition of employer shares by the ESOP. According to the DOL and the Service, an ESOP may not pay more than "adequate consideration" for the shares acquired.

Federal statutes mandate that private companies provide participants with "put" options. With a "put" option, the sponsor company and/or the ESOP must repurchase the departing employee sponsor company shares at a price no less than fair market value ("FMV").

A generally accepted definition of FMV is stated in Revenue Ruling 59-60 of the Internal Revenue Code. The Service defines FMV as "the price at which the property would change hands between a willing buyer and willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts."

Publicly traded companies with ESOPs generally can rely on prices established by arm's-length transactions in the market, as published in public exchanges, to establish the FMV of sponsor company stock. A sponsor company with stock that is thinly traded (i.e., subject to low trading volume) may be required to engage an independent financial adviser to estimate the FMV of the ESOP stock.

However, the majority of ESOP sponsor companies are closely held with no public market for their shares. When this is the case, a primary fiduciary responsibility of an ESOP trustee is to set the FMV of the sponsor company securities owned by the ESOP.

ESOP trustees are required by the DOL to obtain a third-party independent valuation of the sponsor company stock held by the ESOP at least annually, though many sponsor companies are valued more frequently for ESOP purposes (e.g., semi-annually or quarterly).

These recurring ESOP valuations generally are referred to as "valuation updates." Valuation updates are integral to annual ESOP administration procedures. In addition, an ESOP trustee may retain the services of a financial adviser for a proposed transaction involving the ESOP, either as a buyer or a seller.

Although the financial adviser is tasked with providing the trustee with an independent estimate of the FMV of the sponsor company shares, it is ultimately the trustee's fiduciary responsibility for procuring, reviewing, and accepting the FMV of the sponsor company securities owned by the ESOP.

If the trustee were to set the share price as something different than that recommended by the financial adviser, the trustee would need to provide an explanation for the difference.[2]

Financial Statement Normalization Considerations for ESOP Sponsor Company Valuations

A financial adviser typically faces many decisions when performing a sponsor company stock valuation. One typical decision is whether to apply valuation adjustment and normalization adjustments.

The term "valuation adjustment" generally is recognized within the valuation profession as an umbrella term. Often, the term is used to describe adjustments applied to the initial result of a valuation process in order to arrive at the desired level of value based on the ESOP ownership interest.

The generally accepted levels of value regarding the stock of a sponsor company typically are categorized as one of the following:

1. Controlling ownership basis—that is, exercisable, voting control, generally on a marketable basis
2. Noncontrolling ownership basis—that is, the absence of voting control, generally on marketable basis[3]

Unlike the illiquidity inherent in the stock of most private (i.e., nonpublic) companies, the "put" right attached to the ESOP stock of a sponsor company creates a market for the security, rendering the security "generally marketable." The ultimate liquidity created by an enforceable and financially supportable put right is a topic beyond the scope of this discussion.

However, it is important to note that the put right associated with ESOP stock of a financially viable sponsor company typically results in a significant reduction, or even elimination, of the discount for lack of marketability that otherwise would be applied to estimate the FMV of the stock of a private company.

Another frequently recurring valuation adjustment consideration relates to whether nonoperating assets (e.g., excess working capital, nonoperating real estate, litigation awards) or liabilities (e.g., debt on nonoperating assets, litigation claims) exist at a particular valuation date. If so, such items typically are added to (i.e., nonoperating assets) or subtracted from (i.e., nonoperating liabilities) the estimated operating value of the sponsor company to conclude the final total value of the sponsor company equity.

Another analyst decision in all business valuations is whether to normalize a company's historical financial statements.

While the *valuation adjustments* previously discussed are made to preliminary indications of the value of a sponsor company to arrive at the final conclusion of value, *normalization adjustments* typically are made to the reported financial statements of the sponsor company to develop a normal, or reasonable, expectation regarding the sponsor company's financial position and operating results.

Financial statement normalization involves adjusting the sponsor company's historical and prospective financial statements for the impact of recognized accounting items that are determined not to reflect the normal, ongoing operating performance of the sponsor company.

Adjustments often should be made to a company's reported financial results to develop a more accurate estimate of the long-term earning capacity of the sponsor company. Typical adjustments include those for extraordinary and/or nonrecurring items, which may understate or overstate the reported results of normal operations, and any income or expense relating to nonoperating assets.

The resulting cash flow should represent the normalized cash flow that stakeholders (i.e., debt and equity investors) reasonably could expect the sponsor company to generate in future operating periods.

Depending on the sponsor company, there can be a significant difference between operating results reported in historical financial statements and the adjusted/normalized operating results, thereby significantly affecting the estimated value of the sponsor company and its underlying stock.

Financial statement normalization can provide a financial adviser with a clearer picture of recurring expenses, revenue, and cash flow, and a sound basis for comparing the operating results of the sponsor company with the operating results of guideline companies and industry metrics.

Additionally, a rational and well-executed normalization process can provide a solid foundation for developing future performance expectations for the sponsor company and understanding the sponsor company's risk exposures.

In addition to considering extraordinary and/or nonrecurring items, a financial adviser may need to consider normalization adjustments relating to discretionary expenditures. The necessity for and appropriateness of discretionary expenditure adjustments generally is dependent on the level of ownership control the ESOP has over the sponsor company.

However, this statement is only true if an ESOP trustee is (1) acting as controlling shareholder and (2) acting independently from the employer corporation owners/decision makers.[4]

Careful scrutiny should be given to potential normalization adjustments, as such adjustments can exert a material impact on the estimated value of the sponsor company and underlying ESOP shares.

As previously discussed, ESOP transactions are measured by the "adequate consideration" standard. As a result, an overstated or understated ESOP valuation can plague an ESOP sponsor company as ESOPs determined to have paid more than adequate consideration when buying, or receiving less than adequate consideration when selling, can result in serious financial ramifications for the parties to the transactions.

Additionally, ESOP sponsor company valuations ultimately determine the value of ESOP participant retirement accounts. Therefore, a financial adviser

should carefully consider and adequately support any normalization adjustments.

The remaining sections of this discussion focus on the considerations a financial adviser makes when identifying and quantifying normalization adjustments for sponsor company stock valuations. Many of the considerations identified are also relevant in non-ESOP valuation contexts.

Valuation adjustment (i.e., ownership control and investment marketability) considerations are discussed only to the extent they relate to, or are affected by, the financial statement normalization adjustments.

Financial Statement Normalization Adjustments

It is important to note that when completing a business valuation, there are certain normalization adjustments that a financial adviser should consider regardless of:

1. who owns the stock subject to valuation or
2. what level of ownership (i.e., controlling or noncontrolling status) is represented by the subject ownership interest.

These adjustments include unusual or nonrecurring income and expense items. They should be addressed to accurately reflect the expected financial performance and, ultimately, the value, of the sponsor company.

A financial adviser should consider when and how to make financial statement adjustments when completing ESOP sponsor company valuations. Normalization adjustments typically include those for extraordinary and/or nonrecurring items.

The Financial Accounting Standards Board ("FASB") provides guidance in determining such items. According to the FASB Accounting Standards Codification ("ASC") topic 225, an extraordinary item is one that is both:[5]

> Unusual in nature—the underlying event or transaction should possess a high degree of abnormality and be of a type clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the entity, taking into account the environment in which the entity operates.
>
> Infrequent in occurrence—the underlying event or transaction should be of a type that would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the entity operates.

One method frequently applied to identify extraordinary and/or nonrecurring items is to perform year-over-year trend analysis. As implied, trend analysis allows a financial adviser to review historical operating relationships (e.g., balance sheet accounts relative to total assets and income or expense accounts relative to total revenue) over time.

Trend analysis provides the financial adviser with an understanding of recurring, or "normal," financial and operating relationships.

Such relationships can be analyzed by comparing individual asset and liability categories with total assets, and by comparing individual revenue and expense categories with total revenue—a process typically referred to as common-size trend analysis.

However, not all normalization adjustments can be identified based on reviewing the sponsor company's historical financial statement trends as asset, liability, revenue, and expense classifications can change over time, thereby limiting the usefulness of trend analysis.

The process of identifying and estimating normalization adjustments requires informed diligence on the part of a financial adviser.

The review and analysis of the financial and operating records of the sponsor company typically is supplemented by in-depth management interviews, sponsor company site visits, independent industry and economic research, and potential consultation with experts in relevant fields of specialization.

Such due diligence often provides the following:

1. A clearer picture of what can be considered "normal" operations for the sponsor company
2. A solid foundation for any normalization adjustments ultimately incorporated in the valuation analysis

A noncomprehensive list of categories of typical normalization adjustments includes the following:

- Nonrecurring revenue/expense items
- Separation of operating and nonoperating items
- Change of accounting or generally accepted accounting principles ("GAAP") effects on financial statements

The following discussion provides a more in-depth explanation of the above-listed categories.

Nonrecurring Revenue/Expense Adjustments

The income statement includes the economic impact of all the reportable revenue and expense events that took place during an accounting period. However, there may be some events that occurred that may not be part of the normal course of business.

A financial adviser should carefully consider the likelihood of the recurrence of the events and determine whether it is necessary to adjust the reported financial statement results to produce a best estimate of the sponsor company's earning power.

Although nonrecurring items have cash flow consequences, the focus of income normalization adjustments is to provide insight into the core operations of the sponsor company.

A financial adviser may add or subtract nonrecurring items to eliminate their impact on reported income. The normalization process should not be interpreted as "correcting" the reported financial results of the sponsor company.

The objective of the normalization process is to eliminate the impact of reported items determined to be unusual or nonrecurring in nature in order to develop a reasonable expectation regarding normal operating results for the sponsor company.

The following noncomprehensive list includes examples of nonrecurring revenue/expense items that may be present in ESOP sponsor company financial statements:

- Nonrecurring expenses associated with the ESOP installation
- Litigation costs, payments, or proceeds
- Unusual gains or losses on the sale of business assets
- Property loss or extraordinary expenses due to disasters such as fire, flood, hurricane, or other casualty (both physical damage and business interruptions) losses, and so forth, not covered by insurance
- Acquisition-related expenses
- Restructuring-related expenses
- Severance payments
- Nonrecurring bad debt expense, such as the expense associated with the write-down of a note receivable

Certain nonrecurring items may have income tax and/or regulatory consequences. It is important for the financial adviser to understand these relationships and make appropriate adjustments for the related consequences.

Separation of Operating and Nonoperating Items

It is typical for private companies to own nonoperating assets—assets that are not required for ongoing business operations. Although nonoperating assets may provide an income stream, this income stream typically would not represent a normal part of business operations. The liquidation of such assets would not, in theory, impair ongoing business operations.

For example, it is not uncommon for a private company to hold real estate for investment purposes. If such real estate generates rental or lease income which is not central to the operations of the business, this income should be excluded from normalized earnings.

If a financial adviser is applying the market approach to estimate value, it would be reasonable to consider eliminating any material nonoperating assets from the total asset base of the sponsor company (assuming the asset base is incorporated directly in the market approach analysis).

Associated with the removal of nonoperating assets from the asset base of the sponsor company, the financial adviser should normalize the reported income of the sponsor company by eliminating any reported income and expense attributable to the nonoperating asset.

Ideally, such financial statement adjustments are made early enough in the valuation process to allow for the impact of such adjustments to be considered in trend and financial statement ratio analysis. This is particularly important if such analyses are used to select guideline publicly traded companies and develop pricing multiples.

It is important to note that some level of normalization process may also be appropriate with regard to the reported financial results of selected guideline companies (included in the guideline publicly traded company method or the guideline merged and acquired company method).

Normalizing financial statements typically facilitates a better comparison of operating results among the subject sponsor company and the guideline companies.

If the financial adviser removes income associated with nonoperating assets from the historical and/or prospective operating results of the sponsor company, the value of the related nonoperating assets (less any associated debt) should be added to the total indicated operating equity value of the sponsor company (after consideration of any related relevant valuation adjustments such as a discount for lack of control, when appropriate).

Accounting/GAAP Adjustments

A financial adviser should consider making accounting/GAAP normalization adjustments. Comparability is an important consideration in business and stock valuations. Financial statements issued over time that were prepared using the same accounting practices and reported in a similar fashion are considered to be comparable.

Financial statement comparability can become challenging when companies employ a different set of accounting practices for internal bookkeeping and financial statement reporting purposes. This statement is true even for companies that prepare their financial statement in accordance with GAAP.

Unlike the financial statement reporting practices of large public companies, many closely held companies' financial statements are not audited or prepared in accordance with GAAP.

Therefore, the financial adviser often evaluates certain reported items and makes appropriate adjustments to address the impact of differences resulting from alternative accounting practices. Normalization adjustments implemented to address the impact of different accounting practices allow for easier comparison of two or more companies and/or comparison to industry metrics.

One accounting adjustment is to account for differences in inventory accounting methods. These differences include adjusting for the impact of:

1. utilizing the first-in, first out ("FIFO") inventory accounting method versus the last-in, first-out ("LIFO") method and
2. inventory write-down and write-off policies.

The different inventory accounting methods can significantly affect the value of reported inventories, which directly influence cost of goods sold and earnings, and thus the value of the company.

Therefore, for consistency purposes, when implementing the market approach, the financial adviser should consider adjusting the earnings and asset values to the same inventory accounting method that the guideline companies employ. This procedure can be accomplished by using information provided in the financial statements.

Additional items that may be subject to accounting method normalization adjustments include the following:[6]

- Depreciation methods and schedules
- Depletion methods and schedules
- Allowance for doubtful accounts
- Adequacy or deficiency of liabilities (e.g., pension termination liabilities, deferred income taxes, and unrecorded payables)
- Treatment of intangible assets (e.g., leasehold interest)
- Policies regarding the capitalization or expensing of various payments
- Timing and recognition of revenue and expenses (e.g., contract work, installment sales, sales involving actual or contingent liabilities, and prior period adjustments)
- Net operating losses carried forward
- Adequacy or deficiency of assets (e.g., excess or deficient net working capital)
- Discontinued operations

ESOP-Specific Normalization Adjustments

There are some typical ESOP-specific normalization adjustments a financial adviser should consider when developing a valuation of a sponsor company. These considerations include adjustments relating to the impact of (1) stock appreciation rights ("SARs") and phantom stock and (2) ESOP contribution expense.

SARs and Phantom Stock

For some ESOP companies, a component of the overall executive compensation scheme is a benefit represented by stock-based incentives. Stock-based compensation is the practice of compensating key employees based on the sponsor company stock price. This is a typical practice in public companies and a prevalent issue for private companies that are competing with public companies for talent.

The primary purpose of stock-based compensation plans is to align the economic interests of the shareholders with the managers of the sponsor company. Stock-based compensation can take the form of incentive stock options, nonqualified stock options, restricted stock, SARs, and phantom stock.

SARs and phantom stock represent two common types of synthetic equity. These compensation components are deemed synthetic equity because no actual ownership interest is transferred to executives in these plans.

The employee is awarded based on the appreciation of sponsor company stock on which the compensation plans are based. Plans are settled in cash without diluting the ESOP's equity interest in the sponsor company.

For the purpose of financial reporting, SARs and phantom stock plans are forms of deferred compensation. The related benefits are accrued as bonus expenses in the operating statement of the

sponsor company through the eligibility period that the eligible employee can exercise the awards.

To ensure the bonus expense is reflected in the historical and prospective financial statements, the financial adviser may obtain and review the deferred bonus agreement.

The financial adviser may make normalization adjustments to both the historical and the prospective financial statements if it is discovered that the deferred bonus costs are not appropriately included in the financial statements.[7]

ESOP Contribution Expense

A financial adviser should understand the annual ESOP contribution and the accounting associated with it before determining whether to make an adjustment.

A leveraged ESOP trust is funded by borrowing money to purchase shares in the sponsor company. Typically, a loan is established with the participation of both the sponsor company and the ESOP. Sponsor companies are required by GAAP to record the debt on the balance sheet of the plan sponsor as negative equity in an account titled "unearned ESOP shares."[8]

This account represents the shares that are held as collateral for the ESOP debt. Within the ESOP, these shares are held in a suspense account.

The company makes annual tax-deductible contributions to the ESOP for both the principal and interest of the ESOP loan. As the loan is amortized, the sponsor company credits (reduces) the unearned ESOP shares account at the historical cost of the sponsor company stock.

An account called contribution expense is then debited (charged) as an expense equal to the FMV of the shares being released from the suspense account.

As the sponsor company stock increases in value, the ESOP contribution expense increases as well.

Contribution expense can vary significantly for many reasons, which can be challenging for a financial adviser when assessing the reasonableness of reported contribution expense. It may be appropriate to eliminate the reported ESOP contribution expense and replace it with a market-derived, or industry-average, retirement benefit level in order to normalize operating results.

Any adjustment to reported contribution expense should make economic sense for valuation purposes. There are certain factors a financial adviser should consider, including the following:

- Leveraged ESOPs generally report higher-than-normal contribution expenses for several reasons. It is common for a leveraged ESOP to contribute more than required to cover principal and interest payments in order to pay down debt at an accelerated rate.

  Without adjustment, this practice can exert a direct impact on the equity price due to the related reduction in earnings. Furthermore, required contribution levels can limit the sponsor company's ability to reduce cash contributions in the event the sponsor company stock price increases.

- The maturity of the ESOP should be considered. Newer ESOPs may experience greater fluctuations in stock price, while more mature ESOPs may face significant repurchase obligations, each having their own unique impact on contribution expense.

- The early departure of participants can impact contribution expense as significant redemptions can result in increased contribution expense.

- A repurchase study may provide insight to the level of contribution expense that is expected in the future.

In addition to evaluating the characteristics of a sponsor company's ESOP contribution expense, a financial adviser should interview management regarding expected contribution levels. This procedure may help provide insight into the specifics of ESOP contributions that are not obvious from analyzing financial statements alone.

Control-Related Normalization Adjustments

If an ESOP owns a controlling position in the sponsor company, and certain normalization adjustments are deemed appropriate, it is important to consider how the normalization adjustments may affect the level of valuation adjustments incorporated later in the valuation process.

For example, any adjustments to normalize discretionary expenses that result in an increase in earnings and an ultimate increase in value should be taken into consideration when estimating a control premium that might be applied as a valuation adjustment. This circumstance is true in valuations of both ESOP-owned sponsor company stock and any other type of controlling equity ownership interest.

In the context of an ESOP, control-related normalization adjustments should only be made if the ESOP trustee is willing to (1) act as a controlling shareholder and (2) act independently from the employer corporation owners/decision makers.

There is a spectrum of ownership control ranging from (1) absolute operational control to (2) a total lack of any operational control.

In some cases, the determination of ownership control is straightforward; however, the assessment of ownership control, from an operational basis, is not always a clear-cut issue. The degree of control inherent in an ESOP-owned block of sponsor company stock may fall anywhere along the ownership control continuum and may be affected by a number of factors.

To determine the degree of control, a financial adviser should consider the following:

1. The percentage of outstanding shares owned by the ESOP
2. The rights inherent in the ESOP-owned block of sponsor company stock
3. The inherent control in the remaining sponsor company stock that is not owned by the ESOP trust

Ownership control can depend on several factors, including the following:[9]

- Which party controls the sponsor company board of directors
- Which party controls the sponsor company CEO and other executive management positions
- What are the key contractual provisions in the ESOP trust documents and sponsor company stock purchase agreement
- State corporation laws in the state where the sponsor company is incorporated

When assessing the level of ownership control inherent in an ESOP ownership interest, it is important for the financial adviser to obtain and review relevant sponsor company documents. Such a review is important because the application of control-related valuation adjustments does not always relate to whether the ESOP trust owns a noncontrolling interest (less than 50 percent ownership of the sponsor company's outstanding shares).

There are ESOPs that enjoy contractually granted elements of ownership control even if the ESOP owns a noncontrolling interest in the sponsor company equity.

In addition to the usual records required for a valuation engagement, the financial adviser may obtain and review the ESOP document, the ESOP trust document, any ESOP loan documents, the relevant stock purchase agreement, and relevant Forms 5500.

When valuing a controlling ownership interest for ESOP purposes, similar to such a valuation completed for non-ESOP purposes, the financial adviser should understand the facts and circumstances specific to the sponsor company to determine the relevance and level of valuation adjustments.

A noncomprehensive list of normalization adjustments that typically relate to a controlling owner's discretionary expenditures are as follows:[10]

- Excess shareholder/employee compensation
- Employee compensation expense related to less than fully productive shareholder friends and relatives who may be included on the sponsor company payroll
- Shareholder-related personal expenses that are paid by the sponsor company
- Above-market rents/rates paid by the sponsor company for the lease of controlling shareholder-owned real estate or other assets, or the purchase of controlling shareholder-provided services or products

Financial advisers may consider an adjustment for excess compensation of key employees. In private companies, compensation to owners and managers may be based on the desires of the owner rather than the value of the services performed by those individuals.

In an ESOP sponsor company valuation, it is only appropriate to make a compensation adjustment if the compensation policies are likely to be changed. If the higher level of compensation is expected to continue into the future, the ESOP sponsor company valuation should reflect the ongoing compensation practices.[11]

In addition to owner/employee compensation, owners may take out what normally would be considered profits in the form of compensation and personal expenses. Typical examples may include personal car expenses, travel and meal expenses, and certain professional fees. These expenses generally benefit the owners and deviate from the costs required to operate the business.

The financial adviser should consider if employee compensation expense includes any employees who are on the sponsor company's payroll but do not actively participate in the operations of the business. Often there are family members of the

owners who receive some level of compensation from a company without employment capacity. In these situations, compensation expenses should be adjusted.

In the valuation of a controlling ownership interest, discretionary expenditures typically are adjusted to a market-derived, or industry-average, expense level. The normalization of discretionary expenditures does not imply that the hypothetical willing buyer will not make any discretionary expenditures. Rather, the procedure recognizes that the buyer and seller may not make the same discretionary expenditures.

However, it would be rare for an ESOP sponsor company to report discretionary expenses or related-party expenses to the detriment of the ESOP, particularly if the ESOP maintained ownership control or was under the oversight of an independent trustee.

In the valuation of a noncontrolling interest, the financial adviser may not make normalization adjustments for discretionary expenditures. This is because the noncontrolling block of sponsor company stock cannot affect the type/amount of a controlling shareholder's discretionary expenditures.

Therefore, the buyer of the noncontrolling block of sponsor company stock will not have control over the type/amount of the controlling shareholder's discretionary expenditures.

It is important to note that although a financial adviser should consider the need to normalize discretionary expenditures, in theory this should not be an issue in an ESOP sponsor company valuation based on the existence of a trustee(s) who maintains the responsibility of protecting the ESOP's economic interests.

In some instances, the ESOP administrators and the named fiduciary (i.e., the party primarily responsible for the plan) are representatives of the sponsor company. A trustee who is simply taking directions from sponsor company representatives is vastly different than an independent trustee who makes independent decisions.

If the ESOP trustee is not independent, then the company (through its board of directors) has the primary fiduciary duty to act in the best interest of the ESOP participants.

Summary and Conclusion

A well developed valuation of a sponsor company completed for ESOP purposes typically includes an assessment of historical operating results. This assessment frequently results in a "normalization" process, during which the impact of nonoperating assets and liabilities and unusual or nonrecurring income and expense items are adjusted from the historical financial results of the sponsor company.

This normalization process is appropriate because it enables a potential investor to assess the true and continuing economic earning capacity of the sponsor company. The experienced financial adviser should be well versed in the normalization process.

A credible sponsor company value conclusion can be developed if the valuation is based on a supportable level of expected economic earnings for the sponsor company, typically achieved through a diligent normalization process.

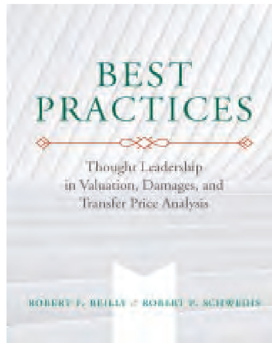
Notes:

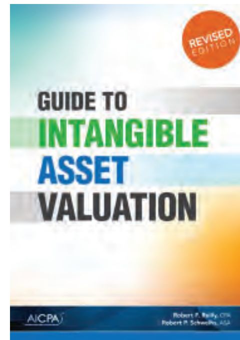
1. "Employee Ownership by the Numbers," National Center for Employee Ownership, www.nceo.org (September 19, 2019).
2. "What Every Valuation Analyst Should Know About Employee Stock Ownership Plans (ESOPs)" (white paper), American Institute of Certified Public Accountants, www.aicpa.org/content/dam/aicpa/interestareas/forensicandvaluation/resources/downloadabledocuments/esop-white-paper-1907-02158.pdf (2019).
3. Robert F. Reilly and Robert P. Schweihs, *Guide to ESOP Valuation and Financial Advisory Services*, 2nd ed. (Chicago, IL: Willamette Management Associates, 2006), 154.
4. Ibid., 152.
5. FASB Accounting Standards Codification Topic 225-20, Income Statement—Extraordinary and Unusual Items (Norwalk, CT: Financial Accounting Standards Board, 2015).
6. Shannon P. Pratt and Alina V. Niculita, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, 5th ed. (New York: McGraw-Hill, 2008), 131–32.
7. "What Every Valuation Analyst Should Know About Employee Stock Ownership Plans (ESOPs)."
8. Ibid.
9. Reilly and Schweihs, *Guide to ESOP Valuation and Financial Advisory Services*, 150.
10. Ibid., 152.
11. Pratt and Niculita, *Valuing a Business*, 817.

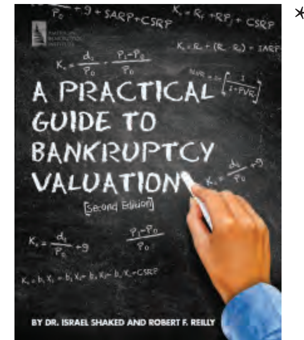
Charles Wilhoite is a managing director and is resident in our Portland, Oregon, practice office. Charles can be reached at (503) 243-7500 or at cawilhoite@willamette.com.

Tia Hutton is an associate also in our Portland practice office. Tia can be reached at (503) 243-7501 or at thutton@willamette.com.

Valuation Textbooks Authored by Robert Reilly and Robert Schweihs







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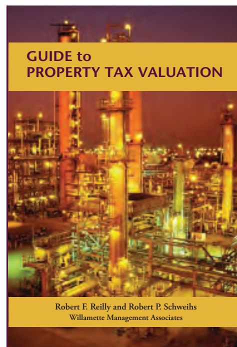

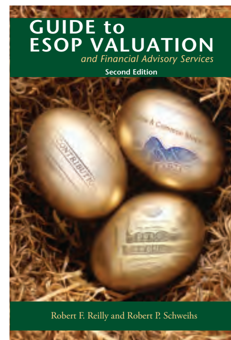

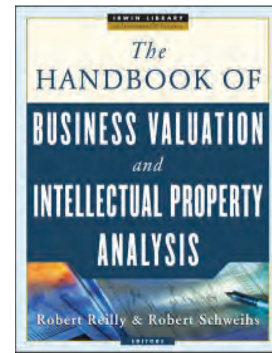

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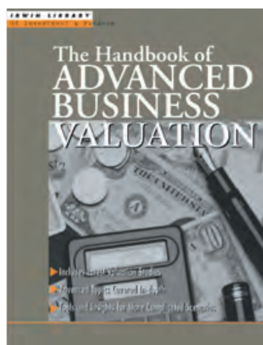

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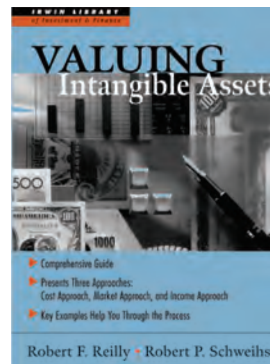

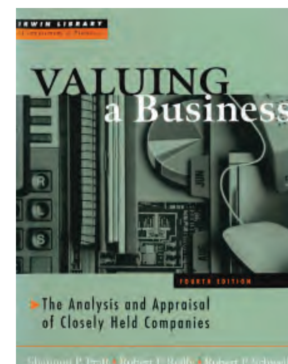

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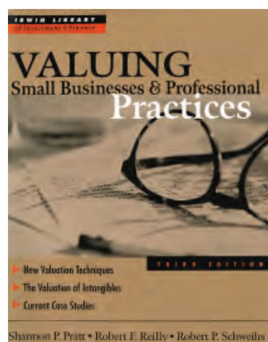
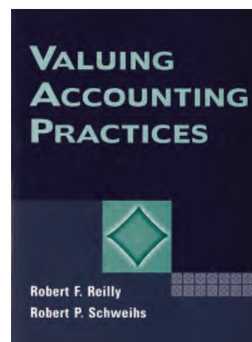
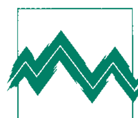




* Authored by Robert Reilly and Israel Shaked, Ph.D.
** Authored with Shannon Pratt
*** Edited by Robert Reilly and Robert Schweihs



Willamette Management Associates

Thought Leadership Discussion

Valuation Treatment of the Repurchase Obligation Liability

Kyle J. Wishing

There are certain valuation aspects that are unique to employee stock ownership plan ("ESOP") sponsor company valuation engagements. The "ESOP" repurchase obligation is one of those aspects. There is a diversity of practice in the valuation profession as to how to treat the repurchase obligation for sponsor company valuations performed for ESOP administration purposes. There are several alternatives that may be appropriate depending on the facts and circumstances of the assignment, and the analyst's interpretation of the fair market value standard of value for ESOP administration engagements. This discussion provides a hypothetical ESOP sponsor company valuation to illustrate the alternative valuation treatments for the repurchase obligation on the sponsor company share price conclusion.

Introduction

This discussion is intended to clarify and enhance the ongoing discussion among valuation analysts ("analysts") related to the treatment and presentation of the repurchase obligation in valuations performed for ESOP administration and regulatory compliance purposes.

There are several procedures that analysts have applied to account for the repurchase obligation in the sponsor company valuation analysis. Additionally, the argument can be made that the repurchase obligation should have no effect on the sponsor company valuation.

The Repurchase Obligation

The term "repurchase obligation" refers to the statutory "put" requirement for sponsor company shares held in ESOP participant accounts. The put option requires the sponsor company to purchase participant shares "under a fair valuation formula."[1]

The put option generally provides that the sponsor company will purchase the ESOP sponsor company shares held by ESOP participants who:

1. depart employment from the sponsor company or
2. qualify for and elect to diversify their sponsor company shares.

This provision provides a higher degree of liquidity than is typically attributed to the shares of closely held corporation.

The economic liability resulting from the statutory "put" requirement for the ESOP sponsor company shares is referred to as the repurchase obligation liability. However, the term repurchase obligation liability is slightly misleading because:

1. under U.S. generally accepted accounting principles, the repurchase obligation is not presented as a liability on the sponsor company balance sheet and

2. the repurchase obligation may have liability and equity characteristics depending on the sponsor company's method for handling share repurchases.

Sponsor companies have several ways of handling share repurchases. A sponsor company can select one, or any combination, of the following alternatives to repurchase shares that are "put" to the sponsor company by the ESOP participants:

- The sponsor company may repurchase the subject shares using sponsor company funds and hold the subject shares in treasury. This alternative is generally referred to as "redeeming."
- The sponsor company may repurchase the subject shares and subsequently contribute the subject shares to the ESOP as an employee compensation expense. This alternative is generally referred to as "recycling."
- The ESOP trust may repurchase the subject shares with cash held in the trust. This alternative is also referred to as "recycling" within the ESOP community. For clarity purposes in this discussion, we refer to this alternative as "ESOP investing."
- The sponsor company may repurchase and "releverage" the subject shares. Releveraging involves the sponsor company contributing shares to the ESOP in exchange for a note. The contributed shares are allocated to participant accounts as the new internal note is amortized, in the same fashion that a leveraged ESOP is structured.

There are pros and cons to each of the repurchase obligation alternatives listed above. These considerations are outside of the scope of this discussion.

Valuation Theory

The nexus for the lack of consensus among analysts trying to address the repurchase obligation liability is uncertainty regarding the application of the fair market value standard of value to ESOP valuation assignments.

Under the Employee Retirement Income Security Act of 1974 ("ERISA"), an ESOP may purchase or sell sponsor company stock from/to a party in interest if:

1. the purchase or sale is for adequate consideration and
2. no commission is charged to the ESOP.

Further, the ESOP trustee may not agree to the terms of a transaction that are less beneficial to the ESOP than adequate consideration.

Adequate consideration for closely held corporations is defined in ERISA Section 3(18)(B) as "the fair market value 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 U.S. Secretary of Labor."

The DOL "Proposed Regulation Relating to the Definition of Adequate Consideration" (the "Proposed Regulation") defines fair market value as "the price at which an asset would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, and both parties are able, as well as willing, to trade and are

well-informed about the asset and the market for that asset."[2]

The terms in the Proposed Regulation are very similar to the terms set forth in Internal Revenue Service Revenue Ruling 59-60, which is applicable for valuations that are performed for estate and gift tax purposes. Both definitions of fair market value assume hypothetical and knowledgeable willing buyers and willing sellers.

The Proposed Regulation and Revenue Ruling 59-60 each list the following eight factors that an analyst may consider when performing a fair market value analysis:

- The nature of the business and the history of the enterprise from its inception
- The economic outlook in general and the condition and outlook of the specific industry in particular
- The book value of the stock and the financial condition of the business
- The earning capacity of the company
- The dividend-paying capacity
- Whether or not the enterprise has goodwill or other intangible value
- Sales of the stock and the size of the block of stock to be valued
- The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over the counter

The eight factors listed above represent a complete list of the factors listed in Revenue Ruling 59-60. The Proposed Regulation adds the following factors to the Revenue Ruling 59-60 list:

- The marketability, or lack thereof, of the securities. Where the plan is the purchaser of securities that are subject to "put" rights and such rights are taken into account in reducing the discount for lack of marketability, such assessment shall include consideration of the extent to which such rights are enforceable, as well as the company's ability to meet its obligations with respect to the "put" rights (taking into account the company's financial strength and liquidity).[3]
- Whether or not the seller would be able to obtain a control premium from an unrelated third party with regard to the block of securities being valued, provided that in cases where a control premium is taken into account:[4]
  - actual control (both in form and in substance) is passed to the purchaser with the sale, or will be passed to the purchaser within a reasonable time pursuant to a binding agreement in effect at the time of the sale and
  - it is reasonable to assume that the purchaser's control will not be dissipated within a short period of time subsequent to the acquisition.

In response to the Proposed Regulation guidance with respect to put rights, analysts have generally decreased the explicit discount for lack of marketability for ESOP valuations relative to discounts typically attributed to the shares of closely held corporations valued for non-ESOP purposes.

The consideration of the subject shares' put rights is an investment value consideration—not a typical fair market value consideration—at least to the extent that analysts have typically adjusted the discount for lack of marketability to account for the put rights.

In other words, the put rights are an investment-specific characteristic that are limited to certain shares (i.e., shares held by the ESOP trust) and shareholders (i.e., the ESOP participants via the ESOP trust), rather than the hypothetical investor population.

A non-ESOP-owner would not benefit from the ESOP put rights. A hypothetical non-ESOP-buyer would not pay for put rights that are no longer attached to the subject shares.

From an economic standpoint, the consideration of the ESOP put rights is appropriate to analyze in a sponsor company stock repurchase transaction. The fair market value (i.e., a hypothetical willing and able buyer and a hypothetical willing seller) and marketability (i.e., consideration of the ESOP put right) provisions within the Proposed Regulation are at odds with each other. A hypothetical willing buyer would not compensate the seller for the put rights because the buyer would not benefit from the inherent ESOP put rights.

This inconsistency gives the analyst three immediate fair market value interpretations ("FMV interpretations") to consider when performing a valuation for ESOP administration purposes. This discussion refers to these FMV interpretations as "transfer tax," "ESOP-hybrid," and "within-ESOP."

Transfer Tax Fair Market Value Interpretation

Under the "transfer tax" FMV interpretation, value is estimated based on a hypothetical sale of the block of shares held by the ESOP trust. The appropriate levels of control and of marketability in the block of shares, and resulting explicit or implicit adjustments to value, are assessed based on the investment-specific characteristics conveyed to a hypothetical third party.

A hypothetical third party would not incur expenses related to the ESOP, so the ESOP contribution expense associated with the repurchase obligation is typically adjusted to a normal retirement contribution expense level based on industry and market data.

This analysis is consistent with a gift and estate valuation engagement, and it ignores the Proposed Regulation guidance with regard to the ESOP put right.

All else equal, a noncontrolling interest valued under this FMV interpretation:

1. will likely have a higher discount for lack of marketability (the ESOP put rights are ignored) than the other FMV interpretations, which would decrease the indicated value, and
2. will normalize ESOP-related expenses, which would typically increase the value conclusion relative to the within-ESOP FMV interpretation (the ESOP-hybrid FMV interpretation also normalizes ESOP-related expenses).

All else equal, a controlling interest valued under this FMV interpretation:

1. will have a similar discount for lack of marketability as the other FMV interpretations (despite ignoring the ESOP put rights, a controlling interest can create a market for the subject shares) and
2. will normalize ESOP-related expenses, which would increase the value conclusion relative to the within-ESOP FMV interpretation.

ESOP-Hybrid Fair Market Value Interpretation

Under the "ESOP-hybrid" FMV interpretation, the analysis is performed in a similar fashion to the transfer tax FMV interpretation. A sale of the ESOP interest is assumed.

The analyst applies normalization adjustments to remove ESOP-related expenses. If the ESOP holds a controlling interest, controlling interest adjustments are considered.

The consideration of the discount for lack of marketability under the ESOP-hybrid FMV interpretation differs from the "transfer tax" interpretation. The analyst's selection of the discount for lack of marketability considers the statutory put right for the ESOP shares, resulting in a lower discount for lack of marketability for a noncontrolling sponsor company subject ownership interest.

All else equal, the ESOP-hybrid FMV interpretation will likely produce a higher indication than the other FMV interpretations for a noncontrolling interest.

On a controlling ownership interest basis, the ESOP-hybrid will generally result in a similar valuation conclusion to the transfer tax FMV interpretation and a greater valuation conclusion than the within-ESOP FMV interpretation conclusion.

Within-ESOP Fair Market Value Interpretation

The "within-ESOP" FMV interpretation is not based on the hypothetical buyer and hypothetical willing seller premise. The subject transaction is between:

1. a noncontrolling shareholder (i.e., an ESOP participant) and
2. the sponsor company or the ESOP.

The within-ESOP FMV interpretation assumes that the sponsor company will operate indefinitely with the ESOP in place under the sponsor company board and management's direction.

Control-level adjustments are not applied under the within-ESOP FMV interpretation without a reasonable and quantifiable expectation for changes in cash flow, capital structure, and so forth. The discount for lack of marketability considers the ESOP put right.

The following factors may decrease the value conclusion using the within-ESOP FMV interpretation relative to the other FMV interpretations:

1. Heightened retirement expenses stemming from the repurchase obligation
2. Lack of control-level adjustments.

The discount for lack of marketability using the within-ESOP FMV interpretation is generally lower than the discount for lack of marketability in a

noncontrolling valuation using the transfer tax FMV interpretation.

Figure 1 summarizes the different considerations for each FMV interpretation and their effect on value.

Valuation Treatment of the Repurchase Obligation

Valuation analyses developed under the ESOP-hybrid and within-ESOP FMV interpretations can be said to consider the repurchase obligation. These are two common FMV interpretations for ESOP administration purposes and will be the focus of the remainder of this discussion.

Valuation exhibits that underscore the valuation treatment of the repurchase obligation are presented in this discussion. The illustrative company, Professional Services Firmco ("PSF"), is a professional services firm that is structured as a C corporation. PSF is in the mature business lifecycle stage.

All of the PSF equity is held by the private company's ESOP trust. The PSF ESOP trust was established in 1990, and all shares held by the trust are allocated to participant accounts.

PSF also sponsors a 401(k) plan and makes contributions to the plan that are consistent with the retirement contributions of its primary competitors.

Exhibit 1 compares the value conclusion for PSF under the ESOP-hybrid and the within-ESOP FMV interpretations.

Value under the ESOP-Hybrid FMV Interpretation

The ESOP-hybrid FMV interpretation considers the repurchase obligation only to the extent that the repurchase obligation provides liquidity (therefore decreasing the lack of marketability) for the subject shares.

The repurchase obligation "liability" does not directly affect the share value conclusion under the rationale that the repurchase obligation liability would cease to exist if the ESOP sold its interest to a non-ESOP third party.

Analysts may increase or decrease the discount for lack of marketability based on the sponsor company's ability to meet its repurchase obligation.

While these assumptions are valid, they may have unintended consequences for the ESOP sponsor company. A higher share price under this FMV interpretation due to normalizing retirement expenses also increases the repurchase obligation.

Depending on the sponsor company's cash flow, balance sheet sources of liquidity, and funded status of the ESOP, this could cause the sponsor company to be cash constrained.

The hypothetical sale transaction assumed under the ESOP-hybrid interpretation may ultimately lead the sponsor company shareholders to enter into an actual sale transaction to eliminate the repurchase obligation.

There are various financial planning and ESOP structural measures that can reduce the financial burden related to the repurchase obligation.

Exhibits 2a and 2b present the PSF adjusted historical financial fundamentals and projected income statements under the ESOP-hybrid FMV interpretation, respectively.

As presented in Exhibit 2a, ESOP contribution expense ranged from 74.4 percent to 115.8 percent of adjusted earnings before interest, taxes, depreciation, and amortization ("EBITDA") over the five years ended December 31, 2019.

Figure 1
Summary of the Alternative FMV Interpretation Valuation Differences

Interpretation	ESOP Compensation Expense	Discount for Lack of Marketability	Ownership Control Adjustments
Transfer Tax	Retirement expenses are normalized (generally increases value)	Does not consider ESOP put right	Yes, if applicable (generally increases value)
ESOP-Hybrid	Retirement expenses are normalized (generally increases value)	Considers put right (generally increases value)	Yes, if applicable (generally increases value)
Within-ESOP	No adjustment	Considers put right (generally increases value)	None

Exhibit 1
Professional Services Firmco
Valuation Summary
As of December 31, 2019

	Valuation Approach and Valuation Method	Relative Emphasis	ESOP-Hybrid Indicated Value $000		Within-ESOP Implicit Analysis Indicated Value $000	Within-ESOP Explicit Analysis Indicated Value $000
	Income Approach - Discounted Cash Flow Method	50%	22,700		12,200	22,700
	Market Approach - Guideline Publicly Traded Company Method	50%	22,700		12,300	22,700
	Indicated Value of Invested Capital	100%	22,700		12,250	22,700
-	Interest-Bearing Debt		-		-	-
=	Indicated Value of Equity before Adjustments		22,700		12,250	22,700
	Nonoperating Assets/Liabilities:					
-	Present Value of the Repurchase Obligation Liability		NA	[a]	NA	(10,600)
=	Indicated Value of Equity after Adjustments		22,700		12,250	12,100
-	Discount for Lack of Marketability	-5%	(1,135)		(613)	(605)
=	**Indicated Value of Equity [rounded]**		**21,500**		**11,500**	**11,500**
/	Number of Fully Diluted Shares Outstanding (000)		100.00		100.00	100.00
	Indicated Equity Value per Share [rounded]		**$ 215.00**		**$ 115.00**	**$ 115.00**

[a] There is no adjustment for the present value of the repurchase obligation liability in the ESOP-hybrid FMV interpretation. As presented in Exhibit 2c, the present value of the repurchase obligation is approximately $19.7 million.

As presented in Exhibit 2b, ESOP contribution expense is expected to range from $2.38 million (or 78.0 percent of adjusted EBITDA) in 2020 to $2.51 million (or 74.7 percent of adjusted EBITDA) in 2022.

As presented in Exhibit 1 (in the ESOP-hybrid FMV interpretation column), the value of PSF invested capital of $22.7 million was estimated using the discounted cash flow method and the guideline publicly traded company method. PSF had no interest-bearing debt. PSF did not have any nonoperating assets or liabilities.

A discount for lack of marketability of 5 percent was applied to the equity value conclusion based, in part, on the ESOP put rights. This discount resulted in an equity value of $21.5 million on a controlling, nonmarketable basis, or an equity value of $215 per share based on the 100,000 shares outstanding in PSF.

The present value of the repurchase obligation is estimated in Exhibit 2c by applying the discounted cash flow method. The repurchase obligation is not considered in the valuation analysis—it was only included for comparison purposes.

The present value of the repurchase obligation is $19.7 million.

Summarized below are the strengths and weaknesses of analyses performed using the ESOP-hybrid FMV interpretation:

- Strengths – Indicates the value of the ESOP shares as part of a sale transaction; provides a threshold for assessing acquisition offers
- Weaknesses – Differs from the sponsor company's expected cash flow as an ESOP sponsor company; may increase the repurchase obligation liability and hinder the sustainability of the sponsor company/ESOP trust; noncontrolling interests held by the ESOP may be overstated if the ESOP were to unilaterally divest its ownership interest to a third party

Value under the Within-ESOP FMV Interpretation

Analyses developed under the within-ESOP FMV interpretation assume that the sponsor company ESOP will remain in place (at least for a number of years). There are a number of factors that influence the repurchase obligation and, therefore, expected ESOP contribution expenses.

Exhibit 2a
Professional Services Firmco
ESOP-Hybrid FMV Interpretation
Historical Financial Fundamentals

Financial Fundamentals	LTM Ended 12/31/19 $000	Fiscal Year Ended December 31, 2018 $000	2017 $000	2016 $000	2015 $000	3-Year Average $000
Revenue	45,090	55,600	51,070	50,990	51,740	50,587
Reported Pretax Income	(730)	330	500	890	600	
Adjustments to Pretax Income:						
+ ESOP Contribution Expense	5,120	4,560	4,080	2,530	3,510	
- Normalized Retirement Expense	-	-	-	-	-	
- Investment Income - Marketable Securities	(40)	(260)	(220)	(80)	(260)	
+ Nonrecurring Expenses	70	100	-	60	90	
= Adjusted Pretax Income	4,420	4,730	4,360	3,400	3,940	4,503
Fundamentals:						
Adjusted Pretax Income	4,420	4,730	4,360	3,400	3,940	
+ Interest Expense	-	-	-	-	-	
= EBIT	4,420	4,730	4,360	3,400	3,940	4,503
EBIT	4,420	4,730	4,360	3,400	3,940	
+ Depreciation/Amortization	390	330	310	310	330	
= EBITDA	4,810	5,060	4,670	3,710	4,270	4,847
Margins:						
EBIT	9.8%	8.5%	8.5%	6.7%	7.6%	
EBITDA	10.7%	9.1%	9.1%	7.3%	8.3%	
ESOP Contribution Expense as % of EBITDA	115.8%	96.4%	93.6%	74.4%	89.1%	

Exhibit 2b
Professional Services Firmco
ESOP-Hybrid FMV Interpretation
Projected and Common-Size Income Statements

Financial Fundamentals	Fiscal Years Ending December 31, 2020 $000	2021 $000	2022 $000	2023 $000	Fiscal Years Ending December 31, 2020 %	2021 %	2022 %	2023 %
Revenue	48,500	50,000	51,000	51,250	100.0	100.0	100.0	100.0
Year-over-Year Change	*7.6%*	*3.1%*	*2.0%*	*0.5%*				
Direct Costs	41,390	42,580	43,390	43,620	85.3	85.2	85.1	85.1
Gross Margin	7,110	7,420	7,610	7,630	14.7	14.8	14.9	14.9
Operating Expenses:								
General and Administrative Expense	4,470	4,590	4,680	4,720	9.2	9.2	9.2	9.2
ESOP Contribution Expense	2,380	2,480	2,510	2,500	4.9	5.0	4.9	4.9
Total Operating Expenses	6,850	7,070	7,190	7,220	14.1	14.1	14.1	14.1
Income from Operations	260	350	420	410	0.5	0.7	0.8	0.8
Income from Operations	260	350	420	410	0.5	0.7	0.8	0.8
+ ESOP Contribution Expense	2,380	2,480	2,510	2,500	4.9	5.0	4.9	4.9
+ Depreciation/Amortization	410	430	430	430	0.8	0.9	0.8	0.8
= EBITDA (adjusted)	3,050	3,260	3,360	3,340	6.3	6.5	6.6	6.5
ESOP Contribution Expense as % of EBITDA	78.0%	76.1%	74.7%	74.9%				

Exhibit 2c
Professional Services Firmco
ESOP-Hybrid FMV Interpretation
Income Approach
Present Value of the Repurchase Obligation

	Valuation Variables		Fiscal Years Ending December 31, 2020 $000	2021 $000	2022 $000	Terminal Year $000	
	ESOP Contribution Expense		(2,380)	(2,480)	(2,510)	(2,500)	[a]
-	Provision for Income Taxes		655	682	691	688	[b]
=	Net Cash Flow to Invested Capital		(1,725)	(1,798)	(1,819)	(1,812)	
×	Present Value Factor		0.9449	0.8437	0.7533		[c]
=	Present Value of Discrete Period Cash Flow		(1,630)	(1,517)	(1,370)		
=	Total Present Value of Discrete Period Cash Flow	(4,517)					
	Present Value of Terminal Period Net Cash Flow:						
=	Adjusted Terminal Period Net Cash Flow	(1,812)					
/	Capitalization Rate	9.0%					
=	Terminal Value	(20,134)					
×	Present Value Factor	0.7533					
=	Present Value of Terminal Period Cash Flow	(15,167)					
	Valuation Summary:						
	Total Present Value of Discrete Period Cash Flow	(4,517)					
+	Present Value of Terminal Period Net Cash Flow	(15,167)					
=	Present Value of Repurchase Obligation Liability [rounded]	(19,700)					

[a] As presented in Exhibit 2b.
[b] Based on a corporate income tax rate of 27.5 percent.
[c] Based on mid-period discounting and a present value discount rate of 12 percent (based on the sponsor company weighted average cost of capital).

These factors include the following:

- The size of the ESOP trust ownership interest in the sponsor company
- The number of shares allocated to participant accounts (term and remaining time to maturity of the internal loan)
- Sponsor company share price growth
- Age of the workforce
- Workforce turnover and average tenure
- Plan vesting requirements
- Terms for cashing out participants
- Redeeming, recycling, releveraging, or ESOP investing participant shares
- Life cycle stage of the company (paying dividends versus reinvesting for growth)
- Funded status of the ESOP

Company management expectations with respect to the repurchase obligation should be reflected in the financial statement projections. A repurchase obligation study may be conducted to inform the sponsor company management and board of the magnitude of the repurchase obligation in light of various scenarios (such as the number of shares redeemed, recycled, or releveraged).

Implicit Adjustment for the Repurchase Obligation

The valuation adjustments for the repurchase obligation may be implicit or explicit. When the adjustment is implicit, the underlying historical financial fundamentals and the projected financial statements include ESOP contribution expenses.

In other words, the cash flow metrics that are relied on in the valuation methods (i.e., EBITDA, cash flow to invested capital, etc.) reflect the ESOP contribution expenses reported on the sponsor company financial statements.

Exhibits 3a and 3b present the historical financial fundamentals and projected financial statements, respectively, with an implicit adjustment for the repurchase obligation.

As presented in Exhibits 3a and 3b, historical and projected earnings before interest and taxes

Exhibit 3a
Professional Services Firmco
Within-ESOP FMV Interpretation
Implicit Repurchase Obligation Application
Historical Financial Fundamentals

	Financial Fundamentals	LTM Ended 12/31/19 $000	Fiscal Year Ended December 31, 2018 $000	2017 $000	2016 $000	2015 $000	3-Year Average $000
	Revenue	45,090	55,600	51,070	50,990	51,740	50,587
	Reported Pretax Income	1,650	2,450	2,400	2,060	2,240	
	Adjustments to Pretax Income:						
+	ESOP Contribution Expense	-	-	-	-	-	[a]
-	Normalized Retirement Expense	-	-	-	-	-	
-	Investment Income - Marketable Securities	(40)	(260)	(220)	(80)	(260)	
+	Nonrecurring Expenses	70	100	-	60	90	
=	Adjusted Pretax Income	1,680	2,290	2,180	2,040	2,070	2,050
	Fundamentals:						
	Adjusted Pretax Income	1,680	2,290	2,180	2,040	2,070	
+	Interest Expense	-	-	-	-	-	
=	EBIT	1,680	2,290	2,180	2,040	2,070	2,050
	EBIT	1,680	2,290	2,180	2,040	2,070	
+	Depreciation/Amortization	390	330	310	310	330	
=	EBITDA	2,070	2,620	2,490	2,350	2,400	2,393
	Margins:						
	EBIT	3.7%	4.1%	4.3%	4.0%	4.0%	
	EBITDA	4.6%	4.7%	4.9%	4.6%	4.6%	
	ESOP Contribution Expense as % of EBITDA	NA	NA	NA	NA	NA	

[a] ESOP contributions are not added back in the implicit repurchase obligation application of the within-ESOP FMV interpretation.

("EBIT") and EBITDA are significantly lower than in the ESOP-hybrid valuation exhibits.

On the other hand, reported pretax income is higher under the within-ESOP FMV interpretation—the lower share price conclusions directly affect ESOP compensation expense.

The indicated value of invested capital of approximately $12.3 million (presented in Exhibit 1) is *more than 45 percent less* than the indicated value of invested capital for the same company valued using the ESOP-hybrid FMV interpretation.

The equity value per common share is $115 in the within-ESOP FMV interpretation compared to $215 per share under the ESOP-hybrid FMV interpretation.

Explicit Adjustment for the Repurchase Obligation

The repurchase obligation may also be adjusted explicitly. An explicit adjustment involves an analysis of:

1. the business without the repurchase obligation liability and
2. the present value of the repurchase obligation liability.

ESOP contribution expenses are added back to the historical and projected financial fundamentals and cash flow (i.e., just as performed in Exhibits 2a and 2b).

The present value of the repurchase obligation liability can be estimated using a discounted cash flow method. The present value of the repurchase obligation liability is subtracted from the sponsor company equity value as a nonoperating liability.

There are various assumptions that the analyst can use to estimate the present value of the repurchase obligation liability. The projected repurchase obligation is a function of the number of shares expected to be repurchased multiplied by

Exhibit 3b
Professional Services Firmco
Within-ESOP FMV Interpretation
Implicit Repurchase Obligation Application
Projected and Common-Size Income Statements

	Fiscal Years Ending December 31,				Fiscal Years Ending December 31,			
	2020	2021	2022	2023	2020	2021	2022	2023
Financial Fundamentals	$000	$000	$000	$000	%	%	%	%
Revenue	48,500	50,000	51,000	51,250	100.0	100.0	100.0	100.0
Year-over-Year Change	*7.6%*	*3.1%*	*2.0%*	*0.5%*				
Direct Costs	41,390	42,580	43,390	43,620	85.3	85.2	85.1	85.1
Gross Margin	7,110	7,420	7,610	7,630	14.7	14.8	14.9	14.9
Operating Expenses:								
General and Administrative Expense	4,470	4,590	4,680	4,720	9.2	9.2	9.2	9.2
ESOP Contribution Expense	1,280	1,330	1,340	1,340	2.6	2.7	2.6	2.6
Total Operating Expenses	5,750	5,920	6,020	6,060	11.9	11.8	11.8	11.8
Income from Operations	1,360	1,500	1,590	1,570	2.8	3.0	3.1	3.1
Income from Operations	1,360	1,500	1,590	1,570	2.8	3.0	3.1	3.1
+ ESOP Contribution Expense	-	-	-	- [a]	-	-	-	-
+ Depreciation/Amortization	410	430	430	430	0.8	0.9	0.8	0.8
= EBITDA (adjusted)	1,770	1,930	2,020	2,000	3.6	3.9	4.0	3.9
ESOP Contribution Expense as % of EBITDA	NA	NA	NA	NA				

[a] ESOP contributions are not added back in the implicit repurchase obligation application of the within-ESOP FMV interpretation.

the share price. ESOP shares that are redeemed by the sponsor company are typically not included in this calculation because the share redemption is a capital transaction.

A repurchase obligation study that includes the sponsor company management's expected strategy for share repurchases may be a helpful tool for performing this analysis.

In this example, the present value of the repurchase obligation analyses, presented in Exhibits 2c and 4c, are simplified. These value estimates are based on projected ESOP contribution expenses provided by PSF management, not a repurchase obligation study.

Exhibits 4a and 4b present the PSF historical financial fundamentals and the projected income statements with an explicit adjustment for the repurchase obligation.

In this analysis, adjusted EBITDA is the same as the adjusted EBITDA in the ESOP-hybrid FMV interpretation and reported pretax income matches reported pretax income when applying the implicit within-ESOP FMV interpretation.

Exhibit 4c presents the present value of the repurchase obligation liability calculation.

The value of invested capital of $22.7 million applying the explicit within-ESOP FMV interpretation is the same value of invested capital estimated using the ESOP-hybrid FMV interpretation (see Exhibit 1).

The equity value is decreased by $10.6 million for the present value of the repurchase obligation. The equity value per share conclusion of $115 per share is the same conclusion in both the explicit and implicit within-ESOP FMV interpretations.

Depending on the facts and circumstances of the analysis, the analyst may decide to blend the ESOP-hybrid and within-ESOP FMV interpretations—assuming, for instance, that the repurchase obligation will continue to be met for a certain number of years before a sale transaction is initiated, when retirement contributions would return to a normalized level.

Summarized below are the strengths and weaknesses of analyses performed using the within-ESOP FMV interpretation:

Exhibit 4a
Professional Services Firmco
Within-ESOP FMV Interpretation
Explicit Repurchase Obligation Application
Historical Financial Fundamentals

	Financial Fundamentals	LTM Ended 12/31/19 $000	Fiscal Year Ended December 31, 2018 $000	2017 $000	2016 $000	2015 $000	3-Year Average $000
	Revenue	45,090	55,600	51,070	50,990	51,740	50,587
	Reported Pretax Income	1,650	2,450	2,400	2,060	2,240	
	Adjustments to Pretax Income:						
+	ESOP Contribution Expense	2,740	2,440	2,180	1,360	1,870	
-	Normalized Retirement Expense	-	-	-	-	-	
-	Investment Income - Marketable Securities	(40)	(260)	(220)	(80)	(260)	
+	Nonrecurring Expenses	70	100	-	60	90	
=	Adjusted Pretax Income	4,420	4,730	4,360	3,400	3,940	4,503
	Fundamentals:						
	Adjusted Pretax Income	4,420	4,730	4,360	3,400	3,940	
+	Interest Expense	-	-	-	-	-	
=	EBIT	4,420	4,730	4,360	3,400	3,940	4,503
	EBIT	4,420	4,730	4,360	3,400	3,940	
+	Depreciation/Amortization	390	330	310	310	330	
=	EBITDA	4,810	5,060	4,670	3,710	4,270	4,847
	Margins:						
	EBIT	9.8%	8.5%	8.5%	6.7%	7.6%	
	EBITDA	10.7%	9.1%	9.1%	7.3%	8.3%	
	ESOP Contribution Expense as % of EBITDA	62.0%	51.6%	50.0%	40.0%	47.5%	

- *Strengths*. These are based on the sponsor company's actual historical and projected cash flow,[5] which promotes ESOP (and sponsor company) sustainability.
- *Weaknesses*. The value conclusion may be depressed due to the repurchase obligation liability, relative to the price that a hypothetical buyer would pay for the company. If the repurchase obligation adjustment analysis is performed implicitly, the trustee will not have an indication of the sponsor company (or ESOP subject interest) value in the marketplace.

Implications from the PSF Example

The PSF example was constructed to illustrate the difference in value due to the treatment of the repurchase obligation in the valuation analysis.

The difference in the value indications is increased due to the following:

1. the ESOP holding all of the outstanding stock in PSF,
2. the ESOP stock being fully allocated to the participant accounts (i.e., the internal loan has reached maturity), and
3. the PSF board electing to recycle the shares that are repurchased.

The repurchase obligation is *significantly higher* under the ESOP-hybrid FMV interpretation—the repurchase obligation liability of $19.7 million is greater than the equity conclusion under the within-ESOP FMV interpretation.

In the ESOP-hybrid FMV interpretation, ESOP contributions are expected to consume more than 70 percent of projected EBITDA. This level of share repurchases would certainly limit capital availability for business initiatives and potentially cause financial distress and restructuring.

Exhibit 4b
Professional Services Firmco
Within-ESOP FMV Interpretation
Explicit Repurchase Obligation Application
Projected and Common-Size Income Statements

	Fiscal Years Ending December 31,				Fiscal Years Ending December 31,			
	2020	2021	2022	2023	2020	2021	2022	2023
Financial Fundamentals	$000	$000	$000	$000	%	%	%	%
Revenue	48,500	50,000	51,000	51,250	100.0	100.0	100.0	100.0
Year-over-Year Change	*7.6%*	*3.1%*	*2.0%*	*0.5%*				
Direct Costs	41,390	42,580	43,390	43,620	85.3	85.2	85.1	85.1
Gross Margin	7,110	7,420	7,610	7,630	14.7	14.8	14.9	14.9
Operating Expenses:								
General and Administrative Expense	4,470	4,590	4,680	4,720	9.2	9.2	9.2	9.2
ESOP Contribution Expense	1,280	1,330	1,340	1,340	2.6	2.7	2.6	2.6
Total Operating Expenses	5,750	5,920	6,020	6,060	11.9	11.8	11.8	11.8
Income from Operations	1,360	1,500	1,590	1,570	2.8	3.0	3.1	3.1
Income from Operations	1,360	1,500	1,590	1,570	2.8	3.0	3.1	3.1
+ ESOP Contribution Expense	1,280	1,330	1,340	1,340	2.6	2.7	2.6	2.6
+ Depreciation/Amortization	410	430	430	430	0.8	0.9	0.8	0.8
= EBITDA (adjusted)	3,050	3,260	3,360	3,340	6.3	6.5	6.6	6.5
ESOP Contribution Expense as % of EBITDA	42.0%	40.8%	39.9%	40.1%				

The failure to include the repurchase obligation cash burden in the valuation analysis may be unsustainable for the sponsor company from a cash flow perspective.

The explicit adjustment for the repurchase obligation under the within-ESOP FMV interpretation may provide the most meaningful information to the ESOP trustee because the repurchase obligation liability is quantified.

The explicit repurchase obligation valuation gives the trustee an idea of the value of the sponsor company without the repurchase obligation (though the valuation will likely be on a noncontrolling basis).

The trustee will also be informed of the present value of the repurchase obligation.

Summary and Conclusion

The repurchase obligation is a financial obligation that is unique to ESOP sponsor companies. There are various factors that may affect the repurchase obligation.

For long-term sustainability and corporate planning purposes, it is important for the sponsor company board, the ESOP trustee, and the analyst to have a mutual understanding of the expectations for the sponsor company business, including the financing of the repurchase obligation.

The current dichotomy in valuation practice related to the repurchase obligation for ESOP administration valuation assignments can lead to a wide range in value conclusions for the same sponsor company.

Value conclusions under the ESOP-hybrid FMV interpretation could result in value conclusions that are not sustainable for the sponsor company. On the other hand, value conclusions under the within-ESOP FMV interpretation may understate the value of shares held by the ESOP relative to market prices.

The example included herein is intended to demonstrate the potential difference in value conclusions due to different FMV interpretations.

In circumstances where the following conditions are present, the value conclusions under the ESOP-hybrid and within-ESOP FMV interpretations will be closer:

Exhibit 4c
Professional Services Firmco
Within-ESOP FMV Interpretation
Explicit Repurchase Obligation Application
Income Approach
Present Value of the Repurchase Obligation

Valuation Variables		Fiscal Years Ending December 31, 2020 $000	2021 $000	2022 $000	Terminal Year $000	
ESOP Contribution Expense		(1,280)	(1,330)	(1,340)	(1,340)	[a]
- Provision for Income Taxes		352	366	369	369	[b]
= Net Cash Flow to Invested Capital		(928)	(964)	(971)	(971)	
× Present Value Factor		0.9449	0.8437	0.7533		[c]
= Present Value of Discrete Period Cash Flow		(877)	(813)	(732)		
= Total Present Value of Discrete Period Cash Flow	(2,422)					
Present Value of Terminal Period Net Cash Flow:						
= Adjusted Terminal Period Net Cash Flow	(971)					
/ Capitalization Rate	9.0%					
= Terminal Value	(10,792)					
× Present Value Factor	0.7533					
= Present Value of Terminal Period Cash Flow	(8,129)					
Valuation Summary:						
Total Present Value of Discrete Period Cash Flow	(2,422)					
+ Present Value of Terminal Period Net Cash Flow	(8,129)					
= Present Value of Repurchase Obligation Liability [rounded]	(10,600)					

[a] As presented in Exhibit 4b.
[b] Based on a corporate tax rate of 27.5 percent.
[c] Based on mid-period discounting and a present value discount rate of 12 percent (the sponsor company weighted average cost of capital).

1. The ESOP owns a smaller ownership interest in the sponsor company.
2. A majority of the ESOP shares have not been allocated to participant accounts.

In lieu of regulatory guidance or valuation industry convergence on the treatment of the repurchase obligation, the ESOP trustee may be in the best position to decide the extent that the repurchase obligation affects the valuation analysis.

Among other things, the ESOP trustee has the task of:

1. overseeing plan assets for the benefit of employee participants and
2. establishing the sponsor company share price for ESOP administration purposes.

The analysis performed by the valuation analyst can inform the ESOP trustee of the value implications of the repurchase obligation. To this end, the ESOP trustee, with the help of the analyst, can determine a share price that is in the best interest of ESOP participants.

Notes:

1. See Internal Revenue Code Section 409(h)(1)(B). This requirement is for all ESOPs formed since 1979 and leveraged ESOPs formed since 1976.
2. DOL Proposed Regulation Section 2510.3-18(B)(2)(i).
3. Ibid., Section 2510.3-18(4)(ii)(H).
4. Ibid., Section 2510.3-18(4)(ii)(I).
5. The caveat here being cash flow to an S corporation ESOP sponsor company. S corporation cash flow is typically tax-affected regardless of FMV interpretation.

Kyle Wishing is a manager in our Atlanta practice office. He can be reached at (404) 475-2309 or at kjwishing@willamette.com.

The Fiduciary Process for the Annual Update of the ESOP Share Value

Frank "Chip" Brown, CPA

This discussion provides an overview from the trustee's perspective of the process for periodic sponsor company valuation for ESOP administration purposes. This overview lists criteria that a trustee typically considers in (1) selecting a valuation adviser, (2) reviewing the sponsor company valuation report, and (3) establishing the fair market value of the ESOP-owned shares for administration purposes.

Introduction

ESOP trustees are required by law to set the sponsor company stock price at least annually. This process allows the ESOP's third-party administrator to perform the mandatory annual accounting and testing procedures that culminate in the issuance of the annual ESOP participant statements.

An ESOP participant statement includes the participant's account balance as of the end of the plan year, based on the new sponsor company stock price.

The ESOP trustee typically sets the share price based on the fair market value of the employer corporation stock as determined by an independent third-party valuation firm.[1]

This discussion provides an overview of the process related to the annual update of the sponsor company share price for plan administration purposes.[2]

The procedures described in this discussion are intended only as general guidelines. The actual procedures necessary for a prudent process will depend on the specific facts and circumstances of the annual sponsor company stock valuation update engagement.

Selecting a Qualified Valuation Adviser

ESOP trustees are expected to act in the best interests of (1) the ESOP participants and (2) the plan beneficiaries.

To exercise prudence in this regard, ESOP trustees often rely on independent professional advisers to help them fulfill their fiduciary obligations.

One example of this exercise of prudence is when the trustee hires an independent valuation adviser to estimate the fair market value of non-publicly-traded sponsor company stock for plan administration purposes.

Given the importance of these periodic sponsor company valuations, it is important that the ESOP trustee hire a qualified, independent valuation adviser.

Moreover, the ESOP trustee should have a reasonable understanding of the overall valuation process, the adviser's actual valuation analysis, and the adviser's written valuation work product. Such an understanding can assist the ESOP trustee to properly fulfill his or her fiduciary duties.

Prudently Investigate the Valuation Adviser Qualifications

In selecting a valuation adviser, the trustee may prepare a written analysis addressing the following topics:

- The reason for selecting the particular valuation adviser
- A list of all the valuation advisers that the trustee considered
- A discussion of the qualifications of the various valuation advisers that the trustee considered
- A list of references checked and a discussion of the references' views on the valuation advisers
- Whether the selected valuation adviser was the subject of prior criminal or civil proceedings
- A full explanation of the bases for concluding that the trustee's selection of the valuation adviser was prudent

For an annual sponsor company valuation update, it is typical to keep the same valuation adviser from year to year. However, it should not be a foregone conclusion that the same valuation adviser will be retained.

While the trustee may not have to go through the same process as it would when first selecting a valuation adviser, the following minimum procedures should be performed and documented:

- The trustee documents in writing that he or she previously performed the analysis of the valuation adviser.
- The trustee states the date(s) on which the trustee performed the analysis, and the results of the analysis.
- The valuation adviser certifies that the information the adviser previously provided is still accurate.

Conflicts of Interest

The trustee typically should not use a valuation adviser for an annual update that has previously performed work for or on behalf of the ESOP sponsor company (as distinguished from the ESOP), any counterparty to the ESOP involved in a prior transaction, or any other entity that structured prior transactions (such as an investment bank) for any party other than the ESOP or its trustee.

The trustee generally should not use a valuation adviser for an annual update that has a familial or corporate relationship (such as a parent-subsidiary relationship) to any of the aforementioned persons or entities. The trustee may obtain written confirmation from the valuation adviser selected that none of the above-referenced relations exist.

Financial Statements

As part of the valuation annual update, it is important that the valuation adviser have complete and accurate financial information, including the sponsor company financial statements. If developing the valuation for the first time, the valuation adviser will typically ask for financial statements from the previous five fiscal years.

If the sponsor company valuation is an update, the valuation adviser will need the most recent set of financial statements.

It is important to determine if there were any changes to previous years' financial statements. For example, there can be changes in accounting methods or financial restatements. In such instances, any updated or revised financial statements for those years should be provided to the valuation adviser.

In certain instances where these changes are material, a trustee may need to determine whether previous sponsor company valuations should be updated as well.

Review and Documentation Related to the Valuation

In connection with the annual valuation update for plan administration purposes, there are various items that need to be included in the valuation report prepared by the valuation adviser. If those items are not included in the valuation report, it is the trustee's responsibility to document those items.

Generally, if the trustee hires a qualified valuation adviser with ESOP experience that follows professional standards, most of the valuation-related documentation requirements should be included and discussed in the valuation report.

The first procedure in reviewing an ESOP employer stock valuation report is to become familiar with the business valuation process. The ESOP trustee should have a sense of the level of due diligence and analysis that was conducted by the valuation adviser in order to reach the sponsor company stock valuation conclusion.

For example, the ESOP trustee may be interested in whether the valuation adviser conducted interviews with company management during the

course of the valuation. It is recommended that the trustee be included in these company management interviews (either in person or remotely).

These sponsor company management interviews are normally conducted in order to:

- understand the nature and history of the sponsor company and
- discuss the historical and prospective performance of the sponsor company.

It is not uncommon for these management interviews to take place in person at the sponsor company facilities. This arrangement provides the valuation adviser the opportunity to tour the sponsor company facilities and view the physical condition of the sponsor company tangible assets.

The interview process will also allow the valuation adviser to gain a better understanding of the sponsor company (1) products and/or services, (2) strategic plan, (3) competitors, and (4) competitive position in the market.

There should be an analysis of the sponsor company'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.

The trustee should document in writing its bases for concluding that the information supplied to the valuation adviser, whether directly from the ESOP sponsor or otherwise, was current, complete, and accurate.

A thorough valuation analysis will be documented with a comprehensive valuation report. It is prudent for the ESOP trustee to review each periodic stock valuation report in order to understand its content.

The following sections of this discussion provide an overview of the typical sponsor company stock valuation report content that should be of interest to an ESOP trustee.

Sponsor Company Description

A valuation report should provide an adequate description for the reader to understand the fundamental position of the sponsor company. A comprehensive description of the employer corporation business will normally include the following:

- Discussion of the history of the employer corporation and its current position
- Description of the products and/or services provided by the employer corporation
- Description of the markets served by the employer corporation
- Description of the environment in which the employer corporation competes and how the company is positioned within that environment
- Discussion of the qualifications of employer corporation management and its depth
- Discussion of significant relationships with related parties, customers, suppliers, and the like
- Discussion of pending litigation that is significant to the employer corporation
- Review of recent transactions in the employer corporation stock (if any)
- Discussion of any recent offers received for the employer corporation or for its assets

Economic and Industry Analysis

The valuation report should provide an overview of economic and industry-specific factors that affect the valuation of the sponsor company.

The economic overview may include a discussion of trends in economic growth, inflation, consumer spending, consumer confidence, interest rates, construction starts, and business spending. In each case, the analysis should be tailored to the economic factors that most directly affect the subject sponsor company.

This section of the report may also include a discussion of leading economic indicators that give insight into the future performance of the sponsor company .

The industry overview section of the valuation report will typically discuss how the industry operates and recent trends affecting companies within the industry. The section may also describe the sponsor company's position in the industry and its market share relative to other competing firms.

The valuation report should be able to explain why the economic and industry analyses are important and relate the critical information and data back to the sponsor company and analysis. For example, if the sponsor company is forecasting 10 percent growth over the next five years compared to 3 percent industry growth, the valuation report should explain and reconcile such differences.

Level of Value and Prerogatives of Ownership Control

During the valuation analysis, the valuation adviser will gain an understanding of the ownership control

attributes (or lack thereof) associated with the ESOP ownership interest. The valuation report should clearly identify the subject ownership interest and describe the prerogatives of ownership control that accompany the subject interest.

The valuation report should identify the specific control attributes of the subject ownership interest and explain how these attributes were considered in the valuation process. Any discount for lack of control or ownership control premium should be discussed and supported in the valuation report. Additionally, any discount for lack of marketability should be explained.

Sources of Information

A comprehensive valuation report typically includes a section that lists the data and documents that the valuation adviser relied on to develop the employer corporation stock valuation opinion.

By reviewing this section of the employer stock valuation report, the ESOP trustee will have an immediate understanding of both (1) the publicly available documents and (2) the non-publicly-available documents that were considered in the valuation process.

The sources of information list should include not only the financial-related documents used in the valuation analysis (e.g., financial statements, empirical market data) but the non-financial-related documents as well (e.g., ESOP documents, employer corporation organizational and strategic documents).

Financial Statement Analysis

As part of the sponsor company stock valuation process, the valuation adviser will analyze the financial performance and financial condition of the employer corporation. A summary of this financial analysis should appear in the valuation report.

The historical financial performance of the employer corporation is reflected on the company income statements and cash flow statements. The valuation report may include a discussion of the following topics:

- The historical growth or decline in sales
- The historical growth or decline in aggregate profitability (i.e., gross profit, operating profit, pretax profit, and net profit)
- The historical growth or decline in profit margins
- The historical growth or decline in cash flow
- The historical payments of dividends

The valuation adviser should also review the sponsor company balance sheet to evaluate its financial condition. The valuation report may contain a discussion of the following balance-sheet-related items:

- The employer corporation liquidity and working capital position
- The employer corporation asset utilization by means of various financial ratios (e.g., accounts receivable turnover, inventory turnover, etc.)
- The employer corporation tangible asset base
- The employer corporation capital structure and leverage

A thorough financial analysis will include not only a discussion of certain financial statement trends but also a discussion of what factors caused the respective trends.

Also useful is a discussion of how the employer corporation performed relative to other companies in the industry. This comparative financial analysis typically identifies the financial strengths and weaknesses of the sponsor company compared to its industry competitors.

The comparative analysis will help the ESOP trustee understand how the sponsor company performed relative to other companies in the industry. This comparative performance analysis may be based on such factors as growth, profitability, and volatility.

Normalization Adjustments

When appropriate, the valuation adviser may make financial statement normalization adjustments related to both:

1. the sponsor company and
2. the selected guideline publicly traded companies.

Some of the typical financial statements adjustments made to the sponsor company include the following:

- Adjustments for extraordinary or nonrecurring income and expense items
- Adjustments for differences in inventory accounting methods
- Adjustments for nonoperating income and expense items
- Adjustments for non-arm's-length transactions/arrangements

- Adjustments for ESOP benefit expense and normalized employee benefit expenses

The valuation report should identify the financial statement adjustments and adequately explain the rationale for each adjustment.

Generally Accepted Valuation Approaches and Methods

There are three generally accepted approaches to the valuation of a business ownership interest: the income approach, the market approach, and the asset-based approach. The valuation report should clearly describe which approaches—and which valuation methods within each approach—were used in the analysis.

In the same respect, the valuation report should explain which approaches were not used in the analysis and why they were not used.

The trustee should be concerned if the valuation adviser changes the selected valuation methods from year to year without proper explanation and support. These unsupported changes often give the appearance that the valuation adviser is attempting to support a predetermined value.

The following discussion on due diligence related to (1) the financial statement projections and (2) the selected guideline companies is based on the procedures set forth in the fiduciary process agreements.[3]

The fiduciary process agreements are specifically required for the subject independent trustees in their role as ESOP trustee in transactions. However, the valuation items in the fiduciary process agreements can be applied to annual update valuation analyses.

Income Approach—Financial Projections

With regard to the income approach, and specifically with regard to the discounted cash flow method, the trustee should understand the following:

- Preparation of the financial projections. The financial projections are often prepared by sponsor company management. In other cases, the projections are prepared by the valuation adviser with input from sponsor company management.

  In the case of management-prepared projections, the report should explain how the valuation adviser tested the reasonableness of the projections. In all cases, the financial projections should be supportable.

- Conflicts of interests for parties that created the projections. If conflicts of interest exist related to the projections, there should be documentation of how such conflicts were considered in determining the value.
- Reasonableness of the projections. At a minimum, the analysis may consider how the projections compare to, and whether they are reasonable in light of, the company'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):
  - Return on assets
  - Return on equity
  - Earnings before interest and taxes margins
  - Earnings before interest, taxes, depreciation, and amortization margins
  - Ratio of capital expenditures to sales
  - Revenue growth rate
  - Ratio of free cash flow (of the enterprise) to sales

  If it is determined that any of these metrics should be disregarded in assessing the 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.

- Comparison to historical performance. If the company is projected to meet or exceed its historical performance or the historical performance of the group of guideline public companies on any of the metrics, document in writing all material assumptions supporting such projections and why those assumptions are reasonable.
- Valuation adviser adjustments to the projections. To the extent that the trustee or its valuation adviser considers any of the projections provided by the ESOP sponsor company to be unreasonable, document in writing any adjustments made to the projections.

- If adjustments are applied to the company's projected financial metrics in a valuation analysis, determine and explain in writing why such adjustments are reasonable.
- Cost of capital components. There should be an explanation of how the valuation adviser estimated the cost of equity capital, the cost of debt capital, and the weighting of each cost component in a weighted average cost of capital calculation.

The trustee should prepare supplemental documentation of the items to the extent they are not documented by the valuation adviser in the valuation report.

Market Approach—Guideline Companies

With regard to the market approach, and specifically with regard to the guideline publicly traded company method and the guideline merged and acquired company method, the sponsor company stock valuation report should include the following:

- Comparability of the guideline companies. The bases for concluding that the guideline 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.
- Criteria used to select the guideline companies. The selection criteria may include standard industrial code, business description, size, growth, profitability or a combination of several relevant factors.
- Detailed description of each selected guideline company. This description may include a discussion of the selected guideline company's business, its products and/or services, and its position in the market. Other information, such as whether the guideline company recently completed acquisitions, may also be relevant.
- Selected multiples. This discussion may include the market-derived valuation pricing multiples that were selected for the analysis. These pricing multiples may include invested capital pricing multiples or equity pricing multiples. Industry-specific factors often influence the type of market pricing multiples that are used in the stock valuation analysis.
- Discounts. This discussion may include an explanation of any discounts applied to the pricing multiples selected. And, if no discount is applied to any given pricing multiple, explain in significant detail the reasons.

Valuation Synthesis and Conclusion

The sponsor company stock valuation report should contain a section that provides:

1. a valuation synthesis of alternative value indications and
2. a final conclusion of sponsor company stock value.

The following factors should be included in this section of the sponsor company stock valuation report:

- A discussion of how each value indication from each approach and method was weighted in the value conclusions. An explanation should be provided for each of the selected weightings.
- A discussion of any valuation premium or discount that may be appropriate to reflect the ownership control, or lack of ownership control, attributes of the subject ESOP ownership interest.

  The discussion of the application of valuation adjustments should include the following:

  - The rationale for each valuation premium or discount
  - The supporting data or factors used to estimate the valuation premium or discount.
- A discussion of nonoperating assets (or liabilities) that need to be factored into the analysis. These may include excess cash or securities, related party loans, excess land, investments in other companies, or other assets that have not been properly reflected in the valuation analysis.
- A discussion of the illiquidity, or lack of marketability, of the subject ownership interest. Most noncontrolling ownership interests in non-publicly-traded companies are relatively illiquid.

  However, the liquidity of the ESOP-owned employer corporation stock may be affected by a put right that is part of the plan. The valuation adviser should consider any such put right in the estimate of the appropriate discount for lack of marketability, if any.

> **"The ESOP trustee places a great deal of reliance on the valuation opinion of the independent valuation adviser."**

In this regard, the valuation adviser should consider various company-specific factors such as:

- the employer corporation's ability to honor the put right,
- the size of ESOP ownership interest,
- demographics of the ESOP participants,
- the employer corporation's expected repurchase liability,
- the employer corporation projected cash flow,
- the employer corporation's ability to raise capital, and
- other expected demands on the employer corporation capital.

- A discussion of any contingent and limiting conditions. The valuation report should contain language that lists any contingent and limiting conditions regarding the analysis and opinion.

After reviewing the valuation report in its entirety, the ESOP trustee should be in a position to address the following questions:

- Was the report readable and easy to understand or was it filled with undefined valuation terms and jargon?
- Was the report comprehensive and organized in a logical manner?
- Has the concluded value changed over time, and if so, what were the primary drivers of this change in value (i.e., company performance, market performance, or a combination of the two)?
- Has the employer corporation financial performance improved or deteriorated over time, and has the concluded value changed accordingly?
- Have the business valuation approaches and/or methods that were applied in the analysis changed over time, and if so, why have they changed?
- Does the employer corporation stock valuation conclusion seem reasonable given (1) the historical and projected financial performance of the employer corporation, (2) the relevant market-based data, and (3) the relevant economic and industry-specific conditions?

Summary and Conclusion

When fulfilling its fiduciary duties, an ESOP trustee will typically hire an independent valuation adviser to assist in estimating the fair market value of non-publicly-traded sponsor company stock.

The ESOP trustee places a great deal of reliance on the valuation opinion of the independent valuation adviser. As a result, the ESOP trustee needs to exercise care in selecting a qualified, independent valuation adviser.

In reviewing the work of the valuation adviser, the ESOP trustee needs to have a basic understanding of the valuation process employed. This understanding will enable the trustee to appropriately conduct a thorough review of the ESOP sponsor company stock valuation report.

The trustee should document in writing its bases for concluding that the information supplied to the valuation adviser, whether directly from the ESOP sponsor or otherwise, was current, complete, and accurate.

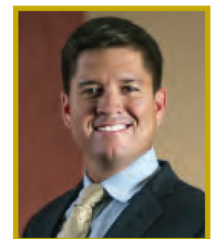
A thorough valuation analysis should be documented with a comprehensive valuation report. It is prudent for the ESOP trustee to review each periodic stock valuation report in order to understand its content.

It is the trustee's responsibility to ensure all relevant items are included and properly discussed. The trustee should prepare supplemental documentation of the items to the extent they were not documented by the valuation adviser.

Notes:

1. The trustee can set the share price at something different than the value provided by the third-party independent valuation firm. However, the trustee would have to explain why he or she differed from the valuation analyst. The trustee ultimately sets the share price.
2. Depending on the plan document, there may be quarterly or semi-annual updates to value. The process for these updates would be generally be similar to that of the annual update described herein.
3. As of this publication, the DOL has established process agreements with five independent trustees.

Chip Brown is a senior vice president for the employee benefits group office of TI-TRUST in Atlanta, Georgia. Chip can be reached at (404) 942-5800 or at chip.brown@ti-trust.com.



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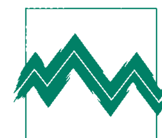

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Pizzella v. Vinoskey: A Costly Lesson to Learn

Lisa H. Tran

In the 2019 Pizzella v. Vinoskey *judicial decision, the United States District Court found that the employee stock ownership plan ("ESOP") fiduciaries of Sentry Equipment Erectors, Inc., did not act with prudence and that they violated their fiduciary duties. The fiduciaries failed to further investigate the inconsistent assumptions applied in the valuation of the sponsor company stock that they relied on for the ESOP to purchase stock from the sponsor company owner. The District Court held that the ESOP fiduciaries were liable for $6,502,500 in damages because they knowingly participated in a prohibited transaction that caused the ESOP to pay more than adequate consideration for the sponsor company stock.*

Introduction

Congress implemented the Employees Retirement Income Security Act of 1974 ("ERISA") to protect employees and the benefit plans employers created for them. One such plan is an employee stock ownership plan ("ESOP").

To protect employees from employers completing stock transactions with the ESOP that benefit the employer-owners at the expense of the employees, ERISA imposes high standards of fiduciary duty on ESOP administrators.

In an ESOP, the employee participants can receive compensation in the form of company shares purchased by the ESOP for distribution to the employees. ERISA bans certain transactions between parties of interest (i.e., the ESOP and company owners) unless these transactions are transacted for "adequate consideration."

Further, it is the responsibility of an ESOP fiduciary under ERISA to ensure that these types of transactions occur at a price that is no more than adequate consideration.

ERISA defines adequate consideration as "the fair market value of the asset as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan in accordance with regulations promulgated by the Secretary."[1]

Private company stock that is held in an ESOP should be valued at least annually. The annual valuation is used for plan administration purposes, such as for providing distributions to departing plan participants.

Significant changes in sponsor company stock valuation conclusions from year to year may occur as market conditions and sponsor company operations change. It is important that any significant changes in the valuation methods and assumptions be discussed with the ESOP trustee(s) and company management.

In *Acosta v. Vinoskey*,[2] the ESOP trustees learned this costly lesson. This case went to trial in the United States District Court for the Western District of Virginia under *Patrick Pizzella v. Adam Vinoskey, et al.*[3]

In its case presented before Judge Norman K. Moon, the Secretary of Labor ("Secretary") alleged that Sentry Equipment Erectors, Inc. ("Sentry"), its chief executive officer, Adam Vinoskey ("Vinoskey"), and other fiduciaries, Kenny Lenoir ("Lenoir") and Michael New ("New") of Evolve Bank and Trust ("Evolve"), hereafter referred to as "Defendants,"

breached their fiduciary duties and thus violated ERISA by approving the ESOP purchase of 52 percent of the Sentry stock at $406.00 per share from Vinoskey.

The Secretary alleged that in paying more than fair market value, the ESOP overpaid by $11,526,000.

The U.S. District Court ("District Court") agreed and ruled that Vinoskey and Evolve were jointly liable for $6,502,500 in damages because they knowingly participating in a prohibited transaction that caused the ESOP to pay more than adequate consideration for the Sentry stock.

For the valuation of stock for ESOP purposes, it is prudent for an ESOP fiduciary to hire a valuation analyst who is not only qualified to perform the valuation, but also understands that continuity in how the valuation is performed is important to the long-term success of the ESOP.

Therefore, any significant changes in valuation methodologies and values from year to year should be reconciled, documented in the report, and explained to the ESOP trustee(s) and ESOP sponsor company management.

This review of the District Court decision indicated that if the ESOP fiduciaries had invested more effort into understanding and resolving the issues identified in the valuation of the sponsor company stock, an audit by the Department of Labor could have been avoided.

Case Background

Founded in 1980 by Adam and Carole Vinoskey (the "Vinoskeys") and based in Virginia, Sentry designs and sells equipment such as conveyors and bottling machines for soft drink manufacturers.

The Vinoskeys created the ESOP, which included a 401(k) defined contribution plan and an employee stock ownership feature.

Because the skills required to operate a bottling plant are in high demand, Sentry retains its employees by providing generous health care (paying 100 percent of the premiums) and retirement benefits, including the ESOP.

Vinoskey was a trustee of the ESOP (and thus a fiduciary under ERISA), the Sentry chief executive officer, and chairman of the Sentry board of directors. Vinoskey was an ESOP trustee from 2006 to at least July 2012.

Sentry hired William Gust ("Gust") of Gentry Locke to provide legal services to the ESOP. Capital Analysts, Inc. ("CAI"), a valuation firm owned by Brian Napier ("Napier"), CAI president, was hired to estimate the fair market value of the Sentry stock on an annual basis for ESOP administration purposes.

From 2005 to 2009, the values of the Sentry stock estimated by Napier ranged from $215 per share (December 2005) to $285 per share (December 2009). Vinoskey testified at trial that he reviewed and understood the valuations of the Sentry stock for ESOP purposes every year.

In 2004, the ESOP purchased 48 percent of the Vinoskeys Sentry stock for $220 per share, or approximately $9.0 million in total. The ESOP paid $1.5 million to the Vinoskeys and the remainder of the price was borrowed from Sentry.

With contributions made by Sentry to the ESOP, the ESOP paid off its debt before 2010. Shares of Sentry stock were allocated to individual ESOP participants as the debt was paid off.

In December 2010, Vinoskey decided to retire and, through the Adam Vinoskey Trust, Vinoskey wanted to sell the remaining 52 percent interest in Sentry to the ESOP ("2010 Transaction"). Gust recommended hiring Evolve to serve as an independent transactional trustee for the 2010 Transaction.

In an email to Evolve on November 9, 2010, Gust invited Evolve to serve as a transactional trustee for the 2010 Transaction, which was estimated at approximately $21 million by Napier. On November 12, 2010, Evolve sent an engagement letter to Sentry for its services as a transactional trustee.

On November 17, 2010, Michael Coffey who had assisted Gust on the ESOP transaction in 2004, emailed New (copying Gust and Napier in the email) an attachment with his price estimate of the 2010 Transaction at $20,931,963.

On the same day, Lenoir and New presented to Evolve's ESOP Administration Committee and provided an attachment showing the size of the transaction was approximately $21 million. Lenoir was one of Evolve's largest shareholders and headed the bank's trust practice. He supervised New, a lawyer employed at Evolve as a senior trust officer.

On November 18, 2010, Evolve accepted the engagement letter with Sentry. On the same day, Lenoir and New toured the Sentry plant on a site visit and interviewed the Vinoskeys and the incoming president, Mike Connor ("Connor").

On November 29, 2010, Evolve contracted with CAI to perform the appraisal of the Sentry stock for the 2010 Transaction. On December 9, 2010, CAI sent a draft to Evolve and Gust that estimated the fair market value of the Sentry shares at $405.73 per share on a controlling basis, or $20,697,330 for the 51,000 shares of Sentry stock owned by Vinoskey.

Upon review of the draft appraisal, Lenoir and New had a few major concerns and emailed Napier about them on December 11, 2010:

- The addback of half of the health care insurance cost paid by Sentry for its employees
- Unexplained and unusually low capitalization rate
- No explanation of how Sentry's industry and the overall economy would affect Sentry going forward. In the November 18, 2010, management interview, Connor had claimed that due to slower growth in the beverage industry, 2011 may be a challenging year for Sentry. Connor believed Sentry needed to diversify further into the food sector because the beverage industry was being affected by the slower economy in 2010.
- No explanation of how Napier adjusted his methodology to account for the valuation of the stock on a controlling basis
- No application of the discounted cash flow method
- No weighting on the asset-based approach which would lower the estimated per share value

On December 13, 2010, Lenoir and New discussed their concerns about the appraisal with Napier. On December 14, 2010, before Napier resolved Lenoir and New's issues and finalized his valuation report, the Sentry board announced that the ESOP would purchase Vinoskey's 51,000 shares of Sentry stock at a price not to exceed $406.00 per share.

On December 15, 2010, Evolve offered Vinoskey, and Vinoskey accepted, the per share price of $406.00. On the same day, Evolve drafted a Resolution of the Special Independent Trustee of Sentry Equipment Erectors stating that the $406.00 per share price did not exceed fair market value.

The transaction was completed on December 20, 2010, without any negotiation by Evolve with Vinoskey, for the ESOP to purchase the stock at a lower price.

The ESOP paid for the 51,000 Sentry shares with $8.5 million in cash, $1.9 million borrowed from Sentry, and a $10.3 million note from Vinoskey at an interest rate of 4 percent. After the transaction closed, Evolve resigned its role as an ESOP trustee for Sentry.

District Court Findings

The District Court ruled in *Acosta v. Vinoskey* that the Secretary's expert witness, Dana Messina ("Messina"), was a qualified expert. Defendants had filed a *Daubert* motion and tried to exclude the testimony of Messina. The District Court held that Messina, who founded the valuation firm Kirkland Messina, was sufficiently qualified to testify about the value of Sentry.

The District Court noted that Messina had earned an MBA from the Harvard Business School and had more than 25 years of business valuation experience. The District Court accepted the Messina calculation of the amount the ESOP overpaid for the Sentry shares.

Messina calculated the damages estimate by determining the fair market value of the Sentry stock and how much more than fair market value the ESOP paid to purchase Vinoskey's shares. The District Court ruled that this approach is generally used by courts to compute overpayments.

In *Acosta v. Vinoskey*, the District Court found that New was not a fiduciary based on the definition set by ERISA. New did not have the authority to authorize the 2010 Transaction or set the stock price without Lenoir's approval. Thus, the claims against New were dropped.

The case went to trial to determine if Evolve and Vinoskey violated their fiduciary duties under *Pizzella v. Vinoskey*. In *Pizzella v. Vinoskey*, the District Court ruled that Evolve and Vinoskey caused

the ESOP to pay more than adequate consideration for the Sentry stock.

The District Court agreed with the Secretary that Evolve did not act prudently and thus violated its fiduciary duties because Evolve did not question or investigate the issues it had identified during its review of the November 2010 Napier appraisal of the Sentry stock.

In reviewing the evidence, the District Court found the following inconsistencies between the November 2010 valuation and prior valuations completed by Napier, which the District Court believed should have alerted the ESOP fiduciaries to investigate further into the November 2010 appraisal.

- Using the capitalization of earnings method, Napier estimated net cash flow using three years of historical earnings (2007 to 2009), thereby capturing Sentry's peak years of earnings and not the full business cycle.

  The Sentry earnings were typically cyclical depending on when large beverage companies made capital investments to their facilities. In his valuations of Sentry before 2008, Napier used five years of Sentry historical earnings in the capitalization of earnings method.

- Napier normalized earnings for the November 2010 appraisal by adding back half of Sentry's health care costs, which he did not do in his prior years' valuations. Napier admitted at trial that the health care cost add-back increased the per share price by $50.00.

  During the November 18, 2010, diligence meeting, New suggested to Vinoskey that Sentry could save money by requiring its employees to pay for some of their health insurance premiums. Vinoskey had adamantly refused because these benefits were important in retaining its skilled employees in a tight labor market.

- Napier used a capitalization rate of 16.2 percent in the 2009 appraisal but a capitalization rate of 12.2 percent in the November 2010 appraisal. Generally, the higher the capitalization rate, the lower the value.

  The capitalization rate that Napier used in the November 2010 valuation was the lowest rate over the five-year period observed. Just 11 days after the 2010 Transaction closed, Napier raised the capitalization rate to 18.2 percent in the December 31, 2010, valuation.

  The lower capitalization rate in the November 2010 valuation was a result of applying a lower company-specific risk premium and a higher long-term growth rate, which Napier explained at trial (and not in his valuation report) was due to valuing a controlling interest in November 2010, instead of a noncontrolling interest in prior years.

- Napier added back excess cash and half the value of the land owned by Sentry for the 2010 Transaction, which increased the per share price of the Sentry stock by $73.81. Napier did not add back these nonoperating assets in his prior years' valuations.

- In the November 2010 valuation, Napier used a 10 percent rate to calculate the Sentry working capital needs (10 percent cash to total assets or $2.2 million), while in the post transaction appraisal as of December 31, 2010, Napier used a 20 percent rate.

  The District Court concluded that appraisals of the Sentry completed after the 2010 Transaction were applicable because they allow the District Court to assess the reliability, creditability, and consistency of the expert witness' methodology in completing these appraisals.

  Further, Napier even testified that he knew Sentry historically had maintained at

> least 30 percent of its cash to cover working capital needs. In addition, Vinoskey had testified that Sentry would need at least $10 million in cash to cover work-in-process and to withstand the cyclicality of the Sentry business.

Messina argued that Napier intentionally caused the Sentry stock value to spike to meet the predetermined price of $21 million for the 2010 Transaction. If Napier had been consistent in how he appraised the Sentry stock at November 2010, the per share value would be $257.50, not $405.73, indicating that the ESOP overpaid for the Sentry stock by $7.5 million, according to Messina.

Napier testified that he was valuing the Sentry stock on a controlling basis for the 2010 Transaction because Vinoskey was selling a 52 percent interest, and after the transaction the ESOP would own 100 percent of the equity and have control over company operations.

Napier argued that the control considerations warranted a 40 percent increase in value and were the primary reason for the changes in assumptions made in his November 2010 valuation.

On the contrary, the Secretary argued that while the ESOP owned 100 percent of Sentry after the 2010 Transaction, it did not effectively control the Sentry operations.

The District Court agreed, and based on the evidence presented, found that the ESOP did not gain effective control of Sentry simply by purchasing 100 percent of the Sentry stock.

Pursuant to the ESOP and Sentry's bylaws, the board of directors have the power to appoint and remove ESOP trustees. Further, pursuant to the ESOP, the Sentry stock owned by the ESOP generally would be voted by the ESOP trustee(s), except in certain circumstances such as the sale of Sentry.

Before 2010, the Vinoskeys and another Sentry manager comprised the Sentry board. Before 2010, the Vinoskeys also served as two of Sentry's three ESOP trustees. Because of Sentry's corporate structure, the Vinoskeys had complete control over Sentry.

Vinoskey and his management team continued to manage Sentry after the 2010 Transaction. After 2010, Vinoskey and four other Sentry managers comprised the board. Sentry's board did not have an ESOP representative or outside directors and the Vinoskeys continued to serve as ESOP trustees, along with Connor.

The Vinoskeys' adamant refusal to cut health care premiums paid by Sentry for its employees was evidence of their absolute control over the Sentry operations.

Summary and Conclusion

While Evolve had concerns about the Napier appraisal of the Sentry stock for the 2010 Transaction, it did not ensure that its questions were addressed before finalizing the transaction. Instead, Evolve settled on the ESOP transaction price before Napier finalized his valuation report.

Additionally, the Evolve due diligence was rushed; its work on the 2010 Transaction began on November 9, 2010, and ended on December 20, 2010, in order for the transaction to close before year-end.

The District Court understood that Sentry would pay less income taxes for the year if the ESOP, a tax-exempt entity, owned 100 percent of the Sentry stock at year-end.

Ultimately, the District Court found that Evolve failed to act prudently as a fiduciary for the ESOP and was liable for damages suffered by the ESOP.

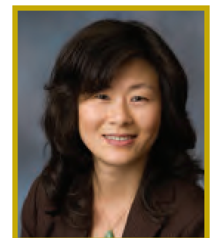
A careful review of the District Court decision indicates that when an ESOP trustee is fulfilling fiduciary duties imposed by ERISA when establishing the value of sponsor company stock, it is important that the ESOP fiduciary selects a valuation analyst who is both qualified to perform the valuation <u>and</u> understands that continuity in how the valuation is performed is important.

Any significant changes in the valuation methodologies and assumptions from year to year should be explained.

Errors or inconsistencies in the valuation that are not investigated and reconciled may draw the attention of regulating agencies, potentially leading to a costly legal dispute and significant financial consequences, as was the case in the 2019 *Pizzella v. Vinoskey* decision.

<u>Notes:</u>

1. Regulation Relating to the Definition of Adequate Consideration; Notice of Proposed Rulemaking, 29 CFR Part 2510 (1988), p. 17,633.
2. Acosta v. Vinoskey, 310 F.Supp.3d 662 (W.D. Va. 2018).
3. Pizzella v. Vinoskey, 409 F.Supp.3d 473 (W.D. Va. 2019).



Lisa Tran is a vice president in our Portland, Oregon, practice office. Lisa can be reached at (503) 243-7510 or at lhtran@willamette.com.

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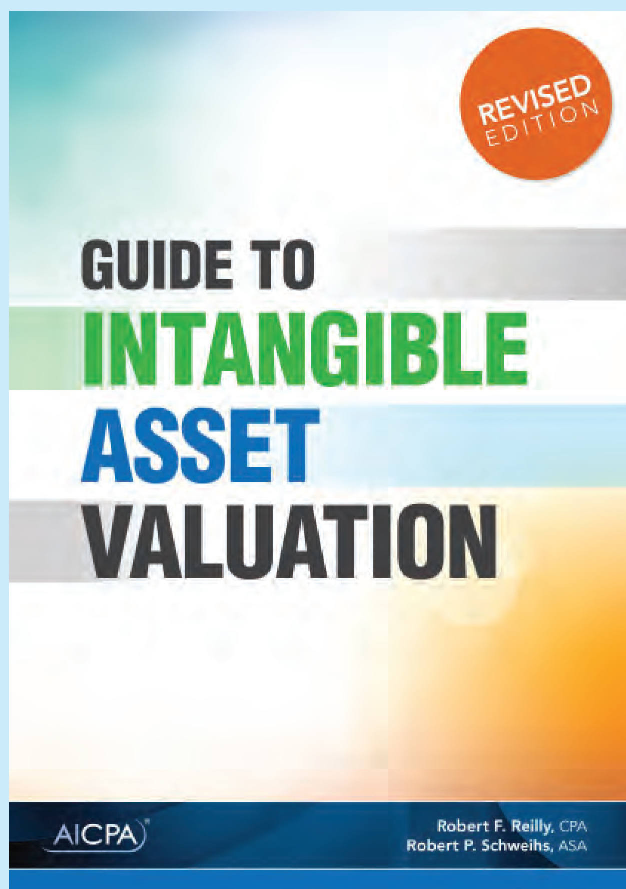
by Robert F. Reilly and Robert P. Schweihs



This 745-page book, originally published in 2013 by the American Institute of Certified Public Accountants, has been improved! The book, now in hardback, explores the disciplines of intangible asset valuation, economic damages, and transfer price analysis. *Guide to Intangible Asset Valuation* examines the economic attributes and the economic influences that create, monetize, and transfer the value of intangible assets.

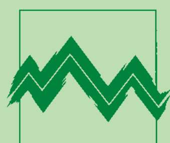
Robert Reilly and Bob Schweihs, Willamette Management Associates managing directors, discuss such topics as:

- Identifying intangible assets and intellectual property
- Structuring the intangible asset valuation, damages, or transfer price assignment
- Generally accepted valuation approaches, methods, and procedures
- Economic damages due diligence procedures and measurement methods
- Allowable intercompany transfer price analysis methods
- Intangible asset fair value accounting valuation issues
- Valuation of specific types of intangible assets (e.g., intellectual property, contract-related intangible assets, and goodwill)

Illustrative examples are provided throughout the book, and detailed examples are presented for each generally accepted (cost, market, and income) valuation approach.

Who Would Benefit from This Book

- Litigation counsel involved in tort or breach of contract matters
- Intellectual property counsel
- International tax practitioners
- Property tax practitioners
- Auditors and accountants
- Valuation analysts
- Licensing executives
- Multinational corporation executives
- Commercial bankers and investment bankers
- Merger & acquisition professionals
- Bankruptcy professionals
- Judges and arbitrators



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Guide to Intangible Asset Valuation

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Fairness from a Financial Point of View: Financial Advice to the ESOP Trustee in a Sponsor Company Sale Transaction

Terry G. Whitehead, CPA

When confronted with a potential transaction, an Employee Stock Ownership Plan (ESOP) is represented by a trustee who typically retains the services of an independent financial adviser. The role of the financial adviser may involve providing a fairness opinion to answer the question of whether the transaction is fair from a financial point of view to the ESOP. In answering this question, the financial adviser may address certain specific elements of the transaction in addition to applying generally accepted valuation methods to develop a reasonable estimate of fair market value.

Introduction

As a fiduciary, the trustee, acting on behalf of the ESOP, typically relies on the fairness analysis and fairness opinion provided by the financial adviser as a factor in advising the ESOP to accept, reject, or negotiate an adjustment to the proposed terms of the transaction.

Although the ESOP trustee may be primarily concerned with the financial adviser's formal final opinion regarding the transaction, an understanding of the factors relied upon by the financial adviser in forming the fairness opinion is important for the ESOP trustee in fulfilling his or her fiduciary responsibility.

The Trustee and the Financial Adviser

As a fiduciary, the ESOP trustee has a responsibility to protect the assets of the ESOP (including the ESOP stock) which represents a retirement benefit for the individual employees of the sponsor company.

Although not a legal requirement, obtaining a fairness opinion can help substantiate that the ESOP trustee acted and made decisions regarding the approval or rejection of the transaction in accordance with the business judgment rule.

In the event that a dispute or grievance should arise from an ESOP participant, the ESOP trustee may be in a much more vulnerable position if he or she did not retain a financial adviser to provide a fairness opinion.

The business judgment rule is a doctrine derived from case law that considers whether directors in a corporation:

1. acted in good faith,
2. acted with similar care as an ordinarily prudent person (i.e., due care), and
3. acted in a manner reasonably believed to be in the best interest of the corporation (i.e., loyalty).

These three components encompass the fiduciary duty standard. Recognizing these considerations, it is understandably prudent for the ESOP

trustee to not only obtain a fairness opinion, but to understand and critically review the analysis of the financial adviser.

In the transaction process, the ESOP trustee typically hires a financial adviser to provide an opinion regarding two primary initiatives:

1. Is the consideration to be received by the ESOP not less than the fair market value of the ownership interest
2. Are the related terms and conditions of the transaction, taken as a whole, fair and reasonable from a financial point of view to the ESOP.

This discussion focuses on certain specific considerations within the valuation process and analysis related to the determination of whether the contemplated transaction is "fair" to the ESOP "from a financial point of view."

This discussion will not review the entire transaction or valuation process, but will specifically address considerations by the financial adviser regarding the following:

- Reconciling the range of valuation method conclusions
- Recognizing the potential impact of escrows and earnouts
- Identifying potential additional transaction benefits to the selling company shareholder(s) other than the ESOP
- Consideration of additional transaction benefits to the ESOP relative to the other shareholder(s)

Valuation Method Conclusions

In order to reach an opinion regarding the consideration to be received by the ESOP, the financial adviser should first determine a reasonable estimate of the company value (i.e., fair market value).

This estimate typically involves the application of one or more generally accepted valuation methods within one or more of the three generally accepted business valuation approaches (i.e., the income approach, the market approach, and the asset-based approach).

It is generally accepted that the concept of fairness, within the context of this type of transaction analysis, considers it appropriate for the financial adviser to conclude a reasonable range of values for the sponsor company (and the sponsor company stock). As a result, a range of value may be developed within each valuation method that the financial adviser applies.

From a theoretical viewpoint, if each of the selected valuation methods is appropriately applied recognizing the facts and circumstances of the subject company, then each of the methods is likely to result in relatively similar conclusions.

However, in practice, for a variety of factors and influences, the selected valuation methods may not closely align. In these instances, the financial adviser will likely assess the strengths and weaknesses within each of the valuation methods utilized in order to provide guidance for his or her ultimate opinion of value.

Figure 1 presents a valuation method summary example as an easily recognizable conclusion of the value range for each method.

Based on the illustrative example presented in Figure 1, strictly considering price and ignoring all other factors, it is unlikely that a purchase price below the lowest method value indication of $18.5 million would be considered a fair price.

A purchase price above the low indication, strictly considering price and ignoring all other factors, would potentially represent a fair price range.

However, a price above the lowest indication of $18.5 million does not necessarily indicate that the purchase price is at least fair market value or fair from a financial point of view.

Typical Procedures in the Valuation Process of the Financial Adviser

The ESOP trustee should understand the valuation process used by the financial adviser to estimate fair market value in order to determine if the concluded value range is credible, reasonable, and appropriate.

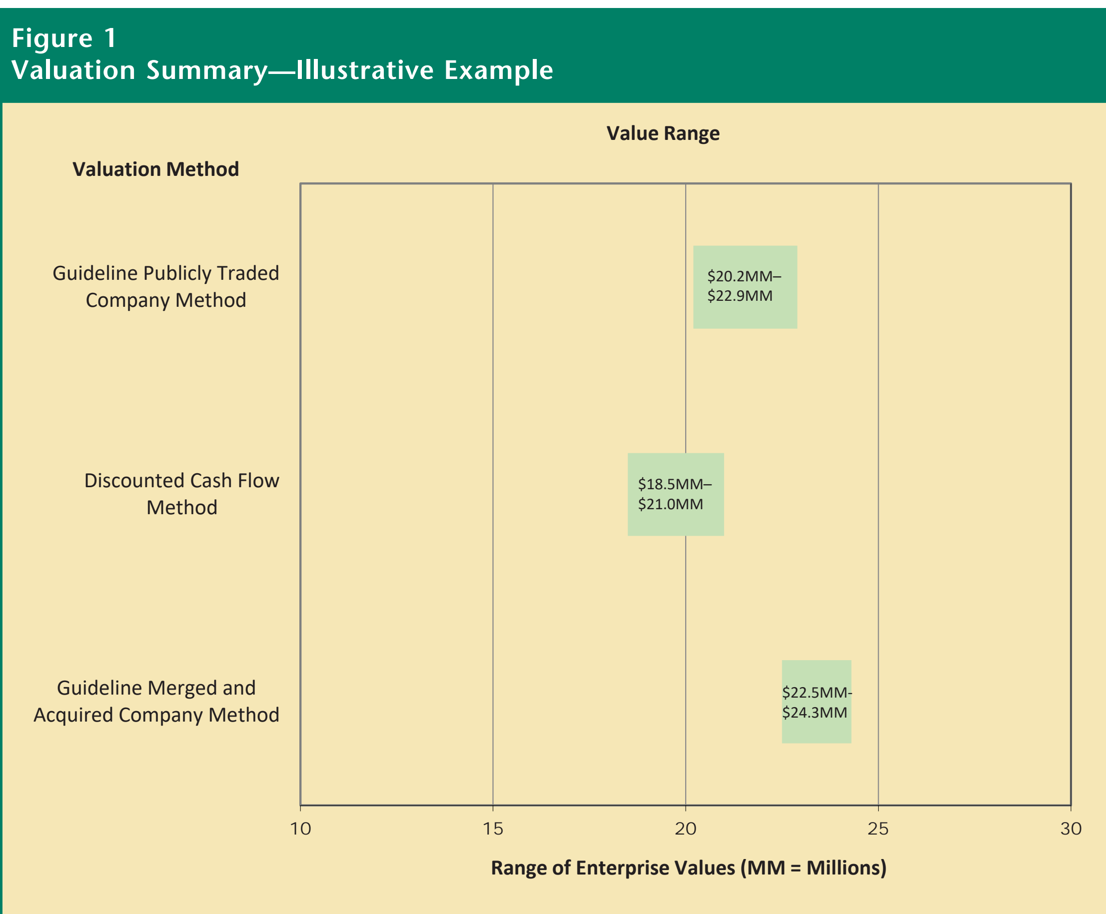
Although each engagement has its own set of facts and circumstances which will impact the valuation approaches and methods considered and relied upon, it is a generally accepted practice for a financial adviser to apply multiple valuation methods in order to provide additional credibility and reliability to the concluded range of value.

In practice, there is no requirement for a financial adviser to rely on more than one method. However, it is typical for a financial adviser to at least conduct multiple methods for analysis to identify a reasonable potential range of values to support the ultimate conclusion and provide sufficient information for the ESOP trustee to make an informed decision.

The analysis conducted by the financial adviser should present a summary conclusion for each method considered as well as a basis of determination

for the final conclusion of value (or range of value). Based on the facts and circumstances of the engagement, the financial adviser may decide to rely on a single valuation method or base his or her conclusion on consideration (i.e., a method weighting) of multiple value indications.

The financial adviser should provide the ESOP trustee with sufficient information and a credible basis for including or excluding the value indications from the final conclusion for each valuation method considered. Such information should reasonably provide a basis as to why the inclusion or exclusion of a prospective valuation method results in an appropriate fair market value estimate for the ESOP.



The initial consideration of a specific valuation approach or method by the financial adviser does not require it to be relied upon in the final value conclusion.

There are a variety of factors that a financial adviser may encounter during the analysis of a specific valuation method that may provide the financial adviser a basis to place greater or lesser reliance on the valuation method, or no reliance at all.

If the financial adviser does not ultimately rely on the value range indication from a specific valuation method, then a comparison of this method to the purchase price is not relevant. As a result, there may be circumstances where the financial adviser concludes a fair market value estimate that is less than the estimated value range resulting from an analysis that was not relied upon.

However, in such instances, the ESOP trustee should recognize and understand the basis for the financial adviser's determination in order to form his or her own opinion regarding the reliability and reasonableness of the financial adviser's conclusions when advising the ESOP in the transaction.

Instances where the purchase price indication is below one or more of the relied upon valuation methods does not automatically indicate that the purchase price fails to meet the required valuation threshold.

Escrows and Earnouts

Typically, the terms of the purchase price in a transaction are defined in a purchase agreement or some other formal document.

A purchase price other than a single lump sum of cash will generally require additional analysis by the financial adviser in order to consider the potential impact to the ESOP from a financial point of view.

Escrows

Merger and acquisition transactions commonly utilize escrow accounts to hold transaction proceeds to provide the buyer protections for unforeseen liabilities or other timing issues and uncertainties.

The financial adviser may consider various levels of escrows to be potentially received and related

probabilities in order to recognize the potential impact on an otherwise unadjusted purchase price.

Although the future results and escrow payments will not be certain at the date of the transaction, based on the facts and circumstances at the time of the transaction, an estimated impact may be considered.

As an example, the following discussion considers a sample analysis for a transaction involving two escrow accounts:

1. A 90-day adjustment escrow of $1 million to primarily offset any identified changes in the final balances of working capital
2. An 18-month indemnity escrow of $1.5 million to primarily cover liabilities and other costs not immediately incurred at the time of the transaction

First, the adjustment escrow may affect the purchase price under consideration if the adjustment escrow considers a working capital balance (or other financial measure or withholding of funds) that is significantly different than the expected operating level at the closing of the transaction.

Generally, the transaction terms agreed to by the buyer and seller will include a provision for the company to retain an appropriate level of working capital. However, if an adjustment escrow is based on an arbitrary amount, it may result in a reduced purchase price paid to the sellers after the impact of the withheld adjustment escrow.

As a result, both the financial adviser and the ESOP trustee should understand the potential impact on final proceeds to the seller as a result of the adjustment escrow.

Based on the financial analysis at the date of the transaction and other relevant known or knowable factors, it is possible that none, some, or all of the adjustment escrow amount should be reduced from the otherwise unadjusted purchase price when estimating the expected proceeds to be received by the seller.

Second, the timing and magnitude of the indemnity escrow may be considered for the potential impact on the expected proceeds to be received by the seller. As an initial test of fairness, the defined purchase price should be adjusted to reflect the estimated proceeds to the ESOP (an "adjusted purchase price").

If the adjusted purchase price is within or exceeds the indicated range of appraised values, then the impact of the escrows is not likely to result in a conclusion that the purchase price is not fair from a financial point of view.

However, if the adjusted purchase price approaches or falls below the lower end of the fair market value range, additional analysis may be necessary to clarify a reasonable impact of the escrows.

Earnouts

Portions of the purchase price may be withheld for future payments based on the post-transaction operating results of the company. These are more commonly used when the target company has a limited operating history or significant uncertainty related to the ongoing earnings of the company resulting from the change in ownership.

Although there are various ways for the financial adviser to consider such a payment structure, one common approach is a probability weighted method.

Under this method, the earnout provisions are analyzed to recognize the potential range of future payments to be received under alternative scenarios or assumptions. Next, each of the identified alternatives is weighted as to its "probability" (i.e., or likelihood compared to the other alternatives) of occurring.

The financial adviser may consult with the company's management, as well as with any other available experts including the buyers and available market data or research, in order to identify reasonable probability estimates for each of the alternatives.

Finally, the expected timing and risk of the future payments should be considered in order to convert the future earnout alternatives to a present value as of the transaction date.

The potential impact of any earnouts should be considered when estimating a reasonable purchase price to be received by the seller. It is important to remember that the objective of the analysis is to identify whether the transaction is fair from a financial point of view.

This perspective does not require that all purchase price uncertainty is removed from the transaction, but rather, that the price is fair to the ESOP based on the facts and circumstances at the time of the transaction.

Additional Transaction Benefits

For transactions of companies with ESOPs owning less than 100 percent of the outstanding stock, it is necessary to identify and consider the transaction benefits for both the ESOP and other non-ESOP owners.

Fair from a financial point of view to the ESOP includes both:

1. a fair price (or "absolute fairness") and
2. fairness among all stockholders (or "relative fairness").

In the financial adviser's relative fairness analysis, the financial adviser will consider the fair market value of the proceeds to all of the sellers.

From the perspective of the ESOP, the terms of the transaction should be at least as favorable to the ESOP as the other non-ESOP shareholders to pass the relative fairness test.

If the terms are more favorable to the ESOP, there would not be an issue of fairness from the perspective of the ESOP. However, if the non-ESOP shareholders are viewed as receiving a premium in price or more preferable terms and conditions than the ESOP, the fair from a financial point of view requirement has likely failed.

Additional transaction benefit considerations may be realized in various forms. Presented below are examples of possible additional transaction benefits.

Future Compensation or Consulting Agreements

The buyer of a company will often require the continued employment of key individuals. In circumstances where such individuals are also shareholders in the company, it may be necessary to analyze the proposed compensation package to identify whether the terms are above market compensation levels or if the financial package resulted in a decrease of the otherwise offered purchase price for the sponsor company.

If the purchase price and future compensation of a non-ESOP shareholder is perceived to be more favorable than the purchase price for the ESOP, then the fair from a financial point of view requirement has failed and would require modification of the transaction terms.

Future Lease of Real Estate

It is common for selling shareholders to own land, buildings, or other fixed assets (the "real estate") used by the company and lease it back to the company.

In a transaction where a non-ESOP shareholder retains ownership of the real estate after the transaction, it may be appropriate for the financial adviser to review the terms of any future rent payments in order to identify any potential "shift" in purchase price to the shareholder/owner of the real estate at the detriment of the remaining shareholders and ESOP.

"From the perspective of the ESOP, the terms of the transaction should be at least as favorable to the ESOP as the other non-ESOP shareholders to pass the relative fairness test."

Repairs or Other Purchase Price Adjustments

Purchase price adjustments and payment terms must be at least equally fair to the ESOP as they are for non-ESOP shareholders. These adjustments include the provisions for escrows and earnouts as discussed previously.

Similar to other purchase price considerations, the amount of any adjustments should be considered when comparing the purchase price to the estimated value range in order for the financial adviser to properly assess the fairness of the transaction terms to the ESOP.

Noncontrolling ESOP Ownership

Another potential benefit to the ESOP may not be directly related to the purchase price. In circumstances where the ESOP is not a controlling owner, there may be another single owner with control.

If such a control owner operates the sponsor company in a manner that does not maximize the potential of the company or future earnings, it may be an important beneficial consideration for the ESOP to complete the transaction at the offered purchase price in order to no longer be subject to the authority of the control owner.

It is not suggested that the ESOP is being treated as an oppressed shareholder, but rather a control owner has latitude to operate the company in a manner of his or her desire, which may not result in the maximization of profits or company value.

Assuming all owners (controlling and noncontrolling) are being compensated equally in the transaction, the elimination of the noncontrolling ownership status of the ESOP may be considered a valuable benefit to the ESOP from a financial point of view.

Favorable Market Conditions

Financial markets, economies, and industries may be cyclical or volatile. Certain industries, and companies operating within such industries, may find

that opportunities to sell or liquidate are limited. For companies with such characteristics, finding a willing buyer may be rare.

Being relevant to a potential pool of multiple buyers may be even more rare. Under such circumstances, fairness from a financial point of view may necessarily consider these qualitative factors in addition to the typical financial calculations of value.

Both the financial adviser and the ESOP trustee should recognize and understand the overall market considerations and the attractiveness of the sponsor company in the respective marketplace in order to develop a reasonable opinion of fairness from a financial point of view.

Consideration of Additional Transaction Benefits

Upon completion of the valuation analysis and gathering of the relevant facts, the financial adviser will typically develop an opinion of how the additional transaction benefits affect the ESOP and whether the terms of the transaction (including the purchase price as well as other nonfinancial considerations) are fair to the ESOP from a financial point of view.

An example regarding consideration of additional benefits from a financial point of view is presented in Exhibit 1.

The examples identified in Exhibit 1 can be seen to be at least equally fair to the ESOP as the other shareholder(s). The fairness from a financial point of view consideration does not require the terms to be equal to all participants.

Based on the example presented in Exhibit 1, the other shareholder(s) appear to be receiving less of a benefit than the ESOP, which from the perspective of the ESOP and the consideration by the ESOP trustee, is perfectly acceptable.

Concluded Opinion

Upon the completion of the analysis, the financial adviser is expected to render an opinion to the

Exhibit 1
Consideration of the Additional Transaction Benefits

	Summary of Additional Considerations and Terms of Purchase		Terms Favor	
	ESOP	Other Shareholder(s)	ESOP	Other Shareholder(s)
Differences in Escrows:				
Adjustment Escrow	Pro rata for 90 days	Pro rata for 90 days, plus 100% over $1.0 million	X	
Indemnity Escrow	Pro rata until $1.0 million for ESOP for 18 months	Pro rata for 18 months and 100% after ESOP total of $1.0 million, plus 100% after 18 months	X	
Additional Transaction Benefits:				
Future Compensation	None	One year continued employment at market estimated compensation of $150,000 per year, plus 2 additional years consulting agreement with a maximum individual commitment of 10 hours per month for $15,000 per year	X	X
Future Lease	None	Continued rent of company facilities from shareholder based on independently assessed market rate with an initial 5-year lease term	X	X
Elimination of Noncontrolling Ownership Status	No longer subject to control owner rights and privileges	NA	X	
Market Participant Interest	Company has never been approached for acquisition in its operating history, only one interested buyer has been identified, future liquidity event not likely, eliminates potential future concern surrounding the company's ESOP repurchase liability	Terms are considered comparable to other identifiable industry transactions, the company and shareholder(s) do not have the financial capacity to materially invest at a level which would result in a meaningful change in operations or improvement in earnings	X	X

ESOP trustee regarding two primary components as to whether:

- the consideration to be received by the ESOP for the ownership interest represents "adequate consideration," and is, therefore, not less than the fair market value of the shares and
- the transaction, taken as a whole, is fair and reasonable, from a financial point of view, to the ESOP.

Figure 2 reflects a representation by the financial adviser of the analysis performed regarding the fairness from a financial point of view.

In Figure 2, the financial adviser has modeled a conservative consideration of the purchase price in the transaction under two scenarios: first, assuming the shareholders will not receive any benefit from the potential future earnouts and second, in addition to the lack of future earnouts, all of the escrows will be fully utilized and, as a result, no additional funds related to the escrows will be received by the shareholders.

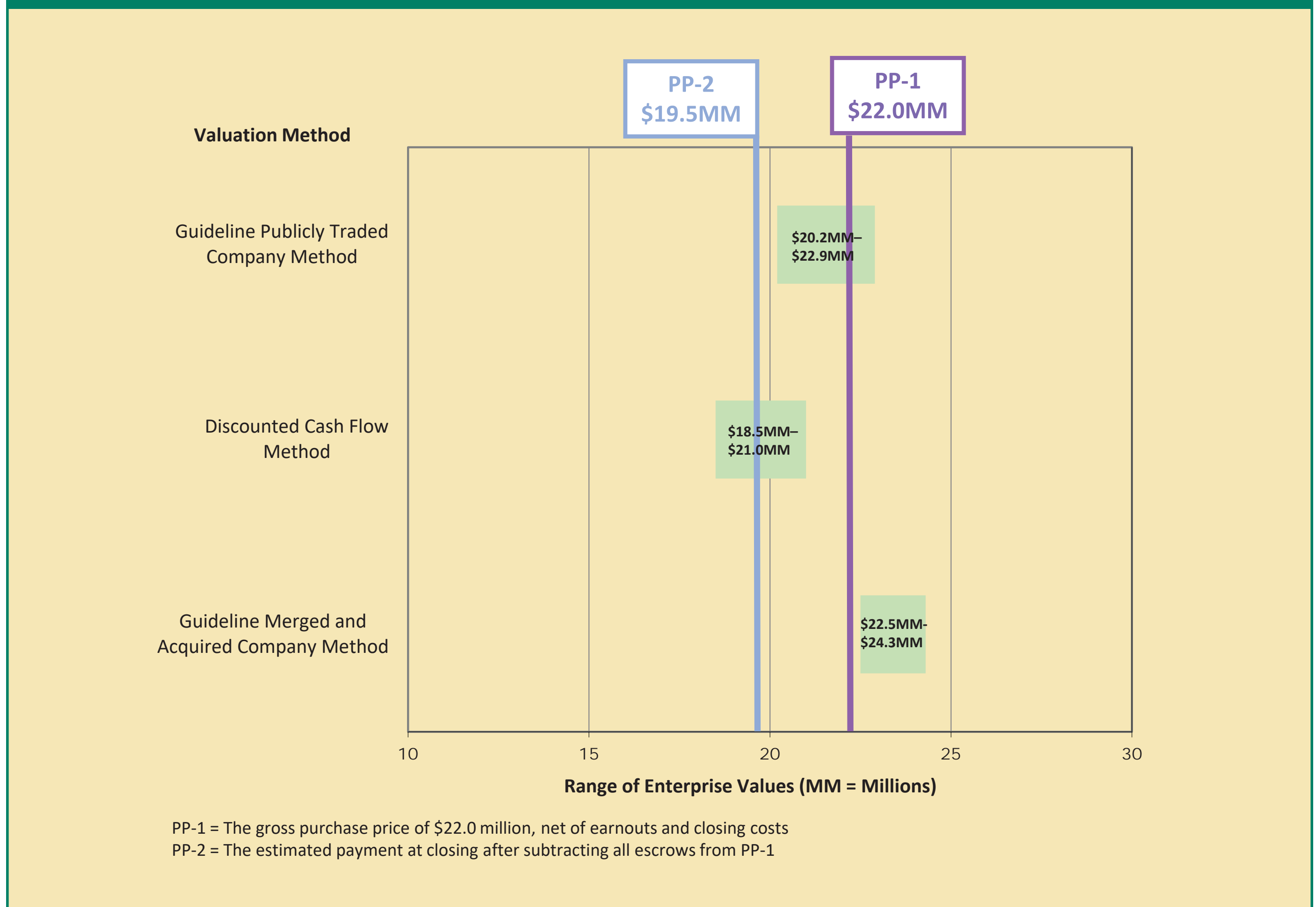
Although there are various methods and ways the financial adviser may consider the identified earnouts and escrows, the identified examples set the bar at the lowest potential purchase price and recognize that, regardless of the probability, the value to be received by the shareholders can only be greater than the indicated bars.

If the worst-case scenario still falls within the reasonable range of fair market value, then it can be reasonably concluded that the terms of the transaction price are fair from a financial point of view.

In order for the opinion of the financial adviser to be expanded to include the requirement that "the transaction, taken as a whole, is fair and reasonable . . . ," it is necessary to consider the summary of additional terms prepared by the financial adviser.

As indicated in the earlier example, the terms of the transaction examined by the financial adviser were considered to be at least as favorable to

Figure 2
Alternative Purchase Price Analyses—Illustrative Example



the ESOP compared to the other shareholder(s).

> **"Ultimately, it is the responsibility of the ESOP trustee to understand the analysis prepared by the financial adviser and recognize the procedures applied as a basis to reasonably rely on the concluded opinion."**

Limitations on Concluded Opinion

Although the analysis performed by the financial adviser can be substantial and significantly thorough, there are still generally recognized limitations and restrictions regarding the concluded opinion which will be included in the final fairness opinion letter.

Some of these generally recognized limitations and restrictions may include the following statements:

- We have reviewed the financial information and other internal data provided to us and other publicly available information, and while we did not verify the accuracy and completeness of such data and information, we have considered the reasonableness thereof and made certain adjustments thereto as necessary and appropriate.
- The opinion does not address (1) the business decision of the sponsor company's shareholders to proceed with the transaction or (2) the tax or legal consequences of the transaction.
- We have not been requested to, and did not, solicit third-party indications of interest from any party with respect to any transaction involving the sponsor company. Furthermore, we were not retained to, nor have we, provided any negotiation services with regard to the transaction.
- Management has represented to us that there have been no material changes in the business, financial position, or results of operations of the company since the date of the most recent company financial statement, and that there are no known contingent liabilities currently existing that may exert a material impact upon the financial operations and continuing economic viability of the sponsor company.
- This opinion does not constitute a recommendation to any shareholder of the company as to how such shareholder should vote with respect to the transaction.

As the above statements suggest, the opinion of the financial adviser does not provide a blanket determination regarding every potential impact relative to the company and the transaction. In each instance, it is likely that there are certain aspects of the transaction that may not be subject to the scope of the analysis by the financial adviser.

Ultimately, it is the responsibility of the ESOP trustee to understand the analysis prepared by the financial adviser and recognize the procedures applied as a basis to reasonably rely on the concluded opinion.

Summary and Conclusion

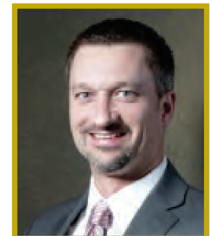
The analysis performed by a financial adviser conducting a transaction fairness opinion engagement may address certain specific questions or elements in addition to the application of generally accepted valuation methods considered to develop a reasonable estimate of fair market value for the sponsor company.

One requirement is that the transaction, taken as a whole, is fair and reasonable to the ESOP. This question, to be answered by the financial adviser as an adviser to the ESOP trustee, may involve the consideration of a number of facts and circumstances, including other potential benefits of the transaction to the ESOP and other shareholder(s).

In practice, should certain additional considerations appear to result in a potential detriment to the ESOP, the parties to the transaction are often motivated to negotiate acceptable terms so the analysis performed by the financial adviser results in an affirmed fairness opinion to the ESOP trustee.

As with any valuation analysis, the future cannot be predicted. However, the fairness analysis and opinion provide a tool to help the ESOP trustee:

1. understand the financial aspects of a proposed transaction and
2. make a decision that is in the best interest of the ESOP participants.



Terry Whitehead is a director in our Portland, Oregon, practice office. Terry can be reached at (503) 243-7508 or at tgwhitehead@willamette.com.

On Our Website

Recent Articles and Presentations

Kevin Zanni, a managing director in our Chicago office, authored a three-part article that appeared in the January 29, 2020, February 5, 2020, and February 12, 2020, issues of *QuickRead* (published by the National Association of Certified Valuators and Analysts. The title of Kevin's article is "Estimating Nonprofit Corporation Asset Values—Parts I, II, and III."

Nonprofit businesses are often involved in arm's-length transactions. Kevin's article provides an example of certain steps and procedures that can be used to value the assets of a nonprofit business. He addresses the procedures for selecting arm's length royalty rates for technologies and other intangible assets. Kevin also discusses best practice concepts applied in the valuation of the total assets of a nonprofit business. Functional obsolescence issues are examined as well. Kevin provides several examples in this series of articles.

Robert Reilly, a managing director of our firm, authored an article that was published in the September/October 2019 issue of *Construction Accounting and Taxation*. The title of Robert's article is "Consider the Sale of the Company to an Employee Stock Ownership Plan."

Owners of private companies, including construction companies, looking for an exit strategy may consider implementing an employee stock ownership plan (ESOP). As part of this consideration, a financial feasibility analysis may be performed. Robert summarizes the analyst's role in such a feasibility analysis. He explains how the information developed in this analysis may be used by the owners, advisers, and other parties to decide how to structure such an ownership transition transaction. Robert goes on to discuss quality of earnings, liquidity, and plan design analyses.

Robert Reilly authored an article that appeared in the February 20, 2020, issue of QuickRead. The title of Robert's article is "Private Company Stock-Based Compensation Arrangements to Attract or Retain Key Employees."

To both attract and retain key employees, many private companies have added stock-based compensation grants to their portfolio of employee compensation arrangements. Stock-based compensation may include such securities as restricted stock awards, restricted stock units, nonqualified stock options, and incentive stock options. An important component of any private company stock-based compensation arrangement is the value of the private company stock. Robert's article summarizes some of the basic but important income tax considerations—for both the employer and the employees—involved in such arrangements.

Brandon McFarland, an associate in our Atlanta office, authored an article that was published in the October 2, 2019, and October 9, 2019, issues of QuickRead. The title of Brandon's article is "The Treatment of Synergistic Value in Dissenting Shareholder Appraisal Rights Matters—Parts I and II."

The Delaware Court of Chancery decisions on the treatment of synergistic value in dissenting shareholder appraisal rights cases provide meaningful guidance to valuation analysts, legal counsel, and other courts. Brandon discusses recent judicial decisions issued by the Delaware Court of Chancery in which synergistic value was a consideration. The decisions summarized in this article include *DFC Global Corporation v. Muirfield Value Partners; Dell, Inc. v. Magnetar Global Event Driven Master Fund Ltd.; Verition Partners Master Fund Ltd. v. Aruba Networks, Inc.*; and *In Re Appraisal of Solera Holdings, Inc.*

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Communiqué

In Print

Robert Reilly, firm managing director, authored an article that appeared in the March/April 2020 issue of *Journal of Multistate Taxation and Incentives*. The title of Robert's article was "Due Diligence Considerations in the Application of Market-Based Evidence."

Robert Reilly also authored an article that appeared in the February/March 2020 edition of *Financial Valuation and Litigation Expert*. The title of Robert's article was "Intellectual Property Valuations within Bankruptcy Controversies—Part 1."

Robert Reilly also authored an article that appeared in the February 2020 issue of *Journal of Multistate Taxation and Incentives*. The title of Robert's article was "Property Tax Valuations of Computer Software."

Robert Reilly also authored an article that appeared in the December 2019/January 2020 edition of *Financial Valuation and Litigation Expert*. The title of that article was "Financial Feasibility Analysis Considerations regarding ESOP and ERISA-Related Litigation."

Robert Reilly also authored a two-part article that appeared in the National Association of Certified Valuators and Analysts ("NACVA") online publication located at www.quickreadbuzz.com. The title of those articles were "The Role of the Valuation Analyst in an ESOP Formation Financial Feasibility Analysis." Part I of that article appeared in the January 9, 2020, issue and Part II of that article appeared in the January 16, 2020, issue.

Robert Reilly updated his nine chapters in the 2020 update to *Valuing Professional Practices and Licenses*. These chapters are Chapter 7A, "Goodwill Valuation Considerations Involving Professional Practices"; Chapter 12 "Reasonableness of Practitioner/Executive Compensation Analyses for Family Law Purposes"; Chapter 14, "Differences in the Valuation of Large and Small Professional Practices"; Chapter 17, "Valuing Identifiable Intangible Assets in a Marital Estate Involving a Professional"; Chapter 17A, "Valuing Intellectual Property Within a Family Law Context"; Chapter 21, "Valuation Professional Guidance from Internal Revenue Service Publications"; Chapter 41, "Accounting Practice Valuation Approaches, Methods, and Procedures"; Chapter 45, "What Family Law Counsel Needs to Know about Valuation Analyst Due Diligence Procedures"; and Chapter 68, "Measuring the DLOM for the Marital Estate Business Ownership Interest."

Kevin Zanni, Chicago office managing director, authored a two-part article that appeared in the NACVA's online publication located at www.quickreadbuzz.com. The title of those articles were "Equity Size Premium Observations and Delaware Fair Value." Part I appeared on November 7, 2019, and Part II appeared on November 14, 2019.

Kevin Zanni also authored a three-part article that appeared at www.quickreadbuzz.com. The title of those articles were "Estimating Nonprofit Corporation Asset Values." Part I appeared on January 29, 2020, Part II appeared on February 5, 2020, and Part III appeared on February 12, 2020.

Charlene Blalock, senior research analyst in our Portland office, along with Justin Nielsen, a senior director with FTI Consulting, authored an article that was published in the Winter 2020 issue of *American Journal of Family Law*. The title of Charlene and Justin's article is "Considering the Subject Industry When Applying the Income Approach."

In Person

Robert Reilly will deliver a presentation at the ASA Philadelphia Chapter annual business valuation conference in Radnor, Pennsylvania, on April 23, 2020. The topic of Robert's presentation will be "Lessons Learned from the *Estate of Aaron U. Jones v. Commissioner of Internal Revenue*."

Robert Reilly will also deliver a presentation at the 20th annual NACVA Minnesota state chapter business valuation conference on May 6, 2020. The topic of Robert's presentation will be "Applications of the Asset-Based Business Valuation Approach."

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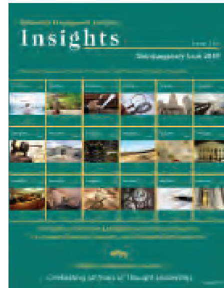

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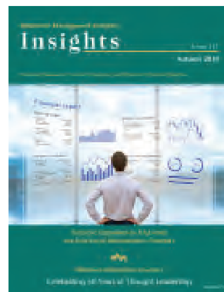

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111 S.W. Fifth Avenue, Suite 2150
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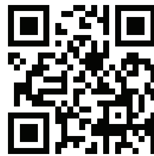

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Chicago Office
8600 West Bryn Mawr Avenue
Suite 950-N
Chicago, IL 60631
(773) 399-4300
(773) 399-4310 (FAX)

Portland Office
111 S.W. Fifth Avenue
Suite 2150
Portland, OR 97204
(503) 222-0577
(503) 222-7392 (FAX)

Atlanta Office
1355 Peachtree Street, N.E.
Suite 1470
Atlanta, GA 30309
(404) 475-2300
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