

*ESOP Valuation Insights*

## CURRENT VALUATION ISSUES WITH REGARD TO ESOP-OWNED EMPLOYER CORPORATION STOCK

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*Independent financial advisers play an important role in many ESOP employer corporation stock purchase, sale, and financing transactions. The financial adviser advises the ESOP trustee with regard to the price and terms of the proposed employer stock transaction. And, the financial adviser assists in negotiations on behalf of the ESOP, helping to ensure that the ESOP participants achieve their maximum economic self-interests. This discussion reviews several current topics with regard to the valuation of ESOP-owned employer corporation stock. This "current issues" discussion is presented from the perspective of the "best practices" that are generally used by ESOP financial advisers.*

### INTRODUCTION

The economic benefits of ESOP ownership of employer corporation stock may be significant. And, these economic benefits often affect all parties to the ESOP formation transaction, including:

1. the selling stockholders of the employer corporation,
2. the sponsor company as a corporate entity, and
3. the sponsor company employees/ESOP participants.

Some of the common economic benefits associated with an ESOP formation include:

1. providing sponsor company employee benefits in a tax-advantaged manner;
2. improving employee morale and commitment at the employer corporation;
3. providing an ownership transition structure that results in the continuity of, and widespread employee ownership in, the sponsor company;
4. providing a tax-advantaged source of funding for sponsor company expansion and capital investment; and
5. serving as a corporate take-over defense and/or as a means of perpetuating jobs at a distressed employer corporation.

The levels of economic benefits to the ESOP participants, to the ESOP sponsor company, and to the selling shareholders depend on numerous factors, including (1)

the financial success of the ESOP sponsor company and (2) the percentage of employer corporation stock (initially and ultimately) owned by the ESOP.

The economic benefits of an ESOP formation have changed over time with various tax law changes. However, as some economic benefits expire, new benefits are often allowed. For example, the Pension Protection Act of 2006 includes permanent rules that allow employers to deduct the dividends paid on the stock held by an ESOP. This is the case provided that the plan allows the ESOP participants to elect (1) to take a distribution of the dividends or (2) to invest the dividends in additional employer shares. (Prior to the 2001 tax act, an employer could only deduct the dividends actually distributed to the ESOP participants).

### INDEPENDENT FINANCIAL ADVISER ISSUES

An independent financial adviser has several important functions with regard to ESOP formations, ESOP employer stock purchase transactions, ESOP financings and refinancings, post-ESOP sponsor company capital transactions, and ESOP plan terminations. This discussion summarizes several of the issues facing analysts who provide ESOP valuation consulting and financial advisory services.

Some of the issues relate more to de novo ESOP formations, some more to seasoned ESOPs, and some more to ESOP plan terminations and exit strategies. And, while the focus of this discussion relates to financial adviser considerations, these topics also affect ESOP trustees, other ESOP professional advisers (e.g., lawyers and accountants), and ESOP participants.

First, this discussion will focus on (1) the procedures performed by the financial adviser and (2) the types of opinions that the financial adviser may issue with regard to an ESOP employer stock purchase/sale transaction.

Second, this discussion will describe how financial advisers (and sponsor companies) deal with the post-stock-purchase decrease in the employer corporation equity value that typically results from a leveraged ESOP formation.

Third, this discussion will outline the common valuation issues related to level of value (i.e., controlling ownership interest versus noncontrolling ownership interest). This discussion will describe the financial adviser's consideration as to when (and how) to value the ESOP-owned employer stock on a controlling ownership interest basis.

Fourth and finally, this discussion will present financial adviser considerations with respect to the effect of the sponsor company repurchase liability on the employer corporation stock value.

## THE ROLE OF AN INDEPENDENT FINANCIAL ADVISER IN ESOP TRANSACTIONS

There is an inherent economic conflict between the buyers and sellers of close corporation stock. The stock buyers want to minimize the consideration they pay in the stock purchase transaction. The stock sellers want to maximize the proceeds they receive from the stock sale transaction.

The final stock purchase/sale transaction price is typically the result of informed (and intense) negotiations between sophisticated (or, at least, well-advised) parties. During these informed negotiations, both transactional parties seek to achieve their maximum economic self-interests.

The same process of informed negotiation and maximization of economic self-interests should occur with regard to an ESOP purchase or sale of employer corporation stock. However, ESOP participants, and even ESOP trustees, are rarely in a position to conduct such negotiations.

Accordingly, the ESOP should be independently represented in such purchase/sale negotiations. This is accomplished when the ESOP trustee is represented by both independent legal counsel and an independent financial adviser. These professional advisers are typically involved in the negotiation and structuring of the employer corporation stock purchase, financing, and sale transactions.

In the ESOP employer corporation stock purchase/sale transaction, the independent financial adviser typically performs several functions. These independent financial adviser functions include:

1. conducting the employer corporation business/stock valuation analysis,
2. assisting the ESOP trustee in the negotiation of the purchase/sale transaction price,
3. assisting the ESOP trustee and the ESOP legal counsel in the structuring of the purchase/sale transaction,
4. advising and counseling the ESOP trustee on the purchase/sale transaction details, and
5. rendering to the ESOP trustee a fair market value opinion, a fairness opinion, and/or a solvency opinion (if such an opinion is requested by the lender).

According to the Internal Revenue Code, an ESOP investing in privately held employer corporation stock is required to obtain an independent appraisal with regard to the initial employer stock purchase transaction.

In the context of the employer corporation business/stock valuation, the financial adviser is acting in the role of an independent appraiser. The U.S. Department of Labor (DOL) regulations require that a qualified independent appraiser is not (1) a party to the transaction or (2) related to any party to the transaction.

According to an Internal Revenue Service definition, a qualified appraiser:

1. publicly holds himself or herself out as an appraiser,
2. performs appraisal services on a regular basis, and
3. is not regularly used by the parties to the subject transaction.

Furthermore, according to the Internal Revenue Service, a qualified appraiser should demonstrate professional experience, continuing education, and an appropriate background.

These Internal Revenue Service "qualified appraiser" requirements are intended to ensure that the independent financial adviser to the ESOP is technically competent. In addition, the financial adviser should demonstrate independence and objectivity in the performance of all of his/her financial advisory services.

To demonstrate independence, the financial adviser typically provides services to the ESOP on either a fixed fee or an hourly billing rate basis. In other words, unlike many investment bankers, the independent financial adviser fees to the ESOP are not contingent on (1) a certain dollar price of the purchase/sale transaction or (2) the successful completion of the purchase/sale transaction.

## THE FAIR MARKET VALUE ANALYSIS

As originally required by the Tax Reform Act of 1986, a fair market value valuation of the employer corporation stock should be performed:

1. when the ESOP first buys the employer corporation stock,
2. at least annually thereafter,
3. when there is an employer corporation stock sale transaction between the ESOP plan and a disqualified person, and
4. when the ESOP sells its employer corporation stock ownership position.

In consideration of the provisions of Internal Revenue Service Revenue Ruling 59-60, the financial adviser will typically consider the following factors in the fair market value valuation analysis of the employer corporation common stock:

1. the nature of the business and the history of the enterprise
2. the economic outlook and the condition and outlook of the industry
3. the book value of the securities and the financial condition of the business
4. the earnings capacity of the company
5. the dividend-paying capacity of the company
6. whether or not the enterprise has goodwill or other intangible value
7. the market price of the securities of corporations engaged in a similar line of business that are traded in a free and open market
8. the marketability, or lack thereof, of the securities
9. whether or not the seller would be able to obtain a control premium for the subject securities

The independent financial adviser is typically retained by the ESOP trustee (or by the fiduciary of the to-be-formed ESOP, in the case of new ESOP formations). The independent financial adviser performs the requested advisory services (including the fair market valuation of the employer corporation stock) for the trustee and on behalf of the ESOP participants.

With regard to the initial purchase of the employer corporation stock, the ESOP trustee will typically request the financial adviser to assist in:

1. the negotiation of the employer stock transaction purchase price,
2. the design of any new class of employer corporation securities that the ESOP will purchase, and
3. the structure of the ESOP employer stock purchase transaction.

In the case of either (1) an initial purchase/financing of employer stock or (2) a subsequent leveraged purchase of a block of employer stock, the ESOP trustee will often request the financial adviser to issue a fairness opinion and/or a solvency opinion.

Current knowledge of the relevant capital market conditions is important to the financial adviser with regard to analyzing the ESOP employer stock purchase transaction. With regard to analyzing, pricing, and structuring the employer stock purchase transaction, the financial adviser will typically consider:

1. the investment return requirements of private equity investors in the relevant transactional market for the employer corporation stock and
2. the current lending requirements of the various financing sources that may be used to finance the leveraged ESOP employer stock purchase transaction.

Accordingly, the financial adviser will structure an ESOP employer stock purchase transaction that is both:

1. an attractive investment to the typical ESOP financing institutions and
2. in compliance with the ERISA and Internal Revenue Code requirements considered by the DOL and the Service.

In addition, with regard to a new ESOP formation, the financial adviser may assist with the investment feature design of the employer corporation security that the ESOP will purchase. This security may be a new class of common stock, convertible preferred stock, or some other type of employer security.

## THE ESOP FORMATION FEASIBILITY ANALYSIS

The ESOP trustee may also retain a financial adviser to conduct a feasibility analysis. This analysis will assist the trustee in determining the viability of the initial employer stock purchase transaction. Among other considerations, the feasibility analysis typically includes the financial adviser's assessment of whether the ESOP sponsor company cash flow can service the debt obligations associated with a leveraged stock purchase transaction.

The feasibility analysis can help both the ESOP trustee and the employer corporation management to assess whether or not to move forward with the ESOP formation. In the ESOP formation feasibility analysis, the financial adviser should be careful to consider both (1) who is the financial adviser's client and (2) who is the beneficiary of the ESOP feasibility analysis.

At the time the financial adviser performs the ESOP feasibility study, a trustee may not yet be named to represent the interests of the to-be-formed ESOP.

Once the decision is made to create an ESOP, a more formal employer stock valuation analysis is often required. The objective of the more formal valuation analysis is to assess the price and structure of the proposed ESOP employer stock purchase transaction.

## THE INDEPENDENT FINANCIAL ADVISER AND THE TRANSACTION FAIRNESS OPINION

Particularly with regard to an initial stock purchase transaction, the ESOP trustee will often request the financial adviser to issue a fairness opinion. In this opinion, the adviser opines on the fairness to the ESOP of the employer stock purchase transaction.

Related to the ESOP employer stock purchase transaction, the financial adviser is typically retained to provide an opinion stating that the proposed transaction is fair—from a financial point of view—to the ESOP. Independent financial adviser fairness opinions may relate to a variety of capital transactions—involving both publicly traded and privately owned ESOP sponsor companies.

In an ESOP employer stock purchase/sale transaction, the financial adviser is typically retained by the plan. This is because the ESOP trustee is responsible for representing the plan participants' interests related to the employer stock purchase/sale transaction. In addition, a fairness opinion related to the ESOP employer stock purchase/sale transaction may help the transaction to withstand the scrutiny of (1) the DOL, (2) the Internal Revenue Service, or (3) the ESOP plan participants.

## INDEPENDENT FINANCIAL ADVISER DUE DILIGENCE PROCEDURES

In the process of preparing a fair market valuation, an adequate consideration opinion, a fairness opinion, or a solvency opinion, the financial adviser will perform a series of due diligence procedures with regard to the employer corporation.

These financial adviser due diligence procedures typically include the following:

1. Collect sponsor company historical financial statements, income tax returns, and legal documents.
2. Conduct sponsor company management interviews and site inspections.
3. Review the current economic conditions and the competitive position of the sponsor company within its industry environment.

4. Analyze and normalize the sponsor company historical financial statements.
5. Compare the sponsor company historical financial performance to the historical financial performance of the relevant industry peer group.
6. Collect and analyze sponsor company prospective financial statements; then, compare the prospective financial statements to (a) the sponsor company historical financial statements, (b) the industry peer group trends, and (c) published industry forecasts or projections.
7. Identify and select the most appropriate business/security valuation approaches and methods (including consideration of all market, income, and asset-based valuation approach methods).
8. Perform the selected business/security valuation methods (e.g., guideline publicly traded company method, guideline merged and acquired company method, discounted cash flow method, direct capitalization method, adjusted net asset value method, and asset accumulation method).
9. Consider the application of all relevant valuation adjustments, including discounts and premiums related to (a) any level of value adjustments and (b) any company-specific risk factors.
10. Prepare a valuation synthesis of all applicable valuation method value indications and reach a final employer stock value conclusion (either a range of values or a point estimate).
11. Analyze the terms of the subject stock purchase or sale transaction, including the exchange any debt or equity securities or any contracts that are part of the consideration.
12. Prepare (as requested) the fair market value valuation opinion report, the fairness opinion, or another type of financial adviser's transaction opinion.

The fairness opinion summarizes the financial adviser's opinion with respect to the pending employer stock purchase/sale transaction. ESOP employer stock purchase/sale transactions are often rigorously scrutinized by regulatory authorities and others to ensure that the ESOP participants receive fair treatment. Therefore, in addition to issuing the fairness opinion, the independent financial adviser will often make a formal presentation to the ESOP trustee prior to the close of the employer corporation stock purchase/sale transaction.

## THE PROFESSIONAL QUALIFICATIONS OF THE INDEPENDENT FINANCIAL ADVISER

Unlike attorneys and accountants, financial advisers are not subject to state or federal licensing requirements. Since

there is no licensing requirement or generalized examination for financial advisers, the ESOP trustee should perform due diligence in the selection of the financial adviser.

In addition to professional experience, relevant professional credentials provide evidence that an individual is qualified to serve as an independent financial adviser in an ESOP employer stock purchase transaction.

The Institute of Chartered Financial Analysts issues the Chartered Financial Analyst (CFA) credential. And, the American Institute of Certified Public Accountants issues the Accredited in Business Valuation (ABV) credential to CPAs who have demonstrated specialized business valuation training, experience, and proficiency. Both credentials (1) involve rigorous testing requirements and (2) require the demonstration of significant professional experience.

Typically, an ESOP trustee will select an independent financial adviser who (1) performs valuations of corporations and corporate securities on a full-time basis, (2) has extensive experience with ESOP formations and ESOP employer stock purchase transactions, (3) is an active member of one or both of the two national employee ownership organizations (i.e., the National Center for Employee Ownership and The ESOP Association), and (4) has expert testimony experience in business/security valuation matters and stock purchase/sale transaction matters.

With regard to independence, the financial advisory firm that values the employer corporation stock should not be: (1) a firm that provides other investment banking services to the sponsor company, (2) a bank or other financial institution that provides commercial lending or trustee services to the sponsor company, or (3) a firm that derives substantial income (other than income from financial advisory services) from any other service to the sponsor company.

The selected independent financial adviser should also be free of any conflicts of interest—both real and perceived. The independent financial adviser is responsible (directly) to the ESOP trustee and (indirectly) to the ESOP participants. Accordingly, any previous financial advisory services or investment banking services performed on behalf of the sponsor company may be perceived as a potential conflict of interest.

## SUMMARY OF THE ROLE OF THE INDEPENDENT FINANCIAL ADVISER

The risk associated with an ESOP employer stock purchase/sale transaction can be greatly reduced when the ESOP trustee retains independent legal counsel and an independent financial adviser. In the employer stock purchase/sale transaction, the ESOP participants are sometimes called “a party without a voice.” For this reason, the DOL may thor-

oughly scrutinize all ESOP employer stock purchase/sale transactions.

The ESOP trustee is responsible to satisfy all of the ERISA requirements that the DOL applies to ESOP employer stock purchase/sale transactions. Accordingly, this discussion focuses on the benefits to the ESOP trustee to retain a competent financial adviser.

The role of the independent financial adviser varies depending on (1) the size and complexity of the ESOP employer stock purchase/sale transaction and (2) the advisory needs of the individual ESOP trustee. Nonetheless, an independent financial adviser can play an important role in advising an ESOP trustee related to employer stock purchase/sale transactions of virtually any size.

## FINANCIAL ACCOUNTING RELATED TO THE LEVERAGED ESOP FORMATION

The initial ESOP purchase of employer corporation stock can be structured as either (1) a nonleveraged ESOP stock purchase transaction or (2) a leveraged ESOP stock purchase transaction.

In a nonleveraged ESOP formation, the sponsor company typically contributes either (1) the employer corporation stock to the plan or (2) enough cash to the plan so that the ESOP can buy the employer stock.

In a leveraged ESOP stock purchase transaction, the ESOP initially borrows funds to buy the sponsor company stock. The ESOP stock acquisition financing is typically based on the creditworthiness of the employer corporation. In the case of a leveraged employer stock purchase transaction, the sponsor company stock is ultimately allocated to the plan participant accounts as the ESOP stock acquisition debt is repaid.

The financial accounting for a nonleveraged ESOP formation will typically result in a significant change in the post-ESOP sponsor company results of financial operations (i.e., the income statement). However, after the formation of a nonleveraged ESOP, there will typically be little impact reflected in the post-ESOP sponsor company statement of financial position (i.e., the balance sheet).

In contrast, the financial accounting for a leveraged ESOP formation will typically result in a significant impact on both the sponsor company post-ESOP statement of financial position and statement of results of financial operations.

In fact, the financial accounting related to a leveraged ESOP formation may result in the sponsor company reporting a negative book value (i.e., negative stockholder's equity account). This negative book value would result from the inclusion of the contra-equity account entitled “unearned ESOP shares” in the shareholder's equity section of the sponsor company balance sheet.

Accordingly, on this part of the discussion will focus on (1) the sponsor company balance sheet and (2) the related change in sponsor company equity value that results from the initial formation of a leveraged ESOP.

The American Institute of Certified Public Accountants Statement of Position (SOP) 93-6 provides professional guidance with regard to the financial accounting for transactions between an employer corporation and an ESOP.

As explained in SOP 93-6, a leveraged ESOP can be financed in one of three ways:

1. a direct loan, in which the ESOP is financed by a loan that is made by a lender (other than the employer corporation) “directly” to the ESOP;
2. an indirect loan, in which the employer corporation provides “pass through” financing to the ESOP by using funds that the sponsor company has borrowed from an outside lender; or
3. an employer loan, in which the employer corporation provides the financing directly to the ESOP, with no related outside (i.e., financial institution) loan.

SOP 93-6 requires the employer corporation to account for both a direct loan and an indirect loan as a liability on the sponsor company’s balance sheet.

## ECONOMIC ANALYSIS RELATED TO THE LEVERAGED ESOP FORMATION

Generally accepted accounting principles (GAAP) require the recognition of the ESOP stock acquisition loan at face value. However, this financial accounting treatment does not consider the economic benefits of ESOP financing—relative to the economics of normal sponsor company financing. From the sponsor company’s standpoint, there are two income tax advantages related to the ESOP stock acquisition debt.

First, the principal payments on the ESOP stock acquisition debt are tax deductible to the sponsor company. Pursuant to Internal Revenue Code Section 415, the income tax deduction allowed for principal payments on the ESOP loan is limited to 25 percent of eligible compensation. Since the leveraged ESOP uses the employer funds to service the stock acquisition debt, the debt service (both interest and principal) is tax deductible.

Accordingly, the bank loan is effectively repaid in pretax dollars. This structure results in a substantial income tax savings for the sponsor company.

Second, the dividends paid by the employer corporation on the ESOP-owned stock may be tax deductible. In this way, the 25 percent of eligible compensation limitation can effectively be exceeded. This is because the dividend pay-

ments to the ESOP are tax deductible and are not included in the Section 415 limitations.

Of course, this income tax deduction is allowed only in the case when the sponsor company dividends are used by the ESOP to service the ESOP stock acquisition debt.

The after-tax cash flow reduction of repaying the ESOP stock acquisition debt is less than the after-tax cash flow reduction of repaying a conventional employer corporation loan.

The economic benefit of these income tax benefits of the ESOP stock acquisition debt can be quantified as the present value of the tax-related cash flow savings. These income tax benefits represent an economic advantage that the ESOP structure brings to the employer stock purchase/sale transaction.

## ILLUSTRATIVE EXAMPLE OF A LEVERAGED ESOP STOCK PURCHASE TRANSACTION

Exhibit 1 presents the liabilities and equity accounts of the illustrative Sponsor Company before and after the formation of a leveraged ESOP. Sponsor Company uses a direct loan to finance the ESOP purchase of the employer corporation stock. The ESOP direct loan results in a liability that is recorded on the Sponsor Company balance sheet.

**Exhibit 1**  
**Sponsor Company**  
**Balance Sheet**  
**As of the ESOP Formation Date**  
**(in \$000s)**

	Pre-Leveraged ESOP	Post-Leveraged ESOP
<b>Liabilities:</b>		
Current maturity of long-term debt	0	1,121
Other current liabilities	<u>5,000</u>	<u>5,000</u>
Total Current Liabilities	5,000	6,121
Long-term debt	0	8,879
<b>Stockholders' Equity:</b>		
Common stock	2,000	2,000
Unearned ESOP shares	—	(10,000)
Retained earnings	<u>13,000</u>	<u>13,000</u>
Total Stockholders' Equity	<u>15,000</u>	<u>5,000</u>
Total Liabilities and Stockholders' Equity	<u>20,000</u>	<u>20,000</u>

In this illustrative example, let’s assume that the ESOP direct loan is a \$10 million principal loan with the following terms: (1) a repayment term of 7 years, (2) an interest rate

of 8 percent, and (3) equal annual payments of \$1,920,724. Based on the GAAP financial statement presentation, the value of the Sponsor Company stockholders' equity after the leveraged ESOP formation transaction is reduced by \$10 million.

However, based on an economic analysis of the leveraged stock purchase, the value of the Sponsor Company stockholders' equity is reduced by something less than \$10 million. This economic effect is due to (1) the lower cost of debt capital relative to the higher cost of equity capital and (2) the income tax deductibility of the leveraged ESOP debt principal repayments.

Exhibit 2 presents the economic benefits of the income tax savings to Sponsor Company related to the tax deductibility of the loan principal payments.

### SIMPLIFIED ILLUSTRATIVE LEVERAGED ESOP TRANSACTION: EXAMPLE CONCLUSION

Based on the hypothetical assumptions presented above, Exhibit 3 indicates that the total present value of the ESOP debt principal deduction income tax benefits is \$2.7 million. This economic benefit implies that the net negative impact of the ESOP stock acquisition debt on the Sponsor Company stockholders' equity value is \$7.3 million.

This result is a favorable conclusion when compared to the financial accounting impact on the Sponsor Company stockholders' equity value of negative \$10 million.

Accordingly, from an economic perspective, there is an incremental impact on the Sponsor Company stockholders' equity value associated with the favorable income tax attributes of the ESOP financing.

### Exhibit 3 Sponsor Company Incremental Value Impact of the Leveraged ESOP Favorable Income Tax Attributes

Year	Income Tax Savings Due to Principal Payment Deduction	Present Value of Income Tax Savings at 10% Discount Rate
1	\$448,290	\$407,536
2	484,153	400,126
3	522,885	392,851
4	564,716	385,708
5	609,893	378,696
6	658,685	371,810
7	<u>711,379</u>	<u>365,050</u>
Total	\$4,000,000	\$2,701,778

Let's assume that the Sponsor Company pre-ESOP equity value was \$15 million. Based on the analysis illustrated

### Exhibit 2 Sponsor Company Economic Benefits Associated with the Income Tax Deductibility of ESOP Debt Principal Payments

Assumptions regarding the leveraged ESOP stock acquisition loan terms:

Face amount of the debt	\$10,000,000
Interest rate	8%
Term of the debt, in years	7
The Sponsor Company effective income tax rate	40%

Debt Term Year	Total Debt Service Payments	Debt Principal Payment	Debt Interest Payment	Income Tax Savings from Principal & Interest Deduction	After-Tax Debt Service Payment
1	\$1,920,724	\$1,120,724	\$800,000	(\$768,290)	\$1,152,434
2	1,920,724	1,210,382	710,342	(768,290)	1,152,434
3	1,920,724	1,307,212	613,512	(768,290)	1,152,434
4	1,920,724	1,411,789	508,935	(768,290)	1,152,434
5	1,920,724	1,524,733	395,991	(768,290)	1,152,434
6	1,920,724	1,646,711	274,013	(768,290)	1,152,434
7	<u>1,920,724</u>	<u>1,778,448</u>	<u>142,276</u>	<u>(768,290)</u>	<u>1,152,434</u>
Totals	\$13,445,068	\$10,000,000	\$3,445,068	(\$5,378,027)	\$8,067,041

in the post-leveraged ESOP example, Sponsor Company stockholders' equity fair market value will be \$7.7 million—and not the \$5 million book value reported in Exhibit 1.

As the ESOP stock acquisition debt is retired, the Sponsor Company stockholders' equity value will tend to return to the pre-leveraged ESOP value of \$15 million. Of course, this assumes that the value of the Sponsor Company underlying business operations remains the same.

In addition, the Sponsor Company equity value will also increase as a result of increases in the employer corporation results of business operations.

## DISCOUNT RATE TO VALUE THE LEVERAGED ESOP INCOME TAX ECONOMIC BENEFITS

Financial advisers should exercise professional judgment in determining the appropriate discount rate to use in discounting the income tax savings. These income savings are typically present valued over the life of the ESOP employer stock acquisition loan.

The value of a corporate bond is determined by discounting the principal and interest payments to present value at the market-derived interest rate (or yield to maturity). A similar type of analysis may be applied here. Alternatively, some financial advisers believe that the appropriate discount rate to present value the leveraged ESOP principal deduction economic benefits (1) should be higher than a corporate bond rate and (2) should reflect the sponsor company's weighted average cost of capital (WACC).

This incremental value analysis is typically conducted on an after-tax basis. This is because the primary focus of the analysis is to quantify income tax benefits associated with the leveraged ESOP.

In the above simplified illustrative example, the after-tax market rate of debt is assumed to be 6 percent. Some financial advisers may conclude that this interest rate is not appropriate. This is because the debt interest rate does not consider the risk associated with the sponsor company's ability to currently utilize the leveraged ESOP income tax benefits.

Some financial advisers may conclude that a reasonable "middle ground" discount rate may be the sponsor company pretax debt rate (of 10 percent in the illustrative example). This pretax debt rate typically falls between (1) the sponsor company after-tax debt rate and (2) the sponsor company pretax WACC.

Financial advisers would typically use a higher present value discount rate when there is some risk that the employer corporation will not be able to take advantage of the ESOP debt repayment income tax savings. For example, this may occur when it is not likely that the sponsor company will be profitable in the future.

If there is a significant probability that the sponsor company will be unprofitable, then there will be no sponsor company income tax savings from the ESOP debt. In that case, the economic benefits of the ESOP debt will decrease accordingly. In addition, the sponsor company financial risk is increased with greater leverage. That increase in sponsor company financial leverage would indicate a corresponding increase in the present value discount rate to account for this increased risk.

If the sponsor company is an S corporation, then there are no income tax economic benefits associated with the deductibility of the leveraged ESOP principal payments. This is because the employer corporation income taxes flow through the individual sponsor company shareholders.

As a practical matter, however, some financial advisers value leveraged ESOP S corporations as if they were C corporations. In that case, the economic analysis of a leveraged ESOP S corporation income tax benefit would be similar to the illustrative analysis presented above.

## SUMMARY OF THE EFFECT OF THE LEVERAGED ESOP INCOME TAX ECONOMIC BENEFITS

This portion of the discussion illustrated the differences in pre-leveraged ESOP and post-leveraged ESOP sponsor company stockholders' equity values. This discussion indicates that the post-ESOP transaction decrease in the sponsor company stockholders' equity value is not a simple calculation.

As described above, there are income tax economic benefits associated with the leveraged ESOP employer stock purchase transaction. These income tax economic benefits partially offset the decrease in the post-leveraged ESOP formation sponsor company stockholders' equity value.

## OWNERSHIP CONTROL ISSUES IN ESOP EMPLOYER STOCK TRANSACTIONS

Similar to any other closely held corporation equity investor, the ESOP trustee is faced with the decision of whether to purchase a controlling or a noncontrolling ownership interest in the employer corporation. The trustee typically makes this decision at the time of the initial ESOP formation and initial employer stock purchase. The trustee may also face this decision again at the time that the noncontrolling ownership ESOP gradually approaches a controlling ownership position in the employer corporation.

Unlike other closely held corporation equity investors, the ESOP may initially purchase a noncontrolling ownership interest in the ESOP sponsor company based on a controlling ownership position price.

This control price may be appropriate if the selling stockholders granted to the ESOP a contractual “purchase right.” That contractual right enables the ESOP to purchase sufficient additional shares of stock (within a reasonable time) to bring the ESOP ownership of the employer corporation voting stock to more than 50 percent.

In addition, the selling stockholders and the ESOP buyer may enter into a “serial sale agreement.” Such an agreement provides for the ESOP to purchase sufficient additional shares to achieve voting ownership control of the employer corporation based upon an agreed upon schedule.

Closely held corporation equity investors recognize that a controlling equity ownership position commands a greater per-share price than a corresponding noncontrolling ownership interest position. This is because such an ownership position generally affords the shareholder the opportunity to effect change in the subject company.

In that regard, the following questions are important to the ESOP trustee contemplating an ownership control transaction in the employer corporation stock: (1) what is the incremental value associated with the economic benefits that ownership control is expected to provide? (2) how much greater price would the ESOP be willing to pay to acquire those ownership control economic benefits? And (3) how much more in additional sale price would the ESOP expect to receive if it was to relinquish the economic benefits of ownership control?

In the 1998 DOL proposed regulations, the DOL indicated that a plan may pay a “controlling interest value” only if a third party would pay such a price. And, the DOL proposed regulations indicate that such a value is unwarranted unless the plan obtains both (1) voting control and (2) control in fact. The DOL proposed regulations were never finalized. However, the proposed regulations provide informal guidance to financial advisers regarding the valuation of ESOP-owned employer stock on a controlling ownership interest basis.

Financial advisers typically adhere to these proposed regulation guidelines in the justification of an ESOP employer stock purchase at a controlling interest price. Financial advisers should carefully consider the issue of when a control level price is justified in order to avoid sanctions pursuant to both the Internal Revenue Code and ERISA.

These sanctions include:

1. the imposition of a substantial nondeductible excise tax on the selling shareholders,
2. a possible unwinding of the entire ESOP employer stock purchase transaction,
3. the imposition of penalties by the DOL on the ESOP fiduciaries,
4. the loss or diminution of the related income tax benefits, and
5. personal liability on the part of the ESOP fiduciaries (i.e., if they fail to recover the excess price paid in the ESOP employer stock purchase transaction).

This portion of the discussion focuses on the following issues regarding the control level valuation of ESOP-owned employer stock:

- factors that financial advisers typically consider when applying an ownership control price premium,
- procedures that financial advisers typically use to estimate the ownership control price premium,
- how the selected business valuation approaches and methods affect the appropriateness and magnitude of the ownership control price premium,
- the impact of the DOL proposed regulations on the application of an ownership control price premium
- the application of an ownership control price premium when the ESOP purchases or sells a majority of the outstanding employer voting stock,
- the application of an ownership control price premium when the ESOP purchases or sells less than a majority of the outstanding employer voting stock, and
- the application of an ownership control price premium in circumstances where the ESOP acquires “creeping ownership” of the employer corporation stock.

## FACTORS TO CONSIDER WHEN APPLYING AN OWNERSHIP CONTROL PRICE PREMIUM

Many closely held business owners attach personal, or “psychic,” value to being their own bosses. From the ESOP trustee’s perspective, any additional consideration paid to purchase ownership control (or received for relinquishing ownership control) should be attributable to the identifiable and quantifiable economic benefits of employer corporation ownership control.

These economic benefits generally result from certain prerogatives, or legal rights, inherent within an employer corporation controlling stock ownership position.

Some of the common prerogatives of close corporation ownership control include the stockholder’s right to:

1. appoint company management;
2. establish company management compensation and management perquisites;
3. establish corporate policy and business practices;
4. acquire or liquidate assets;

5. enter into merger and acquisition transactions;
6. establish, maintain, or terminate contractual or other business relationships;
7. acquire or divest lines of business or business units;
8. liquidate, dissolve, sell out, or recapitalize the subject company;
9. sell or acquire treasury shares;
10. register the company's stock for an initial public offering;
11. declare and pay dividends;
12. change the corporation articles of incorporation or bylaws;
13. change the company's accounting policies and fiscal year end;
14. enter into borrowing arrangements;
15. pledge corporate assets as debt collateral;
16. enter into lease, sale/leaseback or similar arrangements;
17. change the company strategic direction;
18. change the company product/pricing policies;
19. make or defer capital expenditures;
20. make or defer research and development, new product introduction, marketing and advertising, and other expenditures;
21. change the corporation income tax status (e.g., C to S or S to C corporation); and
22. block any of the previous actions.

## HOW THE SELECTED VALUATION APPROACHES AND METHODS IMPACT THE OWNERSHIP CONTROL PRICE PREMIUM

Within each of the generally accepted business valuation approaches (i.e., income, market, and asset-based), there are various valuation methods. The application of these various methods results in a preliminary value indication that reflects none, some, or substantially all of the economic benefits of ownership control.

Additionally, the financial adviser should be aware of which generally accepted business valuation approaches and methods result in value indications on a marketable basis versus a nonmarketable basis.

In the employer corporation stock valuation process, the financial adviser should recognize the aforementioned levels of value that the selected valuation approaches and methods produce. These levels of value affect the valuation of (1) the subject sponsor company and (2) the subject ESOP ownership interest.

Let's assume the financial adviser is analyzing the employer corporation with regard to a proposed control

event transaction. The financial adviser should recognize that a certain valuation approach and method produces a value indication that already reflects the economic benefits of control. Otherwise, the ESOP could pay more than adequate consideration for the subject controlling ownership interest.

This valuation error would occur if the financial adviser applies an ownership control price premium to a value indication that already reflects a controlling interest level of value.

Table 1 on the following page presents:

1. a summary of the generally accepted employer stock valuation approaches and methods,
2. the implied level of value that is typically reflected in the initial value indication from each valuation method, and
3. whether the application of an ownership control price premium is appropriate in the valuation of a controlling ownership interest in the employer corporation stock.

Table 1 summarizes the appropriateness of applying an ownership control price premium to initial value indications produced from each generally accepted valuation method.

As indicated in Table 1, there is a fundamental consideration regarding whether an ownership control price premium should be applied to an initial value indication. This fundamental consideration is the degree to which the historical or expected economic earnings of the sponsor company have already been adjusted to reflect the economic benefits of ownership control.

With regard to the market approach, the financial adviser should consider the capital market conditions in the public markets as of the employer stock valuation date. The financial adviser should consider whether the acquisition price premiums implicit in the analysis of selected guideline M&A companies reflect buyer-specific "synergistic" price premiums—as opposed to market-general ownership control price premiums.

## PROFESSIONAL GUIDANCE EXTRACTED FROM THE 1988 DOL PROPOSED REGULATION

On May 17, 1988, the DOL initially issued (but later withdrew) the "Proposed Regulation Relating to the Definition of Adequate Consideration." While the proposed regulation was never formalized (and was ultimately withdrawn), many financial advisers may consult the proposed regulation for guidance regarding certain employer stock valuation issues.

According to the proposed regulation:

**Table 1**  
**Employer Corporation Stock Valuations**  
**Generally Accepted Valuation Approaches and Methods**  
**The Application of Ownership Control Price Premiums**  
**to Initial Value Indications**

Business Valuation Approach	Business Valuation Method	Typical Concluded Level of Value in Initial Value Indication	Basis for the Level of Value Indication	Application of Control Ownership Price Premium*
Income	Discounted cash flow	Marketable noncontrolling	Cash flow/income not adjusted for control level expenditures	Yes
	Discounted cash flow	Marketable controlling	Cash flow/income adjusted for control level expenditures	No
	Direct capitalization	Marketable noncontrolling	Cash flow/income not adjusted for control level expenditures	Yes
	Direct capitalization	Marketable controlling	Cash flow/income not adjusted for control level expenditures	No
Market	Guideline publicly traded company	Marketable noncontrolling	Based on noncontrolling transfers of public stock	Yes
	Guideline merged & acquired company	Marketable controlling	Based on control event transactions	No
Asset-based	Adjusted net asset value	Marketable controlling	Implied ability to liquidate appreciated assets, including goodwill**	No
	Asset accumulation	Marketable controlling	Implied ability to liquidate appreciated assets, including goodwill**	No

\* with regard to the valuation subject of a controlling block of employer corporation stock.  
 \*\* assumes income used to quantify goodwill is adjusted for control level expenditures.

The Department proposes that a plan purchasing control may pay a control premium, and a plan selling control should receive a control premium. Specifically, the Department proposes that a plan may pay such a premium only to the extent a third party would pay a control premium. In this regard, the Department’s position is that the payment of a control premium is unwarranted unless the plan obtains both voting control and control in fact. The Department will therefore carefully scrutinize situations to ascertain whether the transaction involving payment of such a premium actually results in the passing of control to the plan. For example, it may be difficult to determine that a plan paying a control premium has received control in fact where it is reasonable to assume at the time of acquisition that distribution of shares to plan participants will cause the plan’s control of the company to be dissipated within a short period of time subsequent to acquisition.<sup>1</sup> In the Department’s view, however, a plan would not fail to receive control merely because individuals who were previously officers, directors or shareholders of the corporation continue as plan fiduciaries or corporate officials after the plan has acquired the securities. Nonetheless,

the retention of management and the utilization of corporate officials as plan fiduciaries, when viewed in conjunction with other facts, may indicate that actual control has not passed to the plan within the meaning of paragraph (b)(4)(ii)(I) of the proposed regulation.

The DOL proposed regulation (albeit withdrawn) provides some guidance regarding when it may be appropriate for an ESOP to pay an ownership control price premium for employer corporation stock.

**PROCEDURES FOR APPLYING AN OWNERSHIP CONTROL PREMIUM WHEN THE ESOP BUYS/SELLS A MAJORITY BLOCK OF STOCK**

When the ESOP buys (or sells) a controlling block of the employer corporation stock, the ESOP trustee should expect to pay (or receive) a level of consideration that reflects the control value of the economic benefits received (or transferred). As mentioned above, this level of consideration (1) may already be reflected in the initial value indication of the selected valuation approach/method or (2)

may need to be adjusted into the price through the application of an ownership control premium. That is, the financial adviser's consideration of the ownership control price premium is affected by the manner in which the economic benefits of control were quantified in the selected valuation approach/method.

Let's assume the financial adviser is retained by the ESOP trustee to estimate the fair market value of a controlling ownership position in a sponsor company. In such an assignment, the financial adviser often may attempt to use business valuation methods that directly provide value indications on an enterprise level basis.

One of the benefits of using valuation methods that directly provide value indications on an enterprise level basis is that the financial adviser does not have to quantify a discrete ownership control premium. This is because the estimation of the ownership control price premium is often one of the more controversial aspects of the employer corporation business valuation.

Based on the quantity and quality of available data, the financial adviser may have to use business valuation methods that produce value indications on a noncontrolling ownership interest level of value. In such instances, the financial adviser should estimate the appropriate level of ownership control price premium to apply to the value indication.

As discussed above, the ownership control price premium is typically based on the financial adviser's analysis of merger activity in the subject sponsor company's industry.

The financial adviser should conclude that the selected ownership control premium included in the final value opinion is supported by (1) market transaction data and/or (2) the expected economic benefits of ownership control. That is, the selected ownership control price premium may reflect a combination of (1) the impact of sponsor company adjusted economic income and (2) the application of some level of ownership control price premium.

### APPLICATION OF AN OWNERSHIP CONTROL PREMIUM WHEN THE ESOP BUYS LESS THAN A MAJORITY OF THE STOCK

In certain circumstances, the financial adviser may apply an ownership control premium even when the ESOP buys less than a majority of the sponsor company outstanding stock.

According to the DOL proposed regulation:

. . . if the plan purchases employer securities in small increments pursuant to an understanding with the employer that the employer will eventually sell a controlling portion of shares to the plan,

a control premium would be warranted only to the extent that the understanding with the employer was actually a binding agreement obligating the employer to pass control within a reasonable time.

In these circumstances, the ESOP should be able to pay the same amount that a hypothetical third-party buyer would pay for the subject block of employer corporation stock. There are several considerations that financial advisers use to evaluate the appropriateness and magnitude of an ownership control premium when an ESOP purchases less than a majority block of employer stock.

Some of these considerations include:

1. whether there is a binding contractual agreement granting the ESOP trustee the right to acquire enough employer voting stock to give the ESOP ownership control;
2. whether the ESOP is able to exercise the right to acquire operational control within a reasonable amount of time after the subject employer stock purchase;
3. an analysis of (a) all the rights that will accrue to the ESOP upon receipt of ownership control and (b) any rights related to ownership control that the ESOP will not receive; and
4. whether there is any ceiling or oversight rights regarding employee/shareholder compensation and other perquisites, especially to the selling shareholder(s), during the stock purchase option period.

### APPLICATION OF AN OWNERSHIP CONTROL PREMIUM IN CIRCUMSTANCES OF A GRADUALLY INCREASING ESOP OWNERSHIP

The gradually increasing percentage ownership by the ESOP of the sponsor company stock is usually the result of either (1) the purchase by the ESOP of additional sponsor company shares, (2) sponsor company stock contributions to the ESOP, or (3) the repurchase of non-ESOP shares by the sponsor company.

In these situations, over a period of time, the ESOP may move from a noncontrolling ownership interest position in the sponsor company to a controlling ownership interest position in the sponsor company. In such situations, the financial adviser may apply an ownership control premium to the valuation of the subject employer stock.

This ownership control premium should reflect what a hypothetical buyer would be willing to pay for the economic benefits of ownership control enjoyed by the ESOP-owned block of employer stock.

## SUMMARY OF THE CONSIDERATIONS WITH RESPECT TO THE APPLICATION OF AN OWNERSHIP CONTROL PRICE PREMIUM

This portion of the discussion identifies financial adviser considerations with regard to the fair market valuation of sponsor company stock on an enterprise, or controlling ownership interest, basis.

As the adviser to the ESOP, the financial adviser should provide sound advice to the ESOP trustee, whether related to a stock purchase or a stock sale. Accordingly, the above-mentioned ownership control premium considerations should be reflected in the financial adviser's value conclusion.

A failure on the part of the financial adviser to appropriately address these ownership control premium considerations may result in: (1) an ESOP employer stock purchase/sale transaction that is ultimately unwound by the regulatory authorities, (2) the imposition of significant excise taxes and penalties on the selling stockholders, and (3) the assignment of professional liability to the plan fiduciaries.

## OVERVIEW OF ESOP REPURCHASE LIABILITY VALUATION CONSIDERATIONS

For all ESOPs created after 1979 (and for leveraged ESOPs created after 1976), the sponsor company is required to provide a "put option" to the ESOP participants. The put option is provided at the time when the employer corporation stock is allocated to the individual ESOP participant accounts. This put option is described in Internal Revenue Code Section 409(h). This put option is required for distributions (i.e., from the ESOP trust to the ESOP plan participants) of any employer corporation stock that is not "readily tradable on an established market."

This put option typically creates both an immediate and a future share repurchase obligation on the part of the sponsor company with a maturing ESOP. This ESOP share repurchase obligation is commonly referred to as the sponsor company "repurchase liability."

As the typical leveraged ESOP matures (and the employer stock acquisition debt is paid down), the repurchase liability becomes an increasing financial obligation for the sponsor company.

Financial advisers should consider this obligation (particularly with regard to mature ESOPs) in the employer stock valuation process. Accordingly, the financial adviser's due diligence often involves consideration of how the sponsor company is managing (i.e., preparing for) its ESOP repurchase liability.

## PROCEDURES FOR SPONSOR COMPANIES TO MANAGE THE REPURCHASE LIABILITY

Before the issue of the repurchase liability becomes a serious financial concern, sponsor company management can address this future obligation through proper plan design. The sponsor company can impact the timing and, to a lesser degree, the magnitude of the repurchase liability by designing the plan with future share distributions in mind.

When adopting the specific ESOP plan, the sponsor company has a certain degree of flexibility in the structuring, timing, method, and form of share distributions from the trust to the ESOP participants. In addition, once the employer stock shares are "put" to the sponsor company by the ESOP participant, the sponsor company has some flexibility in how it will repurchase the shares.

There are two common types of distributions from the plan trust to the individual ESOP participant accounts: (1) in-service distributions and (2) termination of employment distributions.

Termination of employment distributions typically represent the largest component of the sponsor company repurchase liability. However, termination of employment distributions are somewhat more predictable and, therefore, can be more effectively managed by plan design considerations.

The following discussion presents the common elements of termination of employment distributions that have the greatest impact on the sponsor company repurchase liability:

1. **Timing of the Distribution.** Related to death, disability, or retirement, distributions must commence no later than one year after the ESOP participant's termination from the employer corporation. Generally, for other terminations, distributions can commence as late as the end of the sixth plan year after the ESOP participant's termination from the employer corporation.

The subject ESOP plan can be designed to accelerate the distributions or to postpone the distributions, as the law allows. Accordingly, to some extent, the sponsor company can defer the current repurchase liability. However, the sponsor company assumes the risk associated with any employer stock price fluctuation over the deferral period, if the ESOP participant's account balance remains invested in the employer stock.

2. **Method of Distribution.** The ESOP plan may be designed to allow for either (1) lump sum distributions or (2) installment payouts. Installment distributions can be made to the ESOP participant over a maximum period of five years.
3. **Form of the Distribution.** The distribution must be evidenced by a note (1) with adequate collateral (2) that bears a reasonable rate of interest. Distributions

can take the form of (1) cash or (2) employer stock. In general, ESOP participants have the right to demand shares of employer stock as the form of distribution for specified time periods.

Distributions in the form of employer stock tend to defer the repurchase liability. However, the sponsor company still faces the risk of employer stock price fluctuation going forward (thereby reducing the predictability of the repurchase obligation). In addition, many plan documents limit the ownership of the employer shares to current employees. This plan requirement would mean that distributions to terminated employees must be made in the form of cash.

4. **Leveraged ESOPs.** For leveraged ESOPs, the timing of the distributions can be deferred until the plan year following the plan year in which the ESOP stock acquisition loan is repaid. This deferral relates to an ESOP loan that is used to purchase the employer shares from the terminated ESOP participants—and not to any subsequent loans.

Financial advisers should realize that the sponsor company should exercise care when using the ESOP debt period to defer distributions. This is because a large repurchase liability will accrue and become due all at once at the end of the ESOP loan period.

Plan fiduciaries should note that, once the various plan provisions are in place with regard to ESOP distribution provisions, it may be difficult to amend these provisions. For example, the Internal Revenue Code prohibits the limitation of any optional form of benefits once these benefits have accrued to the plan participants.

Plan fiduciaries should also note that there are various interpretations of this Internal Revenue Code restriction. Nonetheless, careful plan crafting in the initial ESOP design can go a long way toward providing the necessary flexibility in dealing with this sponsor company repurchase liability distribution issue.

## THE STOCK REPURCHASE DECISION VERSUS STOCK REDEMPTION DECISION

In meeting its repurchase obligation, the employer corporation has the option either to (1) repurchase or (2) to redeem the ESOP participant's employer shares. While this option initially appears fairly straightforward, there are long-term financial implications of the stock repurchase versus stock redemption decision. The differences between these two alternatives are significant both (1) from an employer stock valuation perspective and (2) from an ownership dilution perspective.

The differences between the two types of repurchase obligation fulfillment options can be summarized into the following five transactional factors:

1. **Type of Transaction.** A stock redemption transaction changes the ownership of the employer shares from the ESOP to the sponsor company. Therefore, this type of transaction is considered a capital transaction.

Alternatively, a stock repurchase transaction does not change the ownership of the employer shares (i.e., the employer shares remain part of the ESOP ownership position). In a stock repurchase transaction, the ESOP trust pays for the plan participant's shares, using funds provided by the employer corporation contribution.

2. **Ownership Distribution.** In a stock redemption transaction, the ownership of the employer shares passes from the plan participant to the sponsor company. If the redeemed shares are held in treasury (i.e., cancelled), then both (1) the number of shares outstanding changes and (2) the relative ownership of all remaining shareholders increases (including the ESOP).

Alternatively, in a stock repurchase transaction, the employer shares are recirculated within the ESOP. Therefore, the total number of employer corporation shares outstanding does not change.

The repurchased shares are re-allocated to existing ESOP participants. This reallocation is based on the ESOP participants' current year relative compensation. The relative ownership of the remaining employer corporation shareholders (considering the ESOP as a single shareholder) does not change.

3. **Cost of Handling Stock Repurchases.** The cost of purchasing employer shares from terminated ESOP participants is a function of: (1) the number of employer shares required to be purchased and (2) the stock price (i.e., fair market value) of the employer shares.

The magnitude of the cost is the same for the repurchase transaction as it is for the redemption transaction. However, the stock repurchase transaction can typically be financed with pretax dollars. In contrast, the stock redemption transaction will be financed with after-tax dollars.

4. **Valuation of the Employer Corporation.** The appropriate discount for lack of marketability applied to the value of the employer corporation shares may be affected by this repurchase obligation option decision. This is because the stock repurchase decision "re-circulates" the employer shares, perpetuating (1) the ESOP ownership and (2) the incumbent repurchase liability. In contrast, the stock redemption decision reduces the number of employer shares outstanding.

However, the stock redemption may not reduce the value of those employer shares. Therefore, the stock redemption decision typically does not reduce the employer corporation total repurchase liability.

The fair market value of the employer shares, on an individual shareholder level, does not change in a stock redemption transaction. The total fair market value

of the employer corporation stock is reduced by the amount of the stock repurchase. However, the redemption of the employer shares increases each remaining shareholder's relative ownership position. Therefore, the stock redemption transaction is nondilutive at the shareholder level.

The total fair market value of the employer corporation is reduced by the amount of the stock repurchase in a stock repurchase transaction. However, the shares outstanding remain the same after the repurchase transaction. Therefore, the stock repurchase transaction is dilutive at the individual shareholder level.

Financial advisers (and ESOP fiduciaries) should consider this decrease in the value of the sponsor company resulting from the repurchase liability. In order for the employer corporation to manage the repurchase liability, it is possible to manage this potential decrease in sponsor company value.

If the level of the repurchase liability is within the normal industry range (or "market level") of employee benefits, then the cost associated with the employer stock repurchase decision does not necessarily decrease the sponsor company value.

The transaction is not dilutive in nature, and the ESOP ownership position in the sponsor company (in both absolute terms and relative terms) is perpetuated.

5. Perpetuation of the ESOP. The size of the ESOP is an important consideration in estimating the employer corporation repurchase liability. Obviously, the larger the ESOP, (a) the greater the number of plan participant terminations and (b) the greater the potential magnitude of the repurchase liability.

In the stock repurchase transaction, the number of employer shares outstanding remains constant. As a result, both the absolute ownership position and the relative ownership position of the ESOP remain static.

In the stock redemption transaction, in contrast, both (1) the absolute ownership position and (2) the relative ownership positions of the ESOP are reduced. Over a lengthy period of time, the impact of this change in ownership can be (1) a loss of the ESOP's ownership control position, (2) a reduction in the size of the ESOP, or (3) the eventual termination of the ESOP.

## SUMMARY OF THE CONSIDERATIONS WITH REGARD TO THE REPURCHASE LIABILITY

The stock repurchase versus stock redemption decision may have a material effect on the ESOP, on the sponsor company, and the ESOP participants. All constituents to the ESOP transaction should consider the employer corporation repurchase liability.

The financial adviser (and the ESOP trustee) should consider (1) the timing of ESOP distributions (as estimated

by a repurchase liability study) and (2) the potential cash position of the sponsor company (i.e., whether the sponsor company is leveraged, cash constrained for growth, cash rich, etc.). However, the stock repurchase versus stock redemption decision can help the sponsor company to manage its repurchase obligation.

The employer corporation repurchase liability is an important component of any ESOP formation. The success of the ESOP is affected by the sponsor company's ability to understand and to manage its repurchase liability.

## SUMMARY AND CONCLUSION

This discussion summarized several independent financial adviser issues with regard to the valuation of employer corporation stock for various ESOP purposes. In particular, this discussion focused on:

1. financial adviser services and opinions with regard to ESOP employer stock purchase/sale transactions,
2. financial adviser practices with regard to the typical employer stock value decrease associated with a leveraged ESOP transaction,
3. financial adviser level of value considerations with regard to the application of an ownership control price premium in the valuation of employer stock, and
4. financial adviser valuation considerations (and sponsor company management decisions) related to the impact of the ESOP repurchase liability.

Financial advisers who practice in the ESOP arena should be familiar with the current professional practices related to these issues.

In addition, ESOP trustees, other ESOP professional advisers (e.g., legal counsel, accountants, etc.) and ESOP participants should also be aware of the employer stock valuation implications of these ESOP transaction, financing, and administration issues.

### Notes:

1. However, the DOL notes that the mere pass-through of voting rights to plan participants would not, in itself, affect a determination that a plan has received control in fact. This is true notwithstanding the existence of plan participant voting rights. The determinative consideration is whether the plan fiduciaries having control over the plan assets could resell the sponsor company shares to a third party and receive a control level price premium.

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