

# General Valuation Factors ERISA Counsel May Consider in an ESOP Litigation Case

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*As part of an ERISA litigation matter involving an ESOP's investment in the stock of a closely held sponsor company, the counsel often seeks the services of a valuation analyst. This discussion focuses on the process of retaining a valuation analyst. Understanding the capabilities and services that a valuation analyst provides may help counsel retain, rely on, examine, or defend the valuation analyst.*

## INTRODUCTION

Since the passage of the Employee Retirement Income Security Act (ERISA) in 1974 (the “Act”) and the subsequent creation of the first employee stock ownership plan (ESOP) trusts under that Act, litigation matters surrounding ESOP formation transactions have been prevalent.

In recent years, there has been an increasing number of ESOP litigation matters related to both (1) the ESOP and (2) the closely held sponsor companies. Anecdotal reasons for this increase in ESOP-related litigation involve one or more of the following factors:

1. An increase in the number of ESOPs and ESOP sale or purchase transactions
2. The impact of the economic downturn in 2008 and 2009 which contributed to decreases in ESOP stock prices
3. The success of some claims brought by the Department of Labor (DOL) and/or class action attorneys
4. An apparent increase in activity/scrutiny by some regional offices of the DOL on ESOP-related audits

ERISA claims against the employer corporation and/or the ESOP fiduciary (i.e., the plan trustee) could focus on any number of specific issues, including industry, fiduciary, corporation, and/or valuation issues. Counsel involved in these matters

will often seek out the services of a valuation analyst in one or more of these areas.

This discussion focuses on the following topics:

1. The typical valuation issues counsel may need to consider in an ESOP litigation setting
2. The types of forensic analyses or litigation support services the valuation analyst may offer

This discussion summarizes the types of services and functions that a valuation analyst provides, and explores why counsel should retain a valuation analyst. This discussion primarily focuses on the services that counsel may ask a valuation analyst to provide in support of the client's legal position.

## ABOUT VALUATION ANALYSTS

As mentioned above, there are several specialty areas in an ESOP litigation matter for which counsel may retain a valuation analyst. A few of the specialty areas where forensic analyses or opinions may be required fall within the industry, fiduciary (i.e., ESOP plan trustee), and valuation realms. These three disciplines each involve a different type of consulting expert or testifying expert.

If needed, the forensic analyst may help counsel to examine the issues of the case. Depending on the level of assistance required, the analyst could function in one of two ways.

One, the forensic analyst could be hired solely as a consulting expert. A consulting expert will work with counsel to evaluate various aspects of the case, but will not be called as an expert witness at a trial. Both the identity of and the opinions formed by consulting experts are usually protected from discovery.

Two, the forensic analyst could be hired as a testifying expert. As the name implies, the testifying expert's work concludes with the delivery of expert witness testimony in court.

A testifying expert will accommodate and satisfy Federal Rules of Evidence (FRE) Rule 702, which states "A witness who is qualified as an expert by knowledge, skill, experience, training, or education may testify in the form of an opinion or otherwise if the expert's scientific, technical, or other specialized knowledge will help the trier of fact (i.e., a jury) to understand the evidence or to determine a fact in issue. . . ."<sup>1</sup>

As such, the testifying expert's identity will be disclosed to the court according to the Federal Rules of Civil Procedure (FRCP) Rule 26(a)(1), unlike a consulting expert.

Whereas there are no defined requirements or work product for a consulting expert, a testifying expert submits a written report according to FRCP Rule 26(a)(2)(B). This report accompanies the disclosure of the identity of the testifying expert.

The expert report is required to have a complete statement of all opinions of the expert witness, all supporting data considered in the process of forming those opinions, exhibits summarizing the substance of the opinions, the qualifications and testifying experience of the expert witness, and the compensation to be paid to the identified expert.

As it pertains to the employer stock valuation, counsel may decide to initially retain a valuation analyst as a consulting expert, and then later decide that this consulting role will evolve into a testifying expert role.

A valuation analyst hired as a testifying expert may be formally retained by either plaintiff or defense counsel to provide expert testimony and other litigation support services in matters involving the value of a closely held ESOP sponsor company.

Further, the valuation analyst may provide expert testimony in controversies related to the following:

1. Internal Revenue Service tax audits
2. Department of Labor regulatory audits
3. ESOP participants fraud and misrepresentation claims against selling shareholders
4. ESOP participants ERISA claims against the employer corporation and/or the ESOP trustee

An experienced valuation analyst can add value to the litigation whether he or she is utilized as a consulting expert or a testifying expert in the ESOP dispute.

## THE SCOPE OF WORK THAT COUNSEL COULD NEED FROM A VALUATION ANALYST

Counsel may consider retaining the services of a valuation analyst when there are valuation issues in an ESOP litigation case. However, a discussion of "valuation issues" could veer off in many directions (or get lost in translation) when counsel begins discussing case specifics with the valuation analyst. So what could (or should) counsel ask of the valuation analyst in terms of an appropriate scope of work?

There are several analyses that a valuation analyst can perform, depending on the facts of the case and the needs of counsel, including the following:

1. An appraisal review
2. A fair market value analysis
3. A "look-back" fairness analysis
4. A "look-back" solvency analysis
5. An analysis of the reasonableness of compensation and compensation-related agreements

The following section discusses each of the types of forensic analyses and opinions that a valuation analyst can provide.

### An Appraisal Review

One service that counsel may request the forensic analyst to provide is an examination of valuation work product performed on or for the closely held sponsor company prior to the dispute. In other words, the forensic analyst may formally or informally review the valuations of the closely held ESOP sponsor company relied upon by the ESOP trustee that were performed by the management of the company or another valuation analyst.

Counsel would consider a request for these valuation services because prior indications of value (as evidenced by formal valuation analyses) is a logical starting point when examining a dispute involving a closely held sponsor company stock valuation. Therefore, the valuation analyst may examine any prior (to the formation of the ESOP) stock valuations to determine if those previous stock valuations were appropriate, supported, reasonable, and complete.

First, the valuation analyst reviews for appropriateness any business valuation reports prepared before the closely held company implemented and sponsored the ESOP. This procedure usually means that the valuation analyst assesses the valuation approaches (income, market, asset-based), methods (cash flow, guideline publicly traded market, guideline transaction, net asset value, etc.), and procedures.

This review may also include an examination of the selected standard, premise, and level of value in the valuation. Certification requirements (such as USPAP) may be reviewed to determine that the appropriate provisions in effect at the time of the employer stock valuation were accommodated, if necessary.

Second, the valuation analyst may be asked to review any pre-ESOP business valuations of the company for its supporting analysis of the value conclusions (i.e., the adequacy and relevance of the data examined). This means that the valuation analyst reviews the due diligence procedures performed by the previous valuation firm.

This review includes an examination of all guideline publicly traded companies examined and selected, all guideline transactions considered and selected, data used in constructing a cost of capital analysis, and all other publicly available data that were considered.

The examination also includes data produced by the sponsor company for the valuation, such as historical financial statements, historical adjustments (or normalizations) to earnings figures, and company-provided projected financial performance.

Third, the valuation analyst may review a prior closely held sponsor company valuation for reasonableness. The valuation analyst examines the selected pricing multiples developed and applied within the valuation methodologies, comparing the market and industry conditions that existed at the time of the earlier valuation to the multiples and conclusions drawn by any valuations performed upon or after the formation of the ESOP.

Generally, conclusions are considered reasonable if the comparison between market data and selected valuation pricing multiples reveals similar outcomes (i.e., the pricing multiples selected would be similar).

Fourth, the valuation analyst may review a prior closely held sponsor company valuation for completeness. This entails an examination of the mathematical accuracy of the calculations performed in the valuation, and an inspection to ensure that all adjustments for nonoperating items or premiums and discounts are fully integrated in the value conclusion.

In sum, an appraisal review of a prior valuation opinion on the closely held sponsor company can uncover some interesting findings to counsel involved in an ESOP litigation matter.

## FAIR MARKET VALUE ANALYSIS

Counsel may ask the valuation analyst to perform his or her own fair market value analysis of the ESOP sponsor company. Also, counsel may ask the valuation analyst to perform a fair market value analysis of the consideration received in an ESOP transaction (which, in lieu of cash, may be a promissory note of some sort).

Fair market value, the appropriate standard of value accepted by the DOL for ESOP-related valuation analyses, is typically defined as the price at which an asset 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, and both parties are able, as well as willing, to trade and are well-informed about the asset and the market for that asset.<sup>2</sup>

When performing the fair market value analysis of the ESOP sponsor company, the valuation analyst examines and uses most (if not all) of the same information that was discussed in the previous section. A more detailed explanation of how to conduct a valuation is beyond the scope of this discussion. Suffice it to say that the valuation analyst generally performs the following procedures:

1. Perform a financial statement analysis of the ESOP sponsor company as of the valuation date.
2. Perform all applicable valuation methodology analyses (discounted cash flow, guideline publicly traded company, guideline transaction) as of the valuation date.
3. Recognize and apply all necessary valuation adjustments to arrive at the desired premise and level of value as of the valuation date. This includes all adjustments for sponsor company indebtedness, nonoperating assets and liabilities, and all appropriate discounts and premiums.

A fair market value analysis of any promissory notes exchanged as part of an ESOP transaction involves a few specific steps that are specific to the valuation of interest-bearing securities.<sup>3</sup>

First, both the financial and legal terms of the promissory notes are important to consider and incorporate into a fair market value analysis of the notes. Accordingly, the promissory note agreements should be read and clearly understood.

Items that should be addressed in the promissory note agreements include the following:

1. The notional face amount (in dollars) of the promissory note
2. The stated yield of the promissory note
3. Whether the promissory note pays principal, interest, both, or neither over the term of the note (for example, maybe there is only one payment at maturity)
4. The timing of the coupon cash flows (i.e., annual, semi-annual, quarterly, etc.)
5. The maturity (and, therefore, the term) of the promissory note

Second, the valuation analyst identifies and considers market-based required rates of return derived from interest rate yield data that are contemporaneous to the subject valuation date. The valuation analyst selects an appropriate market yield for the purpose of estimating the fair market value of the subject promissory note.

Third, the valuation analyst performs a present value calculation on the promissory note, using the parameters as set forth in the promissory note agreements and the market-derived interest rate yield data that he or she has collected. By using the stated interest and principal payments in the promissory note agreement and the market yield data in the present value calculation, the valuation analyst considers both the return on investment and the return of investment (which is a topic for another discussion).

This present value calculation is the fair market value calculation of the promissory notes. Further, this calculation will show the discount from, or premium to, face (or stated) value of the promissory note.

Fourth, the valuation analyst may be asked to perform a sensitivity analysis on the promissory notes. The sensitivity analysis expresses the discount or premiums to the face value of the promissory note, given a reasonable range of market yields. The single market yield selected by a valuation analyst is usually in the middle of a wider range of market yields developed to perform the sensitivity analysis.

Performing a sensitivity analysis can be especially important if there are other, unquantifiable aspects of the promissory notes, such as restrictions or allowances to the notes that are not quantifiable or observable within the empirical data. In such instances, a sensitivity analysis illustrates the degree to which the discount or premium to face value of the promissory note would change with

additional (or less) risk than what was selected by the valuation analyst.

In other words, counsel (or the trier of fact) could use the sensitivity analysis as an analytical tool to “select” his or her own market yield to see the resultant discount or premium to the face value of the promissory note.

Therefore, a fair market value analysis of all types of financial securities considered in an ESOP transaction can be very important to counsel in an ESOP litigation matter.

## LOOK-BACK FAIRNESS ANALYSIS

In some cases, counsel may request a fairness opinion for the transaction from the valuation analyst.

A fairness opinion states that a transaction, in its entirety, is fair to a specific party (for purposes of our discussion, an ESOP) from a financial point of view. A fairness opinion is a much broader, more inclusive opinion that covers all financial aspects of a transaction including “adequate consideration.”

Specifically, a fairness opinion typically covers all of the following:

1. All financial elements of the transaction
2. The potential effect of the transaction on the ESOP
3. The financial treatment relative to all other parties to the transaction

In an ESOP litigation matter, counsel may ask the valuation analyst to provide a fairness opinion as of the transaction date, which often occurred years in the past. In cases where the actual transaction occurred at some earlier point in time, this look-back fairness opinion is, of course, retroactive to the original transaction date, and cannot incorporate any facts or data that were neither known or knowable on the date of the transaction. This term is known idiomatically as a “look-back” fairness opinion.

The purpose of asking for a look-back fairness opinion is to aid counsel in examining the value of the assets given up (i.e., the equity of the ESOP sponsor company) as compared to the consideration received in return by the sponsor company (i.e., the promissory notes).

As mentioned above, both the fair market values of consideration given and the consideration received will need to be estimated if counsel has asked the valuation analyst to perform either a fair market value analysis or a fairness opinion.

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**“ . . . the fairness opinion . . . provides the trier of fact with important information regarding various financial and valuation aspects of the historical transaction. . . . ”**

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For counsel, the fairness opinion can be a valuable tool.

First, the fairness opinion is an important procedural tool. It provides important information regarding various financial and valuation aspects of the historical transaction, which may more effectively facilitate a settlement between the ESOP litigation parties.

Second, the fairness opinion is an important legal tool. It provides evi-

dence for the trier of fact to examine when using reasonable business judgment in the evaluation of the historical transaction.<sup>4</sup>

The term “reasonable business judgment” means to act (1) on an informed basis, (2) in good faith, (3) in a manner reasonably believed to be in the best interest of ESOP beneficiaries, and (4) without fraud or self-dealing.

Third, the fairness opinion is an important practical tool. It provides a level of support for the historical transaction that other parties to the deal may find comforting.

It should be noted that there is no generally accepted or statutory definition of the phrase “fair from a financial point of view.” The concept encompasses both legal and financial issues.

The fairness opinion itself does not address the legal aspects of the transaction, which are more properly analyzed in a legal opinion that is separate from the fairness opinion.

With that said, a fairness analysis and opinion provided by a valuation analyst can be a valuable tool for counsel to provide the trier of fact in an ESOP litigation matter.

## **LOOK-BACK SOLVENCY ANALYSIS**

Counsel may request the valuation analyst to perform a solvency opinion for the case. A “look-back” solvency opinion is a retroactive application of a solvency analysis and opinion as of the prior transaction date.

Whereas a fairness opinion examines a transaction and its fairness from a financial point of view to an ESOP, a solvency opinion represents the valuation analyst’s opinion as to whether or not the corporation will become financially insolvent as a

result of a proposed leveraged transaction. In those ESOP transactions involving the exchange or creation of promissory notes, the initial ESOP transaction is regarded as a leveraged transaction.

A solvency opinion can be coupled with a fairness opinion, if both are deemed necessary. While a fairness opinion looks at the total consideration given versus the total consideration received at the time of the transaction, a solvency opinion considers the future of the ESOP sponsor company during and after the transaction, and whether or not it can service the additional debt (i.e., promissory notes) through its operations.

The aspect of whether or not the ESOP sponsor company had the ability to pay down the transaction debt is a question counsel may want to have answered, either separately or in companion with fairness from a financial point of view.

There are three generally accepted solvency tests that can be performed by a valuation analyst as part of the analysis of a solvency opinion. These tests are conducted on a “pass/fail” basis. There is no such thing as being partially solvent or semi solvent.

The three solvency tests are as follows:

1. The balance sheet test
2. The cash flow test
3. The capital adequacy test

While a full description of how to conduct these tests is beyond the scope of this discussion, a summary of the tests is presented next.

The balance sheet test determines whether or not, at the time of the proposed leveraged transaction, and after consideration of the amount of the transaction debt financing, the total fair value of the company assets (both tangible and intangible) is greater than the company total liabilities. The balance sheet solvency test is passed if the fair value of the company total assets is greater than the recorded balance of the company total liabilities.

For the balance sheet test, it should be reiterated here that the company assets are valued at fair value. The fair value of an asset (as defined under GAAP) is the amount at which that asset could be sold in a current transaction between market parties, other than in liquidation.

The cash flow solvency test analyzes the ability of the subject company to service its financial liabilities as they mature. The cash flow test includes an assessment of the company’s historical and projected earnings and cash flow. This

assessment is performed in order to determine the capacity of the ESOP sponsor company to pay its financial obligations, including the debt service on the acquisition financing.

The cash flow test is passed if, in each projected future time period, the company can pay its projected debt obligations from the following:

1. Any excess company cash balance available on the solvency test date
2. The available cash flow expected to be generated by the company during the projection period
3. The availability of any unused credit commitments available to the company

The capital adequacy test determines whether the ESOP sponsor company will have sufficient capital to run its business operations at the time of the debt financing. This solvency test determines whether the company will have an adequate amount of capital to meet the following:

1. Operating expenses
2. Capital expenditures
3. The current portion of liabilities and long-term debt

Like the other solvency tests, the capital adequacy test is a pass/fail test. This test is passed if the subject corporation is expected to have sufficient cash to pay the operating expenses, capital expenditures, and the current portion of all liabilities and long-term debt.

Because the three solvency tests are pass/fail, there is little chance of misinterpretation of the conclusions of a solvency analysis and opinion. Therefore, a solvency opinion and the supporting analysis could be a valuable work product for counsel in an ESOP litigation matter.

## Analysis of the Reasonableness of Compensation and Compensation-Related Agreements

Counsel may ask the valuation expert to perform a reasonable compensation analysis of the executives and/or board members of the ESOP sponsor company. Reasonable compensation is defined by the Internal Revenue Service (the "Service") as "the amount that would ordinarily be paid for like services by like organization in like circumstances."<sup>5</sup>

Owners of most closely held companies prefer to compensate themselves or their managers (frequently they are one and the same) with some combination of base salary and a bonus. Often, the

bonus that the owner/managers pay themselves is virtually all of the profits of the company.

However, if an ESOP is created for a closely held company (with the ESOP becoming a shareholder of the sponsor company), the ESOP is entitled to its pro rata distribution of company profits (i.e., the ESOP's return on its investment), which would in turn be used to amortize any remaining ESOP acquisition debt.

Therefore, the purpose of asking a valuation analyst for a compensation analysis is to ensure that the remaining owner/managers are paying themselves a reasonable rate of compensation (and thus not diminishing the ESOP's required rate of return).

Given the above definition by the Service, the *Internal Revenue Manual* goes further in looking at what factors need to be examined to determine reasonable compensation.<sup>6</sup>

These factors include the following:

1. Nature of duties
2. Background and experience
3. Knowledge of the business
4. Size of the business
5. Individual's contribution to profit making
6. Time devoted
7. Economic conditions in general
8. Time of year compensation is determined

A valuation analyst may rely on empirical compensation study analyses, executive compensation for comparable positions in publicly traded companies (which is disclosed in a public company's Forms 10-K or 10-Q), or other industry-specific data for reasonable levels of owner/manager compensation.

In addition to existing salaries and bonuses for these individuals, there could be other agreements in place that may have value as well, and the valuation analyst should consider them. These agreements include employee agreements, consulting agreements, and deferred compensation agreements.

When examining these agreements, the valuation expert would look at the same factors mentioned above to determine if they are detrimental to the ESOP's required rate of return.

In a legal sense, damages may have occurred if the ESOP wasn't permitted the same return on investment as the owner/managers. Therefore, it is important for counsel to consider this aspect in an ESOP litigation matter.

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# GENERAL VALUATION FACTORS

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## CONCLUSION

In ESOP litigation matters where the valuation of the ESOP sponsor company is one of the factors in dispute, counsel may hire an experienced valuation analyst to serve as either a consulting expert or a testifying expert.

The valuation analyst can provide a number of analyses and opinions, depending on the facts of the case and the needs of the attorney. A discussion between the valuation analyst and counsel at the outset of the litigation matter will benefit both sides in terms of defining the analyses and opinions needed from the valuation analyst, which in turn will make for an efficient process over the course of the litigation.

### Notes:

1. Federal Rules of Evidence, Rule 702, (Pub. L. 93-595, §1, Jan. 2, 1975, 88 Stat. 1937; Apr. 17, 2000, eff. Dec. 1, 2000; Apr. 26, 2011, eff. Dec. 1, 2011).
2. Prop. Reg. 29 C.F.R. § 2510.3-18(b), 53 Fed. Reg. 17,634 (May 17, 1988).
3. The majority of the fair market value analysis will pertain to the valuation of the ESOP sponsor company stock. Much has been written on this subject. Less has been written, however, on the subject of the fair market value of promissory notes. Therefore, in this discussion we are addressing this topic in more detail.
4. While ERISA fiduciaries are not held to a business judgment rule as outlined in ERISA section 404, this rule can be used as a general proxy for reasonableness when examining a transaction.
5. Treasury Regulations, Subchapter A, Section 1.162-7.
6. Internal Revenue Manual, Section 4.35.2.5.2.2 (5/5/2006), Statement 3.



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