ESOPs and Valuations: Increasing Risks for Valuation Firms, IQPAs and Trustees

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Background

An Employee Stock Ownership Plan, or ESOP, is an IRC Section 401(a) qualified defined contribution plan that is a stock bonus plan or a stock bonus/money purchase plan. An ESOP is required to invest primarily in qualifying employer securities as defined by IRC Section 4975(e)(8). The ESOP's technical form is a trust which buys the employer's stock and holds that stock for the benefit of employees who participate in the plan. According to an article entitled, "When Employees Acquire the Company: ESOPs Offer an Attractive Alternative in Alaska," which appeared in the July 2013 edition of *Alaska Business Monthly*, ESOPs are "increasingly becoming more popular in Alaska" and "[i]n Alaska, S corporations, limited liability companies, and smaller businesses are more likely to become employee-owned entities."

ESOPs are gaining in popularity because they allow employees to become owners of the business – thus invested in its success. According to the 2013 Annual Economic Performance Survey by the Employee Ownership Foundation, 77% of respondents indicated that an ESOP positively impacted overall employee productivity, and 94% indicated that creating employee ownership through an ESOP was a "good business decision that has helped the company." Of course, ESOPs also are being used more frequently due to the significant tax benefits offered by ESOPs to the involved parties. These include:

- Owners of closely held C corporations can under IRC Section 1042 defer capital gains tax on stock sold to an ESOP if (i) the ESOP owns 30% or more of each class of outstanding stock or of the total value of all outstanding stock, and (ii) the owners roll over sale proceeds into qualified replacement property, defined as bonds or stocks of domestic operating companies, within a period commencing three months before the ESOP sale and ending 12 months after the sale. Owners who sell their interest in the business are paid in pre-tax dollars from the ESOP and the buyout can be based on a timetable that allows the owners to continue their involvement for a number of years, if desired. Some or all of the sale proceeds can be rolled over into qualified replacement property, and the amounts rolled over are not required to be actual proceeds of the sale but can be equivalent funds from other sources. ESOPs are permitted shareholders of S corporations and the contribution and deduction limits are equal to those of a non-leveraged C corporation ESOP. Although S corporation ESOPs do not qualify the owners for IRC Section 1042 treatment and the S corporation cannot deduct retirement plan contributions for any ESOP participant, an ESOP that holds shares in the S corporation is not taxed on its share of corporate earnings.

- Employer contributions to the ESOP are tax deductible up to a limit of 25% of covered payroll, including employer contributions to other defined contribution plans. Reasonable dividends paid by a C corporation on ESOP held stock is deductible if made in accordance with required conditions, including on dividends voluntarily reinvested in the ESOP by employee participants. Because the ESOP is an entity exempt from federal and state income tax, an ESOP which owns the company can use pre-tax earnings to invest in the business or make acquisitions.

- Employees are taxed on the stock allocated to their ESOP accounts only when they receive a distribution on termination, resignation, disability or death. If the distribution is rolled over into a traditional IRA or successor plan by the employee, then the employee may continue to enjoy tax deferral until the funds are withdrawn.

The foregoing discussion is not exhaustive, but is illustrative of the types of tax benefits which ESOPs can provide to owners, companies and employees. There are additional eligibility requirements and limitations that apply to ESOPs, employee participants, and ESOP contributions that the practitioner must consider when advising a party to a proposed ESOP transaction.

The DSS Case and the Increase in Suspect ESOP Valuations

When a company becomes an ESOP sponsor and administrator, the board of directors of the company appoints trustees for the ESOP. Among their duties, the trustees must fix the price which will be paid for the business or for a qualifying interest. That price is generally determined by a valuation performed by an independent appraiser. This process often raises two issues that are sometimes related, *i.e.*, who are the trustees of the ESOP, and who provides the valuation? If the trustees also happen to be significant shareholders of the company, and the valuation firm is engaged by the trustees, it is easy to see where a valuation firm may be inclined to arrive at a valuation that is unsupported by the financial performance of the company.

On June 4, 2013, the Department of Labor (DOL) filed a suit against Digital Satellite Services, Inc. ESOP, Digital Satellite Services, Inc. Employee Individual Account Plan (EIAP), and James Roorda, CPA, which was based on a fact pattern similar to that described above. In this case, Ron and Dawn Phillips, the 100% owners of Digital Satellite Services, Inc. ("DSS"), caused DSS to set up the ESOP and EIAP Plans in 2003 and 2004. Ron and Dawn were the sole members of the DSS board of directors, and had authority to appoint and remove trustees of the Plans.

Ron and Dawn appointed themselves as trustees to the Plans, along with Ken Shields (the CFO of DSS) and Robert Eddy. Although Mr. Eddy was appointed a special trustee on June 17, 2005, Ron and Dawn did not recuse themselves from participating in the meetings at which the trustees established the stock purchase price in transactions that occurred in 2004 and 2005. Mr. Eddy was not a trustee when the first purchase of shares by the Plans occurred in September 2004, meaning that Ron and Dawn, together with the CFO, were the approving trustees of the initial purchase of stock from Ron and Dawn. In that transaction, the Plans purchased 300,000 shares of DSS stock from Ron and Dawn for $8.85 million.

According to the DOL, the trustees of the Plan relied on appraisals of DSS provided by Matthew Donnelly and his company, the Business Appraisal Institute. Donnelly and BAI provided fairness opinions and valuations for each of the stock purchase transactions in 2004 and 2005. In the words of the DOL:

- the trustees "did not consider whether BAI and Donnelly's valuations contained complete and accurate information about DSS and the market in which it operated, or realistic and sustainable projections;"
- the trustees "did not consider the price at which DSS was willing to sell its assets to…an unrelated entity in determining DSS's fair market value for the Transactions in which the Phillips sold their DSS stock;" and
- "BAO and Donnelly's valuations for the Transactions were in excess of fair market value."

The DSS case was not unusual in asserting that the valuation of a company for ESOP-related purposes was inaccurate, but the pace of these suits has recently picked up significantly. According to a letter from two members of Congress to the DOL dated September 5, 2013, the DOL filed only five suits related to deficient ESOP appraisals from the late 1980's to 2009, but brought ten such suits in the period from July 26, 2011 to September 5, 2013. *The Wall Street Journal* reported in June 2014 that DOL had filed 28 suits tied to ESOPs since October 2009, a 100% increase over the number of suits filed in the prior six years, and nearly all of which relate to valuations. Some believe that this increase is not coincidental, but is related to the 2010 proposal from the Employee Benefits Security Administration to redefine "fiduciary" under ERISA to include appraisers of private company stock. The AICPA noted in a July 2013 letter to Congress that the expansion of the fiduciary definition would conflict with the IRC's requirements that ESOP valuations be obtained annually from an independent appraiser. The AICPA questioned how a fiduciary could maintain an independent perspective while meeting the fiduciary's obligation to act solely in the interest of plan participants and beneficiaries.

Naming of the IQPA as a Defendant

The DSS case was highly unusual in one respect, however. Mr. Roorda, one of the named defendants, served as the Independent Qualified Public Accountant (IQPA), as defined in ERISA Section 103(a)(3)(A), to the Plans from November 2004 through October 2007. Mr. Roorda was alleged by DOL to have:

- "failed to test properly the valuation of the Plan's investments and failed to evaluate whether the Plans were in receipt of dividends declared by DSS;"
- "failed to act according to the requirements of ERISA…"
- performed work "riddled with errors, including improper identification of the Plans' attorney, improperly dated reports, and incorrectly listed Plan trustees;" and
- "knowingly participated in [the] fiduciaries' violations of Title I of ERISA…"

On March 26, 2014, Mr. Roorda's counsel advised the Court that a settlement had been reached with respect to Mr. Roorda. The remaining defendants settled with DOL in May 2014. While it is not clear what, if any, penalty was paid by Mr. Roorda or his firm, the DOL's election to name Mr. Roorda as a defendant in this suit represents a chilling reminder that CPAs who serve as IQPAs must exercise a high degree of care in discharging their duties. And at least as interpreted by the DOL, those duties include testing the valuation of an ESOP's investments and monitoring the actions of fiduciaries such as trustees.

Independent Trustees Come Under Fire for Reliance on Suspect Valuations

In a case settled in June 2014, GreatBanc Trust Company agreed to pay a financial penalty of $5.3 million assessed against it while acting as the successor trustee of Sierra Aluminum Co.'s ESOP in 2006. The DOL alleged that the ESOP purchased shares from the sellers for inflated values well above fair market value, and that the inflated values related to deficient appraisals relied upon by GreatBanc. The DOL maintained that the appraiser had unreasonably relied on Sierra Aluminum's aggressive projections that, among other things:

- projected cash flows for 2007 to 2011 of $60.3 million, while actual cash flows for 2000-2006 were only $25.6 million;
- utilized an improper discount rate for seller notes;
- unreasonably estimated future capex; and
- improperly adjusted cash flows by misstating expenses and profits, and overestimating projected growth.

GreatBanc was alleged to have failed to investigate the credibility of the assumptions, factual bases and adjustments that formed part of the appraisal. Worse, GreatBanc also was alleged to have asked for a revised valuation opinion in order to reconcile the ESOP's higher purchase price with the lower fair market value of the company stock.

Without admitting or denying the DOL's charges, GreatBanc agreed to institute a series of required practices that GreatBanc will follow when acting as trustee for any ESOP which is purchasing or selling, or considering a purchase or sale, of non-publicly traded securities. Announcing the settlement, Assistant Secretary of Labor for Employee Benefits Security Phyllis C. Borzi stated:

> "Others in the industry would do well to take notice of the protections put in place by this agreement. ESOPs are an important tool to promote employee ownership, *not a way to create big cash-outs for owners and top executives*."

The protections to which Ms. Borzi referred comprise ten typewritten pages, but the principal provisions obligate GreatBanc to:

- prudently investigate a valuation advisor's qualifications;
- take reasonable steps to determine the valuation advisor receives complete, accurate and current information for valuation purposes;
- prudently determine that the bank's reliance on the valuation advisor's advice is reasonable before entering into a transaction in reliance on the advice;
- not use a valuation advisor that previously performed work for the ESOP sponsor, a counterparty, or a structuring party (such as an investment bank) or use a valuation advisor that has a family or corporate relationship with any such parties;
- document the reason a particular advisor was selected, the advisors considered, the qualifications considered, a list of references and the results obtained, and a full analysis of the bases on which the bank's selection of the advisor was prudent;
- require the valuation advisor to document any conflicts of interest, the reasonableness of projections, the comparison of a variety of financial metrics on a historical to projected basis, and comparisons to comparable public companies (if any) over at least the last five years, such metrics to include at a minimum:
    - return on assets;
    - return on equity;

  - EBIT margins;
  - EBITDA margins;
  - ratio of capital expenditures to sales;
  - revenue growth rate; and
  - ratio of free cash flows (of the enterprise) to sales.

- to secure from the company (the Plan sponsor) audited unqualified financial statements prepared by a CPA for the preceding five fiscal years, unless those financial statements are unavailable, in which case the trustee will request audited unqualified financial statements extending as far back as possible;

- if the trustee or the valuation advisor is provided unaudited or qualified financial statements prepared by a CPA for any of the five preceding years, the trustee will determine if it is prudent to rely on such statements and, if so, will document the bases for the belief that it is prudent to rely on such unaudited or unqualified statements; and if the trustee cannot reasonably conclude it would be prudent to rely on such financial statements, the trustee will not proceed with the transaction.

Recommendations and Conclusion

Although ESOPs are a well-recognized and tax-benefitted method for owners to sell a business to employees, the developing trend in ESOP litigation poses challenges for any party that prepares, audits, or relies upon ESOP valuations. Prior to taking on an ESOP valuation or audit engagement, a CPA should first consider if prior work for the company sponsor or an affiliate creates the appearance of, or will actually create, a conflict of interest. If so, the CPA should decline the engagement. CPAs who prepare projections for ESOPs must ensure that those projections are reasonable, supportable, consistent with known facts, and contain reasonable assumptions. CPAs must also consider, where applicable, the requirements imposed by AT sec. 301, *Financial Forecasts and Projections*, on compiled, examined, or agreed-upon procedure engagements relating to prospective financial statements. Furthermore, a CPA firm providing

ESOP valuation services must follow the standards outlined in AICPA Statement on Standard for Valuation Services No. 1 when expressing a conclusion of value or a calculated value.

Firms that audit ESOP and other defined contribution plans must be especially sensitive to situations where ESOP trustees are company (sponsor) affiliates with inherent conflicts of interest, and when valuations secured by the trustees are based on unreasonable projections that often include unjustifiable assumptions. The DSS case teaches that CPAs who act as IQPAs may have a heightened duty to test valuations of plan assets when conflicts of interest are readily apparent and ESOP trustees appear to be violating the fiduciary duties imposed upon them. While CPAs are not charged with knowing the laws that govern fiduciary duties, the DSS case seems to imply that the IQPA has a greater responsibility in circumstances where trustee conflicts are obvious.

As for ESOP trustees, the case against GreatBanc is a stark reminder that DOL is not content with pursuing valuation firms that commit wrongdoing, but also will pursue trustees who unreasonably rely on faulty projections. Both individual and corporate trustees should review the agreement provisions between the DOL and GreatBanc Trust Company, which AKCPA members can find on the AKCPA web site at: http://www.akcpa.org/writable/news/settlement_agreement_undertakings_-_dol_and_greatbanc.pdf. Those provisions should be considered best practices when it comes to evaluating trustee fiduciary responsibilities related to valuation firms, valuations, and the content of valuation reports. Even though it may be impractical to apply all these provisions in small engagements, trustees who do so will definitely minimize the chances of being on the wrong end of a suspect ESOP valuation case. And as we've seen, these cases are becoming more prevalent and should therefore serve as a caution in ESOP engagements of all types.