



New Process Guidance for ESOP Trustees

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Introduction to the Brereton, Hanley & Co., Inc. Middle Market Corporate Finance Review

The Brereton, Hanley Corporate Finance Review is a periodic journal designed to assist management and investors in the middle market. The journal attempts to address and explain current and anticipated market influences, investor sentiment and the valuation implications of the economic environment; including private company acquisition activity. By introducing periodic data and highlighting critical market issues, we hope that the Brereton, Hanley Corporate Finance Review can help management and investors gain effective insight into the valuation and organization of their business.

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I. Overview

The Department of Labor (DOL) recently settled a case involving an employee stock ownership plan (ESOP) that provides guidance but also a warning for trustees and employers contemplating ESOP transactions that later go awry. In *Perez v. GreatBanc Trust Co.*, the DOL sued GreatBanc Trust Company (GreatBanc), the trustee of the Sierra Aluminum Company’s ESOP, claiming that GreatBanc relied on a flawed appraisal report to support the ESOP’s purchase of 3.4 million shares of company stock for \$53 million. The DOL claimed that GreatBanc failed to adequately inquire into an appraisal that presented unrealistic and aggressively optimistic projections of the company’s future earnings and profitability; failed to investigate the credibility of the assumptions, factual bases, and adjustments to financial statements that went into the appraisal; and asked for a revised valuation opinion in order to reconcile the higher purchase price the trustee agreed to pay with the lower fair market value of the company stock determined in earlier versions of the appraisal. The DOL and GreatBanc agreed to settle the case for \$5.25 million.

In addition to the monetary settlement, GreatBanc and the DOL agreed to a set of policies and procedures (“Process Requirements”) that GreatBanc must follow in the future when it is engaged to purchase or sell employer securities that are not publicly traded.

II. What are Process Requirements?

The Process Requirements issued do not create any direct obligation, but they do underscore the importance of a thorough and independent analysis. The Process Requirements are not: (i) an amendment to the law (ERISA), (ii) a DOL regulation, (iii) a DOL advisory opinion, or (iv) a DOL Field Assistance Bulletin.

That means, for example, the DOL could not cite these as legal authority or introduce the Process Requirements in court and ask a judge to find a trustee in violation of the Process Requirements.

Perhaps the best way to think about the Process Requirements is to consider them an insight into what the DOL expects of an ESOP Trustee when it is evaluating a purchase or sale of employer securities. While all trustees would not necessarily have to follow the same policies and procedures, the framework provides some indication of what the DOL may be looking for in an audit or other investigation. As such, trustees may want to consider incorporating some or all of the policies and procedures as part of their due diligence.

III. New Material Changes

The policies and procedures that the DOL and GreatBanc agreed to include the following:

Valuation Advisor Selection

With respect to the selection and use of a valuation advisor, the Agreement specifies that in all transactions involving the purchase or sale of employer securities that are not publicly traded, the Trustee will hire a qualified valuation advisor and in doing so will prudently investigate the valuation advisor’s qualifications, take steps to determine that the valuation advisor receives complete and accurate information needed to perform the valuation, and prudently determines that its reliance on the valuation advisor’s opinion is reasonable before entering into any transaction that relies on such opinion. In addition, the trustee must verify that the valuation advisor has no conflicts of interest, such as a familial or corporate relationship.

Financial Statements

The Trustee must request that the company provide the Trustee and its valuation advisor with audited unqualified financial statements prepared by a CPA for the preceding five fiscal years, unless financial statements extending back five years are unavailable.



III. New Material Changes (Continued)

In the absence of such audited financial statements, the Trustee is required to take certain steps before proceeding with the transaction, including additional documentation of why it has chosen to proceed.

Fiduciary Review Process

The Trustee must follow a specified process and document the valuation analysis. The Trustee's reliance on an appraiser's valuation report is contingent on taking certain steps and providing certain documentation. If the valuation report is not consistent with the analysis, then the Trustee must not proceed with the transaction. Again, the trustee is required to document its analysis of such issues.

Fair Market Value

The Trustee cannot cause an ESOP to purchase employer securities for more than their fair market value or sell employer securities for less than their fair market value. The Trustee cannot cause an ESOP to engage in a leveraged stock purchase transaction in which the principal amount of the debt financing the transaction exceeds the fair market value of the stock acquired with that debt, irrespective of the interest rate or other terms of the debt used to finance the transaction.

Additionally, the Trustee must consider (i) plan provisions regarding benefit distributions, (ii) the duration of the ESOP loan, and (iii) the age and tenure of the ESOP participants. The Trustee is then required to consider how these three items might affect: (i) repurchase liability, (ii) prudence of a stock purchase, or (iii) the fair market value of the stock purchased.

Trustees have often considered projected repurchase liability in evaluating the prudence of a transaction. However, it is possible the DOL is suggesting that a company with an older work force, or one that provides accelerated payout of benefit distributions, might be worth less because its obligation to repurchase shares may arise sooner than for another company. Given the complexity of generating a Repurchase Liability Study, this component is often missing in standard valuation reports. However, the impact of future repurchase liability on company value and operations is falling under increased scrutiny.

Fairness Opinion

The Process Requirements now require the inclusion of a number of financial fairness considerations that the appraiser must consider. While these items are standard in

a well written fairness opinion used in a complex transaction, these factors have not historically been relevant in a simple minority interest purchase transaction.

Consideration of Claw-Back

In evaluating proposed stock transactions, the Trustee is required to consider whether it is appropriate to request a claw-back arrangement or other purchase price adjustments to protect the ESOP against the possibility of adverse consequences in the event of significant corporate events or changed circumstances. The Trustee must also document in writing its consideration of the appropriateness of a claw-back or other purchase-price adjustments.

IV. Conclusion

These policies and procedures, in many ways, go beyond the stated requirements in the law. For example, while an ESOP trustee may ordinarily choose to document the retention of a particular appraiser, these policies and procedures impose stricter requirements including a written analysis of the reasons supporting the selection of a particular appraiser, which in all likelihood go beyond the customary practice for most trustees. Further, the requirements of the various written reports by the trustee, as opposed to the appraiser, will seemingly result in a great deal of duplication of effort with the almost certain increase in expense for the plan sponsor.

Although the settlement agreement technically only affects GreatBanc, all trustees should reevaluate their processes used in evaluating stock purchase transactions with respect to non-publicly traded companies in light of the settlement. Assistant DOL Secretary Borzi's press release quote, "*others in the industry would do well to take notice of the protections put in place by this agreement...*", could be interpreted as a cautionary tale to trustees who do not undergo a considered, careful, and well-documented process, per this new guidance.

References: U.S. DOL, ERISA News Release, 6/3/14, "US Labor Department reaches \$5.25M settlement with GreatBanc Trust"; Tax Management Inc., a Bloomberg BNA company, Arlington, VA.; ESOP Law Group.

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