

What you need to know about ESOP valuation season



Dale R. Vlasek, Carl J. Grassi, Patrick J. Berry, Jason M. Smith, James E. Stief, John M. Wirtshafter | Friday, March 16, 2018

It's valuation season for employee stock ownership plans (ESOPs). As the first valuation season following the September 2017 First Bankers Trust settlement, now is a particularly good time for ESOP companies to carefully consider all items their plan trustees will need to review as part of the valuation process.

IMPACT OF FIRST BANKERS TRUST SETTLEMENT ON FIDUCIARY RESPONSIBILITY

On Sept. 21, 2017, First Bankers Trust Services, Inc. entered into a settlement agreement with the Department of Labor regarding its handling of the purchase of Maran, Inc. by the Maran, Inc. ESOP, for which First Bankers was the trustee. While the settlement agreement is similar in many respects to the agreement that GreatBanc Trust Company entered into in 2014 with the Department of Labor with respect to its handling of the purchase of Sierra Aluminum Company stock by the ESOP sponsored by Sierra, it includes some material additions.

Even though the settlement agreements technically only apply to First Bankers and GreatBanc (and arose in a litigation context) they are being incorporated into the ongoing fiduciary responsibility of trustees more generally. Thus, it's reasonable to expect that most ESOP trustees will be looking to meet the settlement agreement requirements as a way of satisfying their fiduciary obligations.

The requirements of the settlement agreements that ESOP companies and plan trustees should pay particular attention to are generally broken down into the following parts:

What you need to know about ESOP valuation season

- A. **Selection and Use of Valuation Advisor – General.** This section describes the steps the ESOP trustee must take in order to have acted prudently in selecting the valuation advisor. In addition to the steps previously required under the GreatBanc settlement, the First Bankers settlement requires that a trustee document what steps it took to determine that the valuation advisor has received complete, accurate, and current information and to ensure the trustee understood the advice of the valuation advisor.
- B. **Selection of Valuation Advisor – Conflicts of Interest.** The ESOP trustee must ensure that the valuation advisor has not done work for the ESOP sponsor or any other party involved in the transaction (other than the ESOP and its trustee). The First Bankers settlement specifies that this includes any committee of employees of the plan sponsor.
- C. **Selection of Valuation Advisor – Process.** The ESOP trustee must undergo a specific process for selecting the valuation advisor. Under the First Bankers settlement, this process must also include at least three references and consideration of whether the advisor has been subject to any regulatory proceedings.

Note that, similar to the GreatBanc settlement, under the terms of the First Bankers settlement, the trustee does not need to undertake a new analysis if:

- The trustee previously performed the analysis in connection with a prior engagement or as part of a vendor risk management program.
 - The previous analysis was performed within the prior calendar year.
 - The trustee documents that it previously performed the analysis, the date(s) of the analysis and the results of the analysis.
 - The advisor certifies that the information is still accurate, including as part of a vendor risk management file.
- D. **Oversight of Valuation Advisor – Required Analysis.** The valuation report must include specific information, including:
- The company projections used in the valuations.
 - How plan documents may affect future repurchase obligations, the prudence of the stock purchase or the fair market value of the stock.
 - The terms and effects of ESOP sponsor debt.
 - The fairness of the transaction; and the financial impact of the proposed transaction on the ESOP sponsor.
- The First Bankers agreement also requires that the report include:
- Whether the terms of any ESOP loan are as favorable as the terms of any loan. between the plan sponsor and any executive of the plan sponsor made within the preceding two years.
 - The risks facing the plan sponsor that could cause the sponsor's financial performance to fall materially below the projections.
 - Any material differences between the present valuation and the most recent prior valuation performed within the past 24 months.
- E. **Financial Statements.** The valuation must be based on audited unqualified financial statements for the preceding five years. If any financial statements are unaudited or qualified, the trustee must

What you need to know about ESOP valuation season

determine and document whether it is prudent to rely on such statements. Further, under the First Bankers settlement, the trustee can approve a transaction even though it is relying on qualified or unaudited financials only if the stock purchase agreement requires the selling or purchasing shareholders who are officers, managers, or members of the board of directors to compensate the ESOP for any losses, etc. related to financial statements that did not accurately reflect the plan sponsor's financial condition.

- F. **Fiduciary Review Process – General.** The trustee must critically review company financials and projections and determine if it is reasonable to rely on them. Under the First Bankers settlement, the trustee must also ensure that the valuation advisor receives the following information:
 - Any prior attempts to purchase or sell stock within the proceeding two years.
 - Any prior defaults within the past five years by plan sponsor under any lending or financing arrangement.
 - Any management letters provided to the plan sponsor by its accountants within the past five years.
 - Any information related to the valuation of the plan sponsor provided to the IRS within the past five years.
- G. **Fiduciary Review Process – Documentation of Valuation Analysis.** The trustee must document its analysis of final valuation report, addressing various specific metrics.
- H. **Fiduciary Review Process – Reliance on Valuation Report.** The trustee must document that it has critically assess the valuation report, and must take specific steps in doing so. It must also document the individuals responsible for the proposed transaction and their material points with respect to it.
- I. **Preservation of Documents.** The trustee must create and preserve, for at least six years, specific documents pertaining to the transaction, including a certification by each employee who was primarily responsible for the transaction, any employee who participated in decisions on whether to proceed or the price of the transaction, or any other employee who made any material decision, that they have read the valuation report, identified its underlying assumptions, and considered the reasonableness of the report's assumptions and conclusions
- J. **Fair Market Value.** The debt financing the transaction cannot exceed the securities' fair market value.
- K. **Control.** Under the First Bankers settlement, if the ESOP cedes any degree of control, the trustee must document any consideration received in exchange, or how the limitation is otherwise reflected in the purchase price, and why it is fair to the ESOP. Also, if the ESOP pays a control premium, the trustee must document why it believes the ESOP is obtaining voting control and control in fact, and identify any limitations on such control as well as the specific amount of consideration the ESOP received for such limitation(s).
- L. **Consideration of Claw Back.** The trustee must consider whether it is appropriate to request a claw-back arrangement or other purchase price adjustment in the event of a significant corporate event or changed circumstances or other purchase price adjustment(s)

What you need to know about ESOP valuation season

M. **Other Professionals.** The trustee may employ or delegate fiduciary authority to qualified professionals

Some employers may be wondering, “Can we continue to use the valuation firm the ESOP has been using?” “Should we and the trustee be doing periodic due diligence on the firms?” “How does this affect our internal (non-commercial) trustees?” “Will these agreements change what the trustee wants from the employer?”

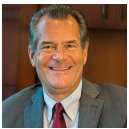
The answers to each of these questions vary, but ESOP companies should keep in mind that all ESOP trustees, including internal trustees, will most likely be looking to meet these requirements. This means that your ESOP trustee will need to consider whether the valuation expert that you wish to use may have a conflict of interest depending on work it has done previously or may be doing for the company or the other non-ESOP shareholders.

In addition, it is appropriate to review the expert’s credentials periodically and to assess the expert valuation methodology. Of course, making that assessment will most likely require outside expertise. It’s also possible that the ESOP trustee and its valuation advisor will be asking for more information from the employer – some of which may never have been requested before. All of this may require additional time, resources and patience from ESOP companies.

While all the extra effort may seem to be a waste of time, it is actually time and effort well spent to be able to demonstrate that all parties – the trustee, the valuation firm, the employer and the ESOP – are fulfilling their ERISA duties.



Dale R. Vlasek



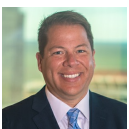
Carl J. Grassi



Patrick J. Berry



Jason M. Smith



James E. Stief



What you need to know about ESOP valuation season



John M. Wirtshafter