



THE FAIR MARKET VALUE STANDARD: ARE THE DOL AND SOME COURTS GETTING IT WRONG?

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Today's Topics

Overview of ERISA Standards for an ESOP Transaction

Additional Sources of Guidance

What is “Fair Market Value”?

Where the DOL and Courts have Gone Wrong

Suggestions Going Forward



Overview of the Standards for an ESOP Transaction

ERISA Regulates the *Process*, Not the Final Value

ERISA 406(a)

Prohibited Transactions

- Prohibits fiduciary from causing a plan to transact with the sponsor company

ERISA 408(e)

Exemption for “adequate consideration”

- Permits ESOP stock purchases from sponsor company if for no more than adequate consideration.

ERISA 402(3)(18)

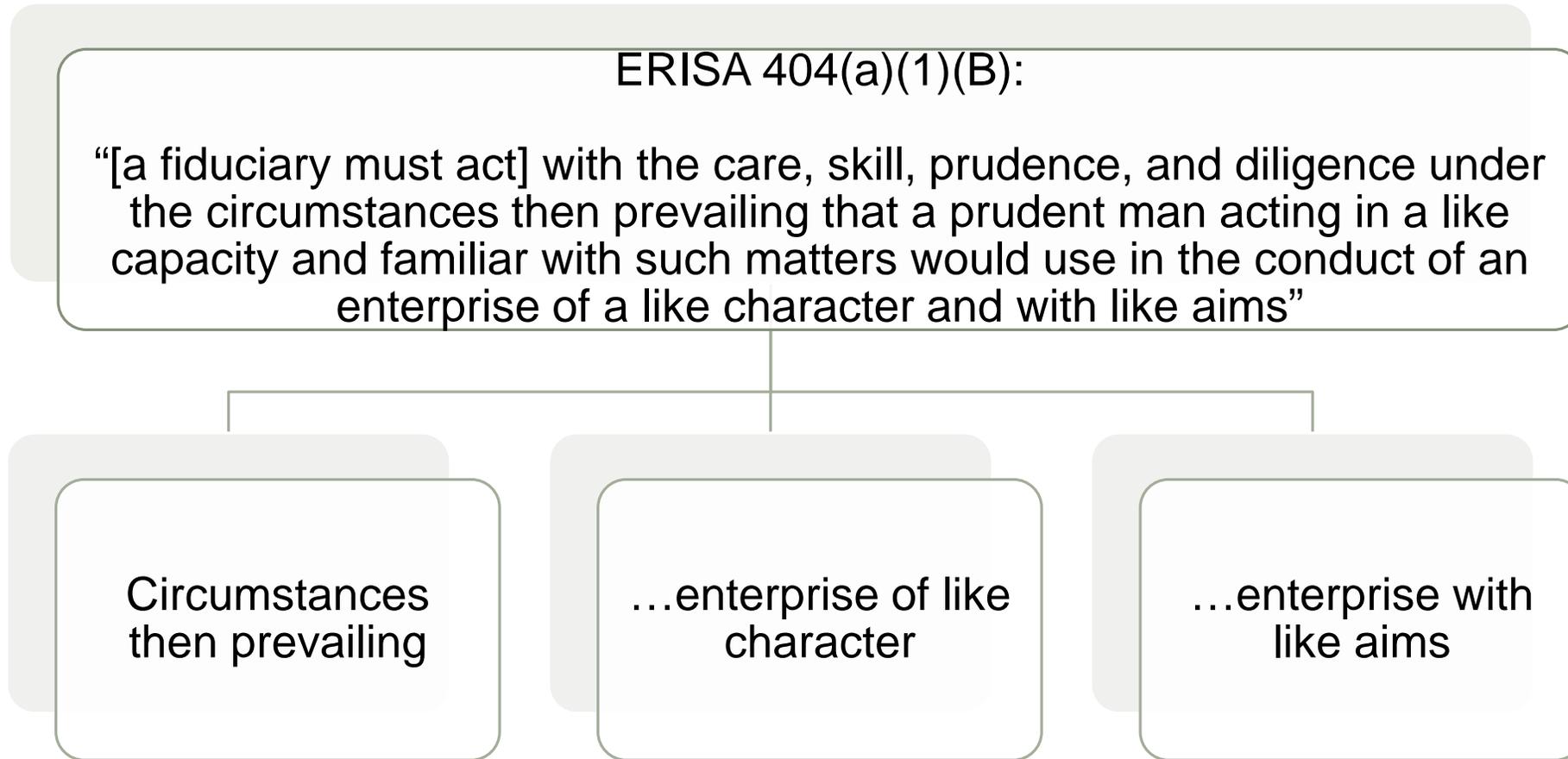
Definition of “adequate consideration” requires “good faith”

- The “**fair market value**” as determined in “**good faith**” by the trustee, pursuant to the plan document and regulations promulgated by the DOL



Overview of the Standards for an ESOP Transaction

How does a court assess “good faith?”





Additional Sources of Guidance

ERISA's Legislative History

Question: What was Congress's view of ESOPs and ESOP transactions when it drafted and debated ERISA?



Additional Sources of Guidance

What did Congress think?

ESOP Sponsor Company

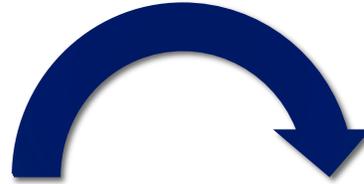
ESOPs originally described as “employee stock ownership *financing*”

ESOPs were viewed as a means of corporate finance

No mention of ESOPs obtaining governance or management control

Extremely strong implication Congress never intended for ESOPs to obtain governance or management control

Congress intended for tax breaks to be an incentive



ESOP

A type of **retirement plan**

Designed to link employee day-to-day performance with company growth

Transfer of “beneficial” ownership to a trust

Retirement plan established by transferring shares at the then-current FMV – Congress rejected other valuation standards





Additional Sources of Guidance

DOL's Proposed Regulation on Adequate Consideration

In 1988, the DOL issued a Proposed Regulation on “Adequate Consideration” (including as it is used in the exemption from PTs).

The Proposed Regulation states that the DOL recognizes the well-accepted definition of “fair market value,” including IRS Revenue Ruling 59-60.

Courts have not been consistent in how they interpret

NOTE: President Trump’s 2019 Executive Orders...



What is Fair Market Value?

“

Price is what you pay.
Value is what you get.

-- Warren Buffet

”



What is Fair Market Value?

What Exactly Is “Fair Market Value”

The price at which an asset would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, and both parties are able, as well as willing, to trade and are well-informed about the asset and the market for that asset.

— *DOL Proposed Regulation 2510.3-18(b)(2)(i)*



What is Fair Market Value?

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The price at which an asset would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, and both parties are able, as well as willing, to trade and are well-informed about the asset and the market for that asset.

— *DOL Proposed Reg. 2510.3-18(b)(2)(i)*

The price at which property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. Court decisions frequently state in addition that the **hypothetical** buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property.

— *IRS Rev. Rul. 59-60*



What is Fair Market Value?



 **Arms-Length**
Arms-length transaction between unrelated parties.

 **Willing**
The parties to the transaction are willing to enter into the transaction.

 **Hypothetical**
Transaction between hypothetical parties interested only in a financial rate of return.

 **Able**
The buyer and the seller have the ability to enter into a transaction.

 **Cash Transaction**
Transaction conducted on an all cash basis.

 **Informed**
The parties to the transaction are informed and understand the Company, and the market.



What Fair Market Value is Not



Related

Not a transaction between related parties or entities.



Coercion

No coercion to enter the transaction. Not a distressed sell.



Strategic

Not a strategic acquisition where the buyer is motivated by a strategic advantage.



Specific Party

No consideration given to the situation of a specific party.



Synergy

No synergies to gain in the transaction.



Formula

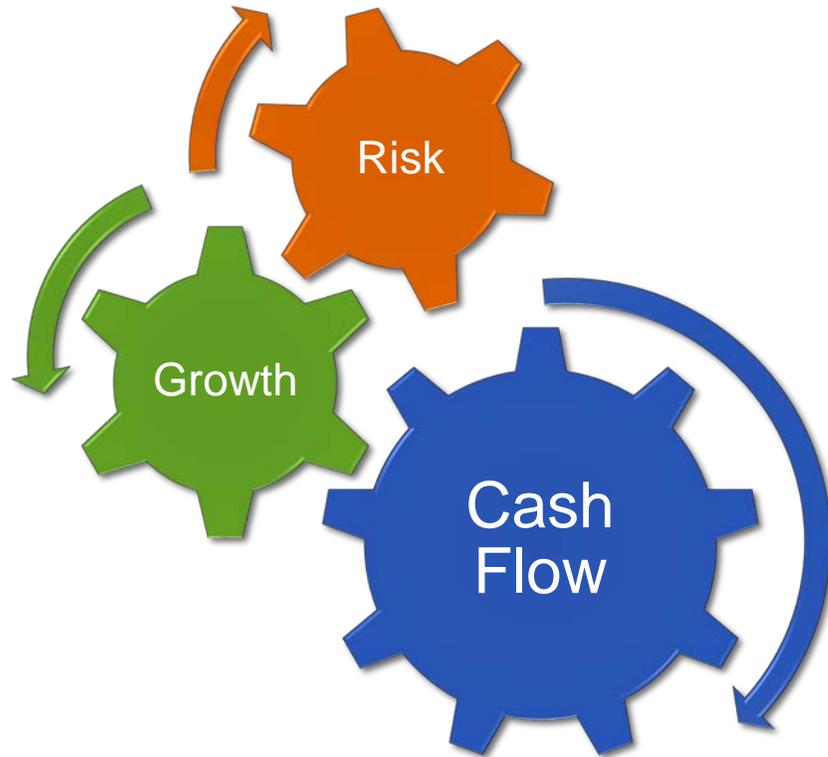
Fair market value cannot be measured by a simple formula, i.e. multiple of EBITDA.



What is Fair Market Value?

How Is “Fair Market Value” Determined?

Valuation is a function of:



Process:

- Assess risk and develop a cost of capital
- Determine expected future cash flows
- Apply the cost of capital to the cash flows



Risk Assessment



External Risks

- Economy
- Technology
- Lifestyles
- Demographics
- Disasters
- Regulations



Industry Risks

- Customers
- Suppliers
- Competition
- Barriers
- Substitutes
- Compliments



Internal Risks

- Strategy
- Personnel
- Organization
- Financials
- Routines
- Culture

Majority of Valuation Work is Unseen

Value

Many users of valuation services are only interested in the concluded value and ignore the process and details that go into a well reasoned valuation analysis.

Research

Hours of research into:

- External Risks (economy, tech, regulations demographics, etc.)
- Industry Risks (customers, competitors, suppliers, barriers to entry, etc.)
- Internal risks (strategy, personnel, culture, financial, etc.)

Analysis

Analysis of the research performed and a complete financial analysis and benchmarking of the Subject Company's financial statement to industry peers. Appropriate adjustments to the financial statements must also be considered and made.



Report

Many only scan the valuation report. A careful study and search of a well prepared valuation can yield valuable management information.

Computations

Complex computations are made to determine cash flows, the cost of capital, adjustments to public guideline companies, discounts for lack of marketability, and other items.

Report

Hours are required to write, edit, proof, and assemble a quality report. A professionally designed report having relevant well reasoned content can be highly valuable when being scrutinized by the Department Labor.



How is “Fair Market Value” Determined?

Asset Approach

- Assets less liabilities
- Holding companies
- Operating companies
- Intangible assets
- “In the final analysis, goodwill is based upon earnings capacity”

Income Approach

- Time value of money
- Capitalized cash flows (CCF)
- Discounted future cash flows (DCF)
- CCF and DCF are really the same thing
- “Valuation of securities is, in essence, a prophecy as to the future”

Market Approach

- Private transactions / Limited information
- Guideline public companies (GPC)
- Adjustments to GPC are needed
- Same as the income approach

Weighting

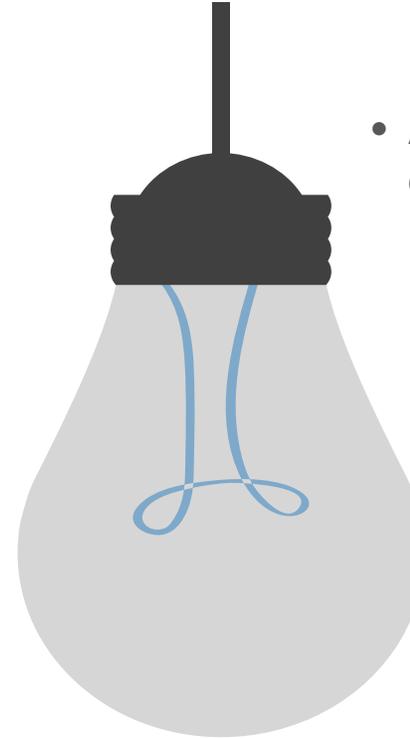
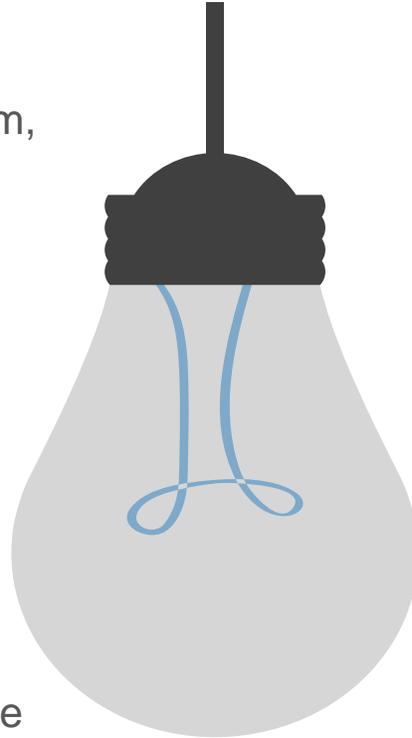
- If done correctly, the different approaches should arrive at similar amounts
- Arbitrary weights of significantly different approaches not helpful





Misconceptions and facts

- Trustee, not the valuation firm, is responsible to determine FMV
- Trustees hire valuation firms to assist them in this responsibility
- The valuation firm's client is the Trust, not the Company
- A valuation is not a guarantee of future performance
- A valuation analyst must rely on representations of management
- Financial projects are to be prepared by management, not the valuation firm



- A valuation is not a due diligence assessment
- A valuation is not a financial statement audit
- A valuation is not a fraud investigation
- A valuation analyst is not a real estate appraiser
- Valuation of individual assets not necessary
- No obligation to hiring a industry expert
- A valuation analyst is not an environmental expert



Where the DOL and Courts Have Gone Wrong

A Concept that is Commonly Overlooked

The Valuation Standard for an ESOP Transaction v. Standard for Annual Valuation

- The standard of value for an ESOP transaction is the same as for annual valuations and reporting – fair market value
- Although ESOP transactions involve questions of fairness, the valuation itself should be identical.
- Note that for annual valuations, IRS guidelines do not even require an independent third-party valuation advisor
- Imagine if annual valuations required the type of analysis the DOL, plaintiffs' firms, and some courts have proposed....
- **Keep in mind:** Congress expressly told DOL to promulgate regulations for purposes of “adequate consideration” determinations, which apply to transactions. Courts also have suggested that DOL should issue regulations. [CITE] If DOL wants a standard different from annual valuation standard, it must issue regulations. Otherwise, the same FMV standard should apply



Where the DOL and Courts Have Gone Wrong

More Concepts that are Commonly Overlooked

The fair market value standard is also a *legal* standard

- If there's one thing judges understand, it is that they are bound by the legal standards that apply.
- ERISA requires the trustee to assess “fair market value.” This is the legal requirement, and there is no discretion for a trustee to assess some other standard of value. *See Reich v. Valley Nat'l Bank of Arizona*, 837 F. Supp. 1259, 1275 (S.D.N.Y. 1993), rev'd on other grounds, 569 F.3d 96 (2d Cir. 2009) (trustee breached its fiduciary duty when it relied on investment value).



Where the DOL and Courts Have Gone Wrong

More Concepts that are Commonly Overlooked

The fair market value standard is also a *legal* standard

- Courts will exclude an expert if the expert relies on an incorrect legal standard. *YETI Coolers, LLC v. RTIC Coolers, LLC*, No. A-15-CV-597-RP, 2017 WL 429210, at *2 (W.D. Tex. Jan. 28, 2017), citing *U.S. Gypsum Co. v. Lafarge N. Am. Inc.*, 670 F. Supp. 2d 737, 744 (N.D. Ill. 2009).
- Courts also should exclude experts who assess the wrong standard of value. *See, e.g., Baldwin v. Bader*, 539 F. Supp. 2d 443, 446, 448 (D. Me. 2008) (excluding expert testimony because valuation methodology was not supported by valuation treatise), citing Pratt, et al., *Valuing Small Businesses and Professional Practices* (1998).



Where the DOL and Courts Have Gone Wrong

More Concepts that are Commonly Overlooked

“Control” is a *valuation* principle

- | | | |
|--|---|--|
| <ul style="list-style-type: none">• Setting company policy and influencing the operations of the business• Appointing management and determining management compensation and benefits• Power to acquire and dispose of business assets• Power to select vendors and suppliers | <ul style="list-style-type: none">• Facilitating business reorganizations:<ul style="list-style-type: none">• a. Business acquisitions• b. Business dispositions• c. Liquidation• d. Recapitalization• e. Initial public offering | <ul style="list-style-type: none">• Sell or acquire treasury shares• Power to dictate dividend policy and payments• Power to revise company organization documents• Ability to establish or revise buy/sell documents• Power to block any of the above |
|--|---|--|



Where the DOL and Courts Have Gone Wrong

Court Decisions v. Core Principles - *Vinoskey*

Hypothetical
buyer *and*
seller

No particular
buyer or
buyer type

Price v. value

Cash
transaction

“As the Court held in its opinion denying Defendants’ Daubert motion to exclude [plaintiff’s expert], [plaintiff’s expert’s] experience with purchasing closely held companies provide[d] guidance on the sort of diligence required in an ESOP transaction, particularly since ‘ERISA’s standards for fiduciaries . . . are at least as high as the due diligence standards followed in private industry.’”

Question: is the court overlooking potential differences between a private-industry transaction’s due diligence and an ESOP trustee’s due diligence?

Do not *need*
more experts

FMV

Assessed at
time of
transaction

Circumstances
then prevailing

Enterprise like
character and
aims

“Beneficial”
interest
transfer

ESOP means of
corporate finance
/ tax breaks



Where the DOL and Courts Have Gone Wrong

Court Decisions v. Core Principles - *Vinoskey*

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“[Plaintiff’s expert] also testified that negotiation is standard in private transactions and that “the reason an ESOP has a fiduciary is so that there is that sort of real world negotiation so that you can end up with a fair price.”

Question: Assuming the Judge viewed this unfavorably, is there a principle that the Judge may have overlooked?

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Where the DOL and Courts Have Gone Wrong

Court Decisions v. Core Principles - *Brundle*

Hypothetical
buyer *and*
seller

No particular
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buyer type

Price v. value

Cash
transaction

The opinion contained a few passages similar to this one:

“A presentation prepared for the sellers, titled ‘Preliminary ESOP Structural Analytics’ and dated September 25, 2013, explained that the ‘Status Quo’ left the shareholders with ‘no exit strategy’ and that they were ‘limited to dividends for liquidity.’”

Question: Assuming the Judge viewed this unfavorably, is there a principle that the Judge may have overlooked?

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Court Decisions v. Core Principles - *Brundle*

Hypothetical
buyer *and*
seller

“[The company’s advisor’s] presentation stressed the after-tax benefits to the shareholders . . . and the Court finds that these after-tax benefits for the Sellers were a major incentive for creating the ESOP. . . .”

Circumstances
then prevailing

No particular
buyer or
buyer type

“[The company’s advisor] had ‘looked at every possible scenario’ and had not ‘seen any possible alternative that produces more after tax cash than the ESOP.’”

Enterprise like
character and
aims

Price v. value

Question: Assuming the Judge viewed this unfavorably, is there a principle that the Judge may have overlooked?

“Beneficial”
interest
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Cash
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Where the DOL and Courts Have Gone Wrong

Court Decisions v. Core Principles - *Brundle*

Hypothetical
buyer *and*
seller

No particular
buyer or
buyer type

Price v. value

Cash
transaction

“It was extremely unusual for the warrant holders to be able to appoint a majority of the board members when the ESOP held 100% of the company's shares.”

Question: Assuming the Judge viewed this unfavorably, is there a principle that the Judge may have overlooked?

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“However, the Fourth Circuit defines ‘control’ as ‘an interest which allows the shareholder to unilaterally direct corporate action, select management, decide the amount of distribution, rearrange the corporation’s capital structure, and decide whether to liquidate, merge, or sell assets.’”

Question: is this definition of “control” necessarily applicable to a FMV estimate?

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Where the DOL and Courts Have Gone Wrong

Court Decisions v. Core Principles

Hypothetical
buyer *and*
seller

“The ESOP's lack of control was further reflected in the plan document ("Plan"), which directed [the trustee] to ‘vote all Employer Securities held by it at such time and in such manner as the Administrator decides[.]’

Circumstances
then prevailing

No particular
buyer or
buyer type

“When asked how the ESOP might go about stopping an action by the board of directors given its minority position, if [the trustee] felt the action was inconsistent with ERISA, [the witness] admitted that the only recourse would be to ‘file a lawsuit to fight about it.’”

Enterprise like
character and
aims

Price v. value

Question: is the court's understanding correct? Does it matter?

“Beneficial”
interest
transfer

Cash
transaction

Do not *need*
more experts

FMV

Assessed at
time of
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ESOP means of
corporate finance
/ tax breaks



Where the DOL and Courts Have Gone Wrong

Court Decisions v. Core Principles - *Vinoskey*

Hypothetical
buyer *and*
seller

No particular
buyer or
buyer type

Price v. value

Cash
transaction

“Under the ESOP Plan, the shares of company stock held by ESOP participants would ‘generally’ be voted by the ESOP Trustee(s), except in ‘certain limited but important corporate matters, such as a sale of all the Company’s assets or merger of the Company,’ when ESOP participants would ‘have the right to instruct the Plan Trustee as to [their] wishes relative to the shares of Company Stock held in [their] ESOP Account.’”

Question: does this passage indicate whether or not the ESOP gained any elements of control?

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Where the DOL and Courts Have Gone Wrong

Court Decisions v. Core Principles - *Vinoskey*

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buyer *and*
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buyer type

Price v. value

Cash
transaction

“But [the company’s] corporate structure and leadership personnel before the 2010 Transaction meant that, absent changes, [the former owners] would retain a firm grip over the levers of power at [the company] after the 2010 Transaction.”

Question: does ERISA’s legislative history indicate what Congress would have thought of this situation?

Do not *need*
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FMV

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transaction

Circumstances
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ESOP means of
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Where the DOL and Courts Have Gone Wrong

Court Decisions v. Core Principles

Various discussion of risk premiums, internal rates of return, costs of capital, and others...

Hypothetical buyer *and* seller

No particular buyer or buyer type

Price v. value

Cash transaction

Circumstances then prevailing

Enterprise like character and aims

“Beneficial” interest transfer

ESOP means of corporate finance / tax breaks

Do not *need* more experts

FMV

Assessed at time of transaction



Suggestions Going Forward

Helpful Tips

- In our experience, cases involving the prudence of an ESOP transaction present a number of challenges for defendants:
 - 1. The Judges are well aware that there is a retirement plan at-issue, and that worker retirement savings are at stake.
 - 2. The Judges are well aware that the duty is a fiduciary duty, the highest known in the law.
 - 3. Many Judges may have one, or no, ESOP cases during their entire time on the bench.
 - 4. Many Judges will have no experience with valuation concepts, standards of value, valuation methodologies, etc. By the time you go to court, you may have spent hundreds of hours on these issues. The Judge may have spent a handful.



Suggestions Going Forward

Helpful Tips

- We propose the following steps to help provide context if there is later scrutiny of a transaction:
 - Don't just document the process. Document the *reasons*. Think about whether the valuation report, workpapers, or notes might be read at a later date by someone scrutinizing the trustee or valuation advisor and whether it might be helpful to include the following:
 - Discussions of fundamental principles and theory. What is the difference between “price” and “value?” Why isn't some auction price the same as a fair market value estimate of an asset? What role does the seller's perspective have in the FMV assessment?
 - Citations and quotations from authoritative texts. If certain principles are subject to “battle of the experts,” provide authority to support the position you are choosing.

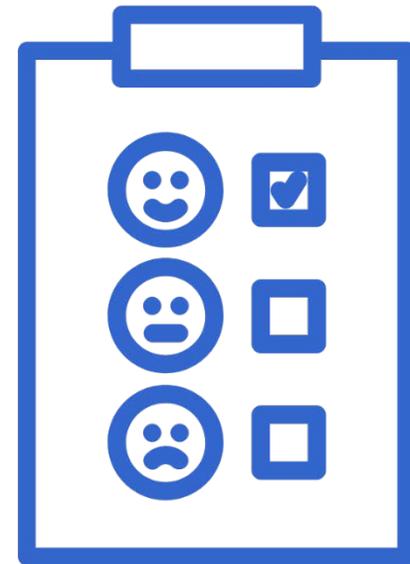


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