Best Practices for Fiduciary Review of ESOP Valuations

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The valuation of a private company's stock is central to the operation of an employee stock ownership plan (ESOP), where the value of employees' retirement benefits depends on the per share price of the plan sponsor's common stock allocated to their individual ESOP accounts. It is also a central focus of lawsuits and investigations brought by participants and the Department of Labor (DOL), which often claim the ESOP paid too much when purchasing the stock in the sponsoring employer.

Under the Employee Retirement Income Security Act (ERISA), an ESOP cannot pay more than the "fair market value" of qualifying employer securities as determined in good faith by the ESOP trustee, and if it sells the stock, an ESOP cannot sell it for less than its "fair market value." Determining whether the value negotiated (or the value assigned, in the case of annual ESOP benefit statement updates, that is used as a basis for benefit distributions and reporting purposes) is no more than "fair market value" is a fiduciary decision made by the ESOP's trustee. If the ESOP holds shares of a public company, the ESOP trustee can look to the price paid by investors on the open market. For private companies whose shares are not actively traded on a public market, the ESOP trustee must determine fair market value by determining what a willing and able buyer would pay a willing and able seller for an asset in a hypothetical arms-length transaction where both parties are well-informed about the asset and neither party is under any compulsion to engage in the transaction.

Because this value determination is based on many variables and professional judgement, often, for liability purposes, the process followed to arrive at the negotiated or assigned value is very important. Cases brought by participants and the DOL question whether the ESOP trustee met its fiduciary duty by acting with the care, skill, prudence, and diligence under the current circumstances that a prudent person acting in a like capacity in a like situation would use. Thus, the question is, how does the ESOP trustee act –

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and show that it acted – in a way that satisfies this high legal standard?

Much to the consternation of the ESOP community, the DOL has yet to issue final regulations providing guidance for an ESOP trustee to follow when determining fair market value of qualifying employer securities that it is acquiring, even though the DOL issued proposed regulations over 30 years ago. Instead, the DOL has entered into a number of "process agreements" settling specific cases and investigations it has brought against ESOP trustees. These process agreements set out steps those trustees are required to take when selecting a valuation advisor and reviewing that advisor's valuation report. While these process agreements are only enforceable against the individual trustees who are parties to the process agreements, they can provide clues to others as to the "best practices" for ESOP trustees to follow:

1. Document, Document, Document!

Written documentation is necessary to show that the ESOP trustee met its fiduciary duties when evaluating and accepting a final valuation. Be sure to document the reasons for the decisions, not just the process taken to reach the decisions. Keep markups of draft valuations, which show that the valuation was reviewed thoroughly and that the ESOP trustee asked questions about the analysis.

2. Do Your Diligence When Selecting a Valuation Advisor

Always select a qualified independent valuation advisor to value the company stock. Investigate the valuation advisor's qualifications and verify there are no criminal, civil, or regulatory proceedings related to the valuation advisor's work. Check references. Choose a valuation advisor that has not previously been engaged to provide similar work for the ESOP sponsor or a related entity (other than the ESOP).

3. Ensure the Valuation Advisor Has the Necessary Data

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Take reasonable steps to confirm the valuation advisor has received all information necessary to accurately value the employer's stock. The information must be accurate, complete, and current. Ask the employer to provide at least five years of financial statements for review by the valuation advisor. If financial statements are not audited, consider requiring an audit, quality of earnings report, or at least reviewed financials, and document why the ESOP trustee believes it is prudent to rely on unaudited or qualified financial statements. Compare the information in the report to the information maintained by the ESOP trustee for consistency.

4. Determine if Company Performance Projections Are Reasonable

Many ESOP valuations rely heavily on projections of the company's future performance in arriving at a value. The final report should identify all individuals providing any projections reflected in the report and analyze any potential conflicts of interest those individuals may have with respect to the ESOP. The final report should also give an opinion on the reasonableness of any projections and explain why and to what extent the projections are (or are not) reasonable. Document data points (such as comparisons to past performance or comparable public companies) the ESOP trustee considered when determining if the projections were reasonable. If the employer is projected to meet or exceed past performance, document why such assumption is (or is not) reasonable. Also, document the reasons for any adjustments made by the ESOP trustee or valuation advisor to any employer-provided projections.

5. Ensure Any Comparisons to Other Companies Are Reasonable

If the valuation report uses comparable companies for any part of the valuation, document the reasons why the specific companies are comparable. Also document the reasons for any discounts applied to comparable companies' metrics or adjustments to the employer's past performance that are used for comparison purposes, if applicable.

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6. Review the Valuation Methods, Weightings, Calculations, and Analysis

Read – and understand – the valuation analysis, not just the executive summary. Document the valuation methodologies used, the weightings given to each methodology, and the reasons for such weightings. Check the math used in various sections of the report. Document the level of any marketability or minority discounts applied and the reasons why such levels are reasonable. If a control premium is applied or implied, review whether the ESOP will actually have an unencumbered right to control the employer. Assess whether the conclusion and overall narrative is consistent with the numbers and analysis. In addition, document any material differences in methodology or assumptions between the present valuation and any other valuations performed in the prior twenty-four months.

7. Determine if the Report Accurately Reflects the Terms of the ESOP and the Transaction

If the ESOP's repurchase liability is considered in the report, confirm that it accurately takes into account the ESOP's distribution provisions, the demographics of the ESOP participants, and other relevant factors. If the employer took on debt in connection with a prior transaction, determine if the report accurately accounts for the impact of such debt. Be sure the company's capital structure, including possible synthetic equity and material terms of any preferred stock, is accurately reflected.

8. Document the ESOP Trustee's Final Determination

Identify in writing the individuals involved with the decision to proceed with the stock purchase. Note if any of these individuals expressed any material disagreement with any conclusions or analysis related to the valuation or the transaction and describe the nature of the disagreement.

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If your company sponsors an ESOP, ask your trustee how it addresses valuation review. If you have internal ESOP trustees rather than an independent trustee, the same or greater care is required in reviewing the valuation. For more information or assistance with ESOP valuation or other ESOP questions, contact Jennifer Cote or another member of Frost Brown Todd's Employee Benefits & ERISA team.

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