The Anatomy, Choices and Litigation Landmines of ESOPs

The Gathering

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- Melisa Silverman is the Managing Partner of The Founders Group, a business exit and succession planning company focused on helping business owners through all stages of a business transition.

- Melisa is also the Founder & President of Avenue M® Advisors, Inc., a national financial valuation services company focused on business valuations for investment purposes (mergers & acquisitions, sales, ESOPs, IP) , tax related matters (409A, conversions of entity structures, trusts and estates, gifts and charitable donations), shareholder disputes, buyouts, etc.

- Melisa was the recipient of the 2018 Peter Christman EPI Exit Planner of the Year Award as well as a nominee of the 2017 EPI Leader of the Year Award.

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- Chelsea Mikula is an attorney with a national litigation practice focusing on business litigation, including ESOP litigation. Chelsea has represented ESOPs and ESOP trustees in litigation across the country.

- Chelsea has taken several cases to verdict at trial and in arbitration. She has represented clients in complicated breach of contract actions, real estate litigation, and other business-related torts.

- Also experienced with consumer product safety issues, Chelsea advises clients on compliance, reporting obligations, recall effectiveness, and in advertising disputes before the National Advertising Division of the Better Business Bureau and the National Advertising Review Board.

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Overviews and Disclaimer

- An overview of advantages and issues with ESOPs as well as trends in ESOP litigation
- Based on publicly available information on ESOP cases (e.g., complaints, opinions, etc.); we recognize there are two sides to every story
- We are identifying recurring themes in the types of issues raised in these cases and commenting on those issues

Outline

- Background on ESOPs and the advantages of ESOPs, as compared to other exit strategy options

- Issues to be mindful of:
  - Internal versus external trustee
  - Developments in the ESOP world/lack of regulation

- Issues in litigation
  - Private plaintiff
  - DOL enforcement
  - Valuation issues
  - Other issues

- Summary of Conclusions

Background

Background

- Qualified retirement plan
- When Congress authorized ESOPs in 1957 and defined their rules in 1974, it had two primary goals:
  - 1) provide tax incentives for owners of privately held companies to sell their companies; and
  - 2) provide ownership opportunities and retirement assets for working-class Americans.

Advantages of an ESOP

- Gradual transition
- Retirement benefit for employees
- No need to disclose information to competitors, as in an M&A deal
- Contributions of stock are tax-deductible
- If an S-Corp, not subject to income tax

Issues To Be Mindful Of

Trustee

- Internal versus external
- Legal obligations of trustee
  - To act for the exclusive purpose of the ESOP participants;
  - Exercise prudence
  - Exercise loyalty
- Responsibilities of trustee:
  - Determine annual value with advice from valuation firm
  - File Form 5500

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Trustee

- Considerations:
  - Cost
  - Communication
  - Independence
  - Liability

Developments in the ESOP World

1. **Interest in ESOPs…and ESOP Transaction Activity…is Skyrocketing**
   a) ESOPs are an underutilized and increasingly popular succession planning alternative with many unique benefits
   b) Popularity increasing due, in part, to demographics and the need for so many businesses to transition ownership

2. **There is Still No Regulation**
   a) The DOL issued proposed regulations – in 1988
   b) Never promulgated regulations and now denouncing proposed regulations
   c) GreatBanc settlement was a landmark case that changed the ESOP landscape; Settlement Agreement is now "The Bible" for proper process
   d) "Process Agreements" – 5 and counting

3. **The DOL Has Been Aggressive…and Successful…in Challenging ESOP Transactions**

4. **Private Plaintiffs are More Aggressive**

Process Agreements

- And then there were five process agreements:
  - GreatBanc
  - First Bankers Trust Services
  - Joyner
  - Alpha Investment Consulting Group
  - Lubbock National Bank (same as GreatBanc)

- The terms contained in the various settlement agreements have been viewed by some (like the DOL) as representing "best practices" for ESOP fiduciaries.

Process Agreements

- Areas under consideration in the Process Agreements include the following categories from the Proposed Regulations:
  - Was the appraiser independent and qualified?
    - Written analysis for why appraiser was selected
  - Did the fiduciary apply sound business principles?
  - Did the fiduciary determine whether it was reasonable to rely on valuation?
    - Document analysis and include reasonableness of projections
    - If weight is not given to one valuation, is it explained in the valuation report
    - If no DCF, explain why
    - Audited or unaudited financial statements
  - Did the fiduciary conduct a prudent investigation of the circumstances then prevailing at the time of the valuation?
  - Were projections used?
    - If they did not have projections, were projections created by management
  - Did the ESOP obtain control?

Litigation Issues

Recent DOL ESOP Lawsuits

- Acosta v. Reliance Trust (Tobacco Rag Processors)
- Perez v. First Bankers Trust (SJP Group)
- Perez v. First Bankers Trust (Sonnax)
- Perez v. Vinoskey (Sentry Equipment)
- Perez v. Potts (Triple T Transport)
- Perez v. Cactus Feeders
- Perez v. Commodity Control
- Perez v. Bat Masonry
- Perez v. Ginsberg (Laser Skin & Surgery of NY)
- Perez v. Bruister (Bruister & Associates)
- Perez v. Gruber Systems
- Perez v. AIT Labs
- Harris v. First Bankers Trust (Rembar)
- Solis v. Webb (Parrot Cellular / EVI)
- Perez v. PBI Bank (Miller's Health)
- Perez v. First Bankers Trust (Maran)
- Acosta v. Wilmington Trust (Graphite Sales)
- Acosta v. Wilmington Trust (HCMC Legal)
- Acosta v. Zander Group (Zander Group)
- Acosta v. Big G Express
- Acosta v. Saakvitne (Bowers & Kubota Consulting, Inc.)

Recent Private Plaintiff ESOP Lawsuits

- Brundle v. Wilmington Trust (Constellis Group)
- Chesemore v. Fenkel (Alliance Holdings; Trachte Building Syst)
- Swain v. Wilmington Trust (ISCO Industries)
- Jessop v. Larsen (Mona Vie)
- Brown v. Wilmington Trust (Henny Penny)
- Allen v. GreatBanc Trust (Personal-Touch)
- McMaken v. GreatBanc Trust (Chemonics)
- Nistra v. Reliance Trust Company (Bradford Hammacher Group)
- Appvion Inc Retirement Savings and Employee Stock Ownership Plan v. Buth
- Godfrey v. Greatbanc Trust Company (McBride & Son)
- Woznicki v. Raydon Corporation

Ways to Value a Company

- Market Comparisons Approach to Value
  - Private Company comparisons
  - Guideline Public Company comparisons

- Income Analysis Approach to Value
  - Value Drivers of Business
  - Discounted Cash Flow Analysis

- Replacement Cost (Asset) Approach to Value

Valuing an ESOP Company

- An ESOP company's shares are valued the same as another operating company

- ESOP shares must not be purchased for more than adequate consideration, or fair market value

- Determined in good faith – using an independent valuation expert retained by the ESOP's trustee

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Fair Market Value

- **Definition of FMV:**

  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, both parties being able, as well as willing, to trade and well-informed the asset and the market for the asset.

  ➢ Title I of ERISA and the Proposed Regulation Relating to the Definition of Adequate Consideration (Prop. Reg. Section 2510.3-18(b)(2)(i))

- **Key Concepts**
  - Arm's-length transaction
  - Hypothetical buyer and seller
  - No undue influence to buy or sell
  - Knowledgeable buyer and seller
  - ESOP is a financial buyer

DOL’s Thoughts on ESOP Valuations

- **Tim Hauser**, Deputy Assistant Secretary for Program Operations of the Employee Benefits Security Administration:
  - ESOP valuations are the “first, second, third, and fourth problem” with ESOPs that the DOL is trying to address
  - ESOP valuations have been “an area of chronic problems”
  - Concerned with valuator’s “blind acceptance” of “unrealistic growth projections”

Most Problematic Valuation Issues

1. Projections
2. Control premiums & control adjustments
3. Management synthetic equity & dilution (SARs, ISOs, etc.)
4. Guideline public company comparisons
5. Warrants & dilution
6. Prior valuations, offers, deals, indications of value
7. Discount rate, WACC, beta, risk
8. Cyclicality / changing industry dynamics
9. Exit multiple / implied LT growth rate
10. Normalization adjustments / add-backs
11. No DLOM
12. Key customer risk
13. Insufficient time allowed for trustee/valuator due diligence

PROJECTIONS

Projections – Case Examples

- **Acosta v. Reliance Trust (Tobacco Rag Processors)** – overly aggressive projections
- **Perez v. First Bankers Trust (Sonnax)** - aggressive projections that were inconsistent with historical performance and built growth upon the company's best year ever
- **Perez v. Commodity Control** – overly aggressive projections
- **Perez v. Gruber Systems** - unreasonably aggressive management projections that excluded consideration of the company's Chinese operations, which had been unprofitable for years and was a drain on value
- **Acosta v. Wilmington (Graphite Sales)** – used projections with $27 million value when it recognized $21 million was more appropriate
- **Perez v. Vinoskey (Sentry Equipment)** – criticized for lack of projections

Roles & Responsibilities with Projections

- **Management:**
  - Prepare & take responsibility for projections
  - Develop support for key assumptions
- **Company/Seller Advisors:**
  - Review for reasonableness before "published"
  - Help management substantiate key assumptions
- **ESOP Valuator:**
  - Review, understand, question & scrutinize
  - Compare with past performance & industry trends
  - Assess level of conservatism & aggressiveness
- **ESOP Trustee:**
  - Review, question, understand & scrutinize
  - Understand valuator's analysis of projections
  - Ultimately approve the value conclusion based on projections and valuators assessment of them

Management Projections

- **Forecast should be prepared by the management team that will be responsible for achieving the forecast (not the seller or sell-side advisor, who will/may be out of the picture)**

- Forecast should not deviate significantly from past performance or industry trends unless there is compelling evidence to support assumptions

- Forecast should reflect a "50/50" probability of achieving

- Forecast should include sufficient investment (in personnel, CAPEX, working capital, etc.) to accommodate growth

Cyclicality & Representative Cash Flows

- Beware of “recency bias” – building forecast (or applying capitalized cash flow and/or applying multiples) off last year, which was the best/worst year ever, without consideration of historical performance trends

- Be mindful of industry trends & cyclicality

- Valuation is inherently forward-looking; all earnings streams used should represent normal levels

- Potential ways to account for abnormal performance:
  - Discount rate (subject company risk)
  - Terminal year cash flow
  - Multiples selected
  - Normalized cash flow

Long-Term Growth Rate

- Often used to project cash flows beyond the projection period (i.e., oftentimes, from year 6 to infinity)
- Typically, should reflect inflation + economic/industry growth
- Most common LT growth rate is 2% to 6%
- Growth beyond these levels is often unrealistic, as it implies that the company will perpetually gain market share and outperform the economy
- Remember, forever is a long time
- Be careful with “exit multiples” in your DCF…There is an implied growth rate buried in that multiple

CONTROL PREMIUMS

Control Premiums – Case Examples

- **Acosta v. Reliance Trust (Tobacco Rag Processors)** - Failed to discount despite not having control
- **Perez v. Cactus Feeders** - Valued on a control basis, but ESOP did not obtain control
- **Harris v. First Bankers Trust (Rembar)** - Double-counted value of control by applying control premium and making control adjustments
- **Acosta v. Wilmington Trust (Graphite Sales)** - Added a 10% control premium
- **Perez v. Vinoskey (Sentry Equipment)** – multiple factors "unilaterally direct corporate action, select management, decide the amount of distribution, rearrange the corporation's capital structure, and decide whether to liquidate, merge, or sell assets"

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Control Premiums & Control Adjustments

- Be wary of percentage control premiums
- Preferred approach is to directly make adjustments to cash flows to reflect cash flows available to controlling-interest ESOP shareholder
- If control doesn't enhance cash flows, what is the value of control? And it works both ways…what should DLOC be if there is no difference between control & minority cash flows?
- Valuator should normalize to "control" only if such adjustments to cash flows (e.g., owners' compensation) are expected to materialize under ESOP ownership
- ESOP should not pay for cash flows that are not available to it as the 100% shareholder

Qualification of Valuation Advisor – Case Examples

- **Perez v. Bruister** - Court found, among other things, that fiduciaries failed to investigate the appraiser's education, prior fraud conviction, and practice of using outside valuation service
- **Acosta v. Wilmington Trust (HCMC)** – DOL alleged failure to investigate experience with type of company at issue and valuation approaches and analyses
- **Acosta v. Reliance (Tobacco Rags)** – Willamette's previous relationship with the Company and Selling Shareholder
- **Acosta v. Wilmington Trust (Graphite Sales)** – valuation firm SRR, had connection to company
- **Perez v. Vinoskey (Sentry Equipment) –** DOL and court question the independence of Napier/CAI as he did prior valuations for Sentry ESOP

Insufficient Due Diligence Time – Case Examples

- **Perez v. First Bankers Trust (Sonnax)** - Insufficient time to complete due diligence
- **Perez v. Vinoskey (Sentry Equipment)**
  - Six weeks
  - "There is no clear amount of time a fiduciary is required to dedicate to a transaction, and the Court finds the amount of time spent on the deal is likely less important than whether reliance of Napier's valuation was prudent."

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Inappropriate Market Comparable – Case Examples

- **Solis v. Webb (Parrot Cellular / EVI)** - public comparables were not comparable enough
- **Perez v. First Bankers Trust (Maran)** - utilized non-comparable guideline public companies
- **Acosta v. Reliance (Tobacco Rags)** – reliance in incomparable “comparable” companies
- **Perez v. Vinoskey (Sentry Equipment)** – lack of market comparability

Takeaways

- Documentation is key to ensure you remember the steps taken and issues considered at each step of the transaction
  - Be prepared to discuss and defend all of the issues discussed today
- Hire experienced advisors
- Valuation is THE CRITICAL component
  - Heightened scrutiny of valuation firms
  - Defend key valuation issues
- Fiduciaries must have an "eye-single" for the benefit of the ESOP participants

Thank you!

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