

## The Business Appraiser As ESOP Trustee

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Since the passage of the Employee Retirement Income Security Act (1974) (ERISA), more and more companies have opted to share ownership with their employees. This act created Employee Stock Ownership Plans (ESOPs) as the vehicle to foster this form of worker capitalism.

This industry specific valuation paradigm requires the interpretation of correlations arising

It has been estimated that approximately 11,500 U.S. corporations have adopted ESOP plans and trusts. Among other requirements, the company stock held by the ESOP needs to be valued at least annually by a qualified appraiser. The determination of fair market value is the traditional role played by the business valuation expert. However, the complexity of some ESOP transactions, case law developments, and the maturity of many plans create the need for special situation trustee services.

A recent members' survey conducted by the ESOP Association reports that 72% of all U.S. ESOPs are self-trusted. With the maturing of many of these companies, mergers/acquisitions, recapitalization, and consolidations are clearly on the rise. These activities often create a high degree of concern for "internal" trustees. It becomes difficult for many people serving as "directed trustees" to perform their functions in the context of a "deal" situation. In the normal course of business, ESOP trustees are not independent, but serve at the will of the board and officers. These directed trustees have dual, and often conflicting, directives. They must follow the instructions of their superiors as well as adhere to ERISA rules. Many conflicts of interest may arise. Consider the situation where the president of the company is: 1) a participant in the ESOP; 2) a shareholder; 3) holds stock options; and 4) serves as trustee. An offer is made topurchase the company or its assets. Can this individual be considered to be an objective fiduciary? We think not.

Anyone who can be designated as a "disqualified person" appears to be at risk. Disqualified persons are generally considered to be those who provide services to the plan, those who own more than half of the company, the company itself, certain employee owners, and company officers and directors. ERISA fiduciaries are generally identified in one of three classes (Sect. 3 (21)):

1. Those who manage or dispose of plan assets;
2. Those who offer investment advice;
3. Those who administer plans.
4. The independent trustee falls into Category 1.

The first question that comes to mind is: "Why not just hire a traditional institutional trustee?" That may be a viable alternative, but it is not the only one. The "Kroy" case provides some insight into the potential pitfalls of limiting the company to that singular option.

In the Kroy case (Reich v. Valley National Bank of Arizona, 1993 U.S. Dist. Lexis 11837 - August 19, 1993) the judge basically said the trustee did not perform the necessary duties required under ERISA to adequately discharge his fiduciary responsibilities. An ensuing suit against the appraiser by the trustee was decided in favor of the appraiser (Bank One Arizona v. Benchmark Valuation Consultants No. CV 94-14352 - October 25, 1999, Judge Kalish). The trustee was found liable even though he relied on a fair market value appraisal, a fairness opinion, and a "prudence opinion." Based on Kroy, the buck stops with the trustee in spite of the advice received from an independent financial advisor.

If "Kroy" serves as a wake-up call to trustees, then the recently decided "Dairy Fresh" case (Dairy Fresh Corporation v. Poole) is an alarm clock. In this case, an ESOP was established in 1988. The ESOP borrowed \$5.2 million to purchase newly issued company shares. What happened next is bizarre, but not unique. Post-transaction, the ESOP held 88% of the outstanding shares. It should have received far less, but the appraiser double counted the debt: once on the balance sheet of the company, and again on the liabilities of the trust. Seven years later, as part of other litigation, the non-ESOP shareholders uncovered the mistake and pursued legal remedies to "reform" the original transaction. This error came to the attention of the Department of Labor (DOL). The DOL filed claims against the company and the trustee.

The company's claim against the trustee for the initial botched transaction did not find favor with the court. However, the DOL's claims against the company and the trustee did.

The court found the company (serving as plan administrator) in violation of ERISA. Further, the court determined that the trustee violated his duty of loyalty and prudence. Both the company and trustee were permanently removed as fiduciaries. It is unlikely that an experienced ESOP valuation practitioner, serving as trustee, would have found himself in this kind of situation.

## Functions to Perform

The activities conducted by the appraiser/trustee differ according to facts and circumstances. The most crucial variable is whether the ESOP is the buyer or the seller. The trustee is equally liable in either case. The activities precedent to the sale of an ESOP company would include the following activities:

- Review ESOP plan and trust
- Review bylaws and related documents (minutes)
- Analyze stock register
- Review purchase offer
- Read and analyze all prior appraisals and support documents
- Interview appraiser and review files
- Collect all plan administrator reports and calculations
- Notify employees of the offer
- Negotiate transaction and terms
- Negotiate closing documents
- Negotiate non-competition agreements and payments
- Collect money and disburse funds
- Terminate trusteeship

These duties are not performed in a vacuum, but with ongoing input from the other trust advisors. A buy-side due diligence outline would look somewhat similar, but the trustee would be concerned with financing issues, at least with respect to ERISA requirements, including:

- Terms of the loan(s) including interest rates
- ESOP capacity to repay debt
- In S-corporations, the availability of distributions to amortize debt
- The existence and servicing requirements of other corporate debt
- Other potential claims against cash flow
- Repurchase liability

It's considered to be imprudent for a trustee to allow an ESOP to take on debt that it does not have a good chance to repay. A financial analysis of the company's earning capacity and debt repayment viability needs to be prepared and analyzed by the trustee for acceptability.

The interest rate on ESOP loans must be reasonable and the timing and duration of loan repayment palatable to the plan and the company's capacity. It may be advisable to use "super-common" or convertible preferred stock in situations where payroll is too low to amortize debt with payroll based contributions alone (C-corps). For "S" corporation ESOPs, the company's ability to pay distributions must be considered in the overall financing structure.

## **The Houlihan Valuation Advisors Approach**

We believe that it takes three skill sets to serve capably in the capacity of transaction trustee in an ESOP context. They are:

- ESOP knowledge and experience
- Valuation and fairness expertise
- Transaction experience

It goes without saying that a thorough knowledge of the ESOP environment is critical to the process. We have worked with plan fiduciaries for 25 years and experienced a broad variety of situations that are truly unique to ESOPs. During that time frame we have been involved in providing hundreds of valuation and fairness opinions to trustees in almost every industry imaginable. We live in the business transaction world, be it a merger, acquisition, consolidation, spin-off, roll-up, IPO, or bankruptcy reorganization.

In addition to possessing the requisite experience to serve as independent trustee, we find that our selection is cost effective. Our research indicates that most institutional trustees require a fairness opinion on any significant ESOP transactions. That is because they don't possess the skills necessary to perform the required activities. A fairness opinion can cost the company (or the ESOP) from \$20,000 to \$100,000 or more.

In most instances HVA does not require a fairness opinion. Rather, HVA will perform a due diligence review of the work performed by the appraiser selected to value the company shares being



bought or sold by the ESOP. Waving the fairness opinion is not done just to save fees. From our perspective, it's just not practical. We asked several noted ESOP attorneys if getting a fairness opinion would lower the transaction risk profile. In each instance the answer was "no." The appraiser/trustee will be held to a higher standard. After all, HVA renders financial opinions every day, for a living. How could HVA possibly hide behind an opinion provided by others when this is a staple product offered by the firm?

In summary, the role of the ESOP transaction independent trustee is complex and requires a multiplicity of talents. A fundamental understanding of ESOPs, legal precedents, and ERISA requirements are necessary. A thorough knowledge of valuation principles and procedures lend credibility to the trustee's determination of adequate consideration. Experience in sophisticated financial transactions is a cornerstone, underpinning the entire decision making process.

For more information regarding this service offering, please call Allan Lannom FASA at our Chicago office (312-499-5970) or e-mail him at [alannom@houlihan.com](mailto:alannom@houlihan.com).