Unlocking ESOPs: Best Practices for Valuation Oversight & ERISA Compliance

McKONLY & ASBURY
TAX | ASSURANCE | CONSULTING | ACCOUNTING

INTRODUCTION

Danielle Guinter,
CPA, MAcc

Partner

Director of ERISA Services

Eric Blocher,
CPA, ASA, CVA

Partner

Director of Business Valuation Services

Shalane Cohen,
CPA

Principal

FIRM OVERVIEW

McKonly & Asbury is a team of CPAs and Business Advisors serving clients from our offices in Camp Hill, Lancaster, Bloomsburg, and Philadelphia.

We provide **Advisory & Business Consulting**, **Audit & Assurance**, **Entrepreneurial Support & Client Accounting**, **Internal Audit**, **Professional Placement**, **Tax**, and **Technology** services to a variety of industries including:

- Affordable Housing
- Construction
- Employee Benefit Plans
- Family-Owned Business
- Healthcare
- Manufacturing & Distribution
- Nonprofits

AGENDA

- Best practices for administering and overseeing an ESOP
- Considerations when reviewing your ESOP's valuation report
- Lessons learned from recent ERISA court cases

BEST PRACTICES

- Understand the Plan Document
  - Plan Amendments
- Eligibility
- Allocations
  - Understand Plan Compensation
  - Sample Test
    - ***Select individuals that have a certain compensation included***
  - Review with your service provider
  - Review participant statements
    - ***Plan compensation vs. gross compensation

BEST PRACTICES

- Reconcile Plan Compensation

- Understand Allocation Types
  - Cash contributions
  - Forfeitures
  - Re-allocated shares

Remember if one person’s allocation is wrong, all allocations are wrong

BEST PRACTICES

- Contributions
  - Cash contributions for a leveraged plan

- Distributions
  - Company purchases stock (Redeeming)
  - Re-allocated shares to other participants
  - Redeeming vs recycling and purchase obligation study
  - Diversification
    - 10 years of participation vs 10 years of balance in the plan

ESOPS AND VALUATION

- **Disclaimer!** – the following slides are my own beliefs based upon my experience over twenty-eight years in the business valuation profession.
- The unique facts and circumstances of each ESOP should be considered in every valuation and may cause the appropriate answer for your ESOP to be different than views expressed on these slides.
- Did I "CYA" enough with the above?? I think so… let's have at it!

ESOPS AND VALUATION

- A Company owned by an ESOP is different than other companies, but it also **isn't different**. The value of Company owned by an ESOP can and should go DOWN at times, just as any other business would.
- Unfortunately, I have seen valuations for ESOP companies that seem to believe that "value" should ALWAYS go up each year. This is simply not true. Economic factors such as increasing interest rates or decreasing net income and cash flow can and should result in a decrease in value.
- The assumptions used in valuations should be consistent with sound economic and valuation theory and not used just to support a desired value or value trend (ie. increasing each year).
- If assumptions in a valuation change from year to year, I believe those changes should be explained in the valuation.

ESOPS AND VALUATION

- One of the trends that I am seeing is a **Schedule** showing the change from the prior valuation, from a $ and/or % perspective for information used such as:
  - Change in the Cost of Debt
  - Change in the Cost of Equity
  - Change in the Risk-free rate (part of the cost of Equity)
  - Change in the WACC (weighted average cost of capital) debt and equity % assumptions
  - Change in EBITDA multiples used
  - Change in the total fair market value and price per share for each method (typically the Income and Market approaches)

ESOPS AND VALUATION

- The Trustee for the ESOP should be reviewing the annual **draft** valuation
- Best Practice suggests that the Trustee for the ESOP should be an Independent “Outside” Trustee
  - This can assist in the Trustee truly being a fiduciary for the ESOP without any potential conflict of interests
  - An Independent Trustee often has experience reviewing business valuations and may be more apt to challenge assumptions or obtain clarity where needed

ESOPS AND VALUATION

- 3 valuation approaches should be **considered** for every valuation.
  - Asset Approach
  - Market Approach
  - Income Approach
- *My belief* is that the Income Approach should be used in almost every valuation. I believe that cash flow is most often the driver of “value” and it is what an investor is most concerned with. The Asset and Market approached may not apply or make sense in every valuation

ESOPS AND VALUATION

- If multiple approaches are used, and it is not a bad thing when done properly, the approaches should reasonably reconcile, in total value and in certain other data points.
- For example, if the Guideline Public Company Method (a Market Approach) and an Income Approach are used then:
  - The debt/equity percentages used for the Weighted Average Cost of Capital (WACC) should most likely be similar between the 2 methods or an explanation of why they are different should be in the valuation.
  - This is because the debt/equity percentages of the WACC used in the Income Approach should be at “market” levels which the Guideline Companies presumably represent

ESOPS AND VALUATION

- Most ESOPs are valued under the assumption that the “most likely purchaser” is a C Corporation, so even if you are a 100% ESOP owned S Corporation (with great tax benefits) you will probably be valued with C Corporation taxes factored into the value.
- If you are an ESOP operating in PA you may want to see if your valuation includes the impact of H.B. 1342 which became effective in July of 2022.
- H.B. 1342 reduces the PA corporate net income tax from 9.99% to 4.99% by 2031 and represents a possible increase to value through a reduction in the estimated C Corporation tax rate.

ESOPS AND VALUATION

- The ESOP Valuation Elephant in the Room - DOL updated Regulations on Valuation
- The SECURE 2.0 retirement plan legislation enacted in December 2022 directed the DOL to issue updated regulations
- The updated regulations are to provide needed guidance on the definition of “adequate consideration”
- The DOL issued a “proposed regulation” addressing this in 1988 but it was never finalized
- The DOL is in the process of updating regulations that are anticipated to drop in the Summer of 2024
- The impact is unknown at this point… The ESOP Association has published it own proposal for the Regs hoping the DOL might rely on them

SCALIA V. WILMINGTON TRUST

- DOL reached an agreement with Wilmington Trust, N.A. requiring Wilmington to pay $80 million to 21 ESOPs for which it served as the trustee.
- DOL alleged Wilmington caused losses to the ESOPs when it authorized them to pay more than fair market value for privately held employer stock, violating ERISA.
- Wilmington agreed to settle EBSA's claims without admitting or denying those allegations

"Companies acting on behalf of retirement plan participants must always act in good faith and in the best interest of their employees," said Solicitor of Labor Kate S. O'Scannlain. "When they breach that obligation, they put their employees' financial security in jeopardy, and will face legal action."

https://www.dol.gov/newsroom/releases/ebsa/ebsa20200430

DOL RECOVERY FOR STOCK OVERPAYMENT

- EBSA alleged Reliance Trust Company caused RVR Inc. Employee Stock Ownership Plan to overpay when it purchased 100% of the shares of RVR Inc. for $105 million in May 2014.
- In August 2023, DOL recovered $22.5 million from Reliance.
- Lawsuit also alleges ERISA violations against fiduciaries including RVR board members for failing to monitor Reliance. These claims are still pending.

“When a trustee purchases stock on behalf of a retirement plan such as the RVR Employee Stock Ownership Plan, its first responsibility is to make sure that the plan’s participants get a fair deal and don’t pay more than the worth of the stock,” said Assistant Secretary for Employee Benefits Security Lisa M. Gomez. “Plan fiduciaries’ duty of loyalty is owed to the plan’s participants, not to sellers looking out for their own bottom line. When fiduciaries cut deals for the financial benefit of sellers at the expense of their employees, the Department of Labor will take appropriate action to ensure that plan participants get full value for their money.“

https://www.dol.gov/newsroom/releases/ebsa/ebsa20230913

REMOVAL OF RETIREMENT PLAN FIDUCIARY

- Federal court grants preliminary injunction ordering the removal of the CEO and co-owner of Ascent Construction Inc. as trustee of the company's employee stock ownership plan
- EBSA discovered -
  - the CEO withdrew more than $300,000 in employees' retirement funds in 2021 and 2022 to cover business expenses
  - Failed to pay $30,000 distribution to a beneficiary
  - Attempted to withdraw retirement funds again

"The removal of Bradley L. Knowlton is a necessary first step to make certain the retirement funds of Ascent Construction's employees are managed in their best interests," said Employee Benefits Security Administration Regional Director Klaus Placke in San Francisco. "We will continue to work hard to ensure the retirement these employees have worked toward."

https://www.dol.gov/newsroom/releases/ebsa/ebsa20230801#:~:text=During%20its%20investigation%2C%20the%20Employee,in%20violation%20of%20the%20Employee

ESOP PARTICIPANTS SUE FORMER CHAIRMAN

- ESOP shares of 80/20 Inc. were sold to private equity for $18.2 million - $10.1 million of which went to the ESOP. The ESOP was terminated and all shares redeemed and account balances distributed in 2021 and 2022.
- The participants allege –
  - Private equity paid bonuses to leadership to sway them to private equity and away from the ESOP
  - “Plaintiffs estimate that 80/20 Inc. (the Company) had approximately $105 million in sales in 2020, based on historic revenue and growth rates,” the complaint states. “The average machinery company at the time was worth 3.06 times its sales—supporting a $321 million valuation of 80/20 Inc. at the time of the MPE deal.”

“Defendants John Wood and Brian Eagle violated their ERISA fiduciary duties by failing to exercise or enforce the ESOP’s right to buy 80/20, Inc. shares from the company founder’s estate,” the complaint states. “They further violated ERISA by divesting the ESOP from the company altogether for less than fair value in a deal that benefited company leadership at the expense of the ESOP. Defendants MPE Partners II, L.P. and MPE Partners III, L.P. acquired the company’s equity knowing that their bargain was the result of their co-Defendants’ violations of ERISA.”

https://www.plansponsor.com/indiana-erector-set-manufacturers-former-chairman-sued-by-esop-participants/

SHIPP VS. CENTRAL STATES MANUFACTURING, INC.

3 participants of the Central States Manufacturing, Inc.'s ESOP filed a complaint against the company, board of directors, individual members of its board of directors, and GreatBanc Trust Company (the ESOP trustee) (the Fiduciaries).

The Plaintiffs allege –

- breach of fiduciary duties under ERISA by causing the ESOP to engage in a re-leveraging transaction.
- transaction diluted the value of the existing participants' accounts
- fiduciaries intended to benefit the company by reducing the per-share price of the company stock, thus reducing the company's repurchase obligations.

The Fiduciaries failed –

- To give to give due consideration to the impact of the transaction on the per-share value of the company stock held by existing ESOP participants;
- to consider viable alternatives to the transaction that would not have minimized the dilutive effect on, and the harm to, the participants
- to place the interests of ESOP participants over the interests of the company

https://natlawreview.com/article/fiduciary-obligations-re-leveraging-transaction-heads-court-shipp-v-central-states

CONTACT INFORMATION

Danielle Guinter,
CPA, MAcc

Partner

dguinter@macpas.com

717.972.5734

Eric Blocher, CPA,
ASA, CVA

Partner

eblocher@macpas.com

717.972.5730

Shalane Cohen,
CPA

Principal

scohen@macpas.com

717.972.5783

McKonly & Asbury

Tax | Assurance | Consulting | Accounting

UPCOMING EVENTS

AFFORDABLE HOUSING WEBINAR SERIES

July 18

Low-Income Housing Tax Credits 101

July 25

Affordable Housing Audit and Financial Statement Essentials

August 1

Acquisition/Rehab First Year Credits

Register Today!

McKONLY & ASBURY
TAX | ASSURANCE | CONSULTING | ACCOUNTING

Visit us online at **www.macpas.com** for more information.