JANUARY/FEBRUARY 2004

valuation & litigation briefing

Is an ESOP right for your clients?

The loss-of-earnings model may be troublesome in wrongful termination cases

Detecting valuation errors

How to find weaknesses in the “third-party” limiting condition

J.L. PIERSON & CO. LLC
BUSINESS VALUATION

P.O. BOX 2392 DARIEN, CT 06820-0392

NYNJCT-BV.COM
(203) 325-2703 Business Valuation (203) 434-4648

Is an ESOP right for your clients?

An employee stock ownership plan (ESOP) can be an excellent tool to provide equity ownership and increase employee loyalty while providing a vehicle to increase the principal shareholder's liquidity. An ESOP is a retirement plan, usually covering all full-time adult employees, in which a trust holds stock in the employee-participants' names. After workers leave the company (whether they quit or retire), they cash in on the proceeds due them.

To help determine whether an ESOP is right for your business clients, be aware of their finer points and how appraisers value participants' shares.

What is an ESOP?

An ESOP is a defined contribution plan, meaning that employers make defined yearly contributions that accumulate to produce a benefit that is not defined in advance. (In contrast, a "defined benefit" pension plan guarantees employees a fixed benefit schedule and employers fund the plan as needed to meet those payments.)

ESOPs are never "key executive" plans. Rather, the applicable rules ensure a broad base of participation. Because of their borrowing power and tax advantages, ESOPs are often used to buy out all or part of an owner's interest in established, profitable, closely held businesses or to acquire blocks of stock in public companies.

An ESOP is also a tax-qualified employee benefit plan designed to invest primarily in the sponsoring company's securities, which subjects it to the Employee Retirement Income Security Act (ERISA) of 1974. In simple terms, an ESOP's tax benefits are that:

- The company can deduct contributions to the ESOP, including payments on loans the ESOP takes to buy company stock,
- The company can deduct dividends paid on ESOP-held stock, and
- Owners of closely held companies who sell to an ESOP can avoid paying capital gains taxes on the sale proceeds by reinvesting them in securities of U.S. companies.

Thus, ESOPs can be beneficial to both employees and employers.

How does a business establish an ESOP?

To set up an ESOP, employers create a trust fund to which they contribute company stock or cash to buy stock (either new or existing shares). ESOPs may be leveraged and borrow money to buy stock on the employers' credits.

Stock is held as long as participants are employed and receiving ESOP allocations, but the employees do not own the stock directly. Rather, ESOP trustees hold it in their names. Almost all ESOP contributions come from employers, not employees themselves.

In leveraged ESOPs, companies can contribute up to 25% of participants' eligible payroll to repay the ESOP loan's principal portion. Under Internal Revenue Code (IRC) Section 133, 15% is allowed for nonleveraged ESOPs. Participants can sometimes expand or reduce these limitations.

ESOPs may be leveraged where they use borrowed funds from an external lending source, usually at favorable financing rates because of excellent tax advantages to all concerned parties. Companies may then contribute cash to buy back stock from current shareholders or contribute additional diluted shares to the ESOP.

Under IRC Section 1042, sellers can indefinitely defer capital gains taxes otherwise due from these sales, as long as they've held the stock three years. The ESOP receives at least a 30% interest in the company's stock as long as the sales proceeds are reinvested within a year into a qualified replacement property (QRP), usually in the issuing company.

The bank loan and dividends employers pay on leveraged ESOPs are effective pre-tax reductions of employers' taxable income. Cash flow is affected by contributions to fund share purchases or pay off the loan to buy the stock, and by payouts to shareholders who opt to leave the company.

In the case of a termination and stock sale, the ESOP or the company customarily has a right of first refusal to buy back shares. The employer often provides a "put" option allowing the ESOP participant to redeem the stock for cash or repayment for up to a five-year period. (See "The put option," below.)

Employee owners can sell shares depending on what their plan allows. In ESOPs, shares can usually be sold when employees leave the company or immediately after vested options are exercised (that is, as soon as the shares are acquired). As long as there is one ESOP participant, he or she receives the same increase in value that the other owners benefit from on their shares.

What are some ESOP participants' rights?

An ESOP trustee is the legal owner of the shares and must receive whatever information other shareholders receive. But most ESOP trustees and some option companies voluntarily pass along at least some financial information to employees.

The most important special right shareholders have in most states is that if the company is sold, all shareholders owning the same class of stock receive the same price. This applies to any shares owned through an ESOP or options that (as in many plans) vest on sale.

These participant rights are limited compared with the initiating company owners' rights, because owners have often used their own money, almost always after they paid taxes on it, to buy the shares at their full price.

Because shares were contributed to employee ESOP participants' accounts, they have no tax consequences on the contribution until they receive the shares. With options, employees often buy shares at a considerable discount.

How is ESOP share value defined?

As is the case with most businesses, an appraiser must understand the company's industry and operations to derive a value conclusion. And, because the appraisal is most commonly performed for transaction purposes, the standard of value is fair market value (FMV), which we will discuss here.

The Tax Reform Act of 1986 requires a qualified, independent appraiser to annually appraise the total ESOP participants' share value. Under IRS guidelines, "qualified" means the analyst regularly performs business appraisals and has knowledge of ESOP transactions.

The put option

The put option associated with employee stock ownership plans (ESOPs) is the factor that generally distinguishes ESOP shares from non-ESOP shares. Under IRC Section 409(h)(1)(B), employer securities that an ESOP acquired after Dec. 31, 1979, must include a put option if the securities are not freely and actively traded on an established market at the time of distribution to the participants. This allows them to sell the stock back to the company at its current fair market value. At a minimum, the put option must be available during two periods — one for at least 60 days immediately after distribution and one for at least 60 days during the following plan year.

An appraisal report is supported by documentation, which explains the methods, procedures, quantitative and qualitative analysis, calculations, and assumptions used to arrive at an impartial opinion. Typically, the definition of value incorporates the following four legal assumptions under FMV standards:

1. The purchaser is prudent and profit seeking, and would obtain no synergistic benefit from the acquisition.

2. The business will continue as a going concern and not be liquidated.

3. The business would be sold for cash or cash equivalent.

4. The business would be held on the market for a reasonable time period.

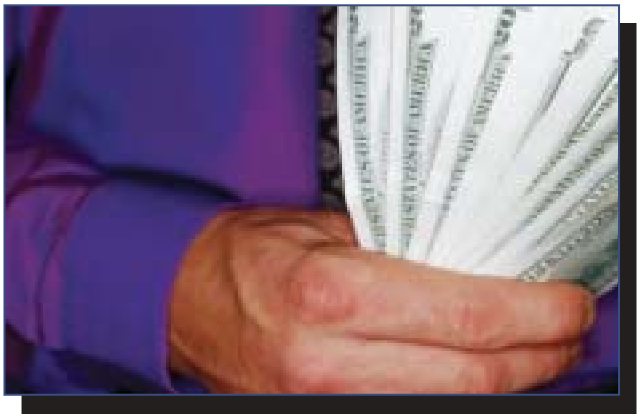
FMV is defined in Revenue Ruling 59-60 as: "The price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts." In addition, court decisions frequently state that the hypothetical buyer and seller are assumed able, as well as willing, to trade and to be well-informed about the property and its market. Also implied in this definition, which is widely used in valuation practice, is that the value will be stated in cash or cash equivalents and that the property would have been exposed on the open market for a period long enough to allow market forces to establish the value.

Whom should you consult?

Determining the value of an ESOP is a complex process incorporating many technical and regulatory factors. We would be pleased to answer your questions or provide further information on your request. ❑

The loss-of-earnings model may be troublesome in wrongful termination cases

A wrongful termination case may involve alleged discrimination, sexual harassment, an employment contract breach or the dismissal of an otherwise at-will employee. Regardless of the allegations underlying the action, attorneys often engage damages experts to calculate loss of income and benefits. Typically, they construct a model setting forth the plaintiff's loss of income and benefits. But the model can be problematic in attempting to account for an uncertain future.



Front and back

In a wrongful termination case, the defendant's expert needs to evaluate the plaintiff's expert's calculations and independently quantify the plaintiff's earnings loss. The losses that both experts address include both "back pay" (losses from the date of termination up to the trial date) and "front pay" (impending losses from the date of trial until some point in the future).

Usually, the front pay component represents a much larger portion of the employee's earnings loss than back pay. Accordingly, the experts largely base the calculation on projections of events that will occur in the future.

As in the case of any projection, front pay assessments abound with assumptions and certainty is either scarce or nonexistent. If you factor in the biases that retaining counsel introduces into the equation, the plaintiff's and defendant's experts' assumptions may start to widely diverge. Thus, in quantifying the various components of the earnings loss, one expert may be overly aggressive while the other is too conservative.

Key components

To reach the most reasonable value of the employee's alleged losses, experts and counsel need to carefully consider each important component entering into the calculation. Here are several items susceptible to bias:

The time period between termination and commencement of new employment. When an employee secures a new job shortly after departing from an old one, the experts are usually in agreement. But a terminated employee is often out of work for an extended period and may still be unemployed at the time of trial or resolution.

Investigating the reasons for the extended period of unemployment may reveal that the plaintiff has not made reasonable efforts to seek employment or that the employee had incentives to remain unemployed. For example, he or she might have been receiving disability insurance benefits because of emotional strain allegedly caused by the termination. Disability income can reduce the employee's financial burden and his or her need to return to work.

When incentives of this nature are apparent, an expert should limit the earnings loss relating to the "out-of-work" period to the amount of time it should take the employee to find work, assuming he or she makes reasonable efforts to do so. If the employee has made a good faith effort to secure employment but has been unsuccessful, greater out-of-work earnings losses would be reasonable.

The value of at-risk deferred compensation. Employers often try to tie a portion of compensation to the employee's own performance as well as to the company's. In addition, the worker's rights to certain components of performance-based compensation are not immediate, but become vested over a period of time.

Base compensation and bonuses represent the immediate portions of an employee's compensation and are easily quantifiable. But the values of deferred compensation components, such as retirement benefits and stock options, are usually more difficult to quantify.

Patterns of compensation among peers

Typically, a plaintiff has an optimistic view of how his or her earnings would have grown — if he or she had not been terminated. The employee's anticipation of expected earnings growth is often inconsistent with the actual compensation increases his or her peers receive.

For instance, if other middle management employees averaged only 5% annual increases during the three-year period following the plaintiff's termination, the plaintiff's expert's use of a 10% growth rate is probably exaggerated. Likewise, the defendant's expert's assertion of a 2% growth rate might be too conservative. Similarly, if members of the peer group received only 2,000 stock options per year, incorporating grants of either 1,000 or 5,000 options into the loss-of-earnings calculation would probably suggest some bias.

The value of stock options depends on many factors — including growth rates, interest rates, dividend rates, volatility of the stock, grant and vesting schedules, and expected time until the options are exercised. Each of these components could have a major impact on the options' value. Obviously, a plaintiff's expert is likely to take an optimistic view of these variables, while a defendant's expert takes a more pessimistic one. Thus, arriving at a reasonable value requires a careful and realistic view of each variable.

Other factors

Experts should carefully evaluate many other components of an earnings loss calculation to remove bias. A nonexhaustive list includes the terminated employee's historical longevity on the job and work life expectancy, the circumstances surrounding his or her termination, the versatility of the worker's skill set, and contractual issues. A damages expert's evaluation of these variables often requires consultation with vocational and compensation experts.

Please call with your questions regarding damages calculation. We have experience and expertise in these matters, and would be glad to advise you. ❑

Detecting valuation errors

Valuation has been called both an art and a science. A well-researched, soundly reasoned valuation report can be instrumental in generating a settlement agreement in a dispute. But what is the single most important factor in determining a report's value to your case? Usually, it's the valuator's expertise, rather than the report's cost or the firm's reputation.

Competence means more

A competent valuation professional approaches an assignment from a well-informed business perspective. Such an expert sees beyond the numbers, formulas and theories and clearly communicates his or her value opinion's bases.

But in many larger firms — even those with sterling reputations — economics dictate that partners parcel out valuation assignments to staff with varying degrees of training and experience. Staffers short on business experience may not know how to dig deep to uncover relevant information about the company being valued. So knowing how to evaluate an individual valuator's ability to defend his or her report is important.

The analyst should always be asking, "Does this make sense?"

As judges and opposing counsel look more critically at valuation reports, boilerplate write-ups or one-size-fits-all approaches no longer hold up under scrutiny. An experienced preparer knows what does — and what doesn't — make sense in a given situation.

Some common mistakes

Understanding the quality and the composition of the earnings stream being valued is critical to arriving at a fair opinion. An inexperienced (or biased) preparer may:

- Apply price/earnings (P/E) multiples to earnings streams or time periods that are not comparable. For instance, he or she may apply the average P/E ratio for Fortune 500 manufacturing companies to the earnings stream of a $1 million service company, or use the risk-free cost of capital on a small company.
- Commingle pre- and post-tax data. This may take the form of applying a post-tax P/E ratio to a pre-tax income stream.
- Rely on industry averages without adequate analysis. This analysis would include examining how the subject company relates to the industry.

In addition, an inexperienced preparer sometimes relies exclusively on historical financial statements, failing to perform site visits or question management about the entity's future prospects. Small businesses' historical financial statements are frequently systematically distorted (for example, understated earnings) — usually to reduce taxes or prepare for a pending divorce.

Exclusively relying on these statements generates an equally distorted opinion of value. The analyst should always be asking, "Does this make sense?"

Differences of opinion also often arise among valuation experts as to capitalization rates and discounts. Common mistakes here include:

- Using rates from inconsistent time periods,
- Applying rates on "safe" investments to small businesses (which are inherently much riskier), and
- Mistaking historical results for required rates of return.

Discount mistakes include:

- Applying a discount or premium to an inapplicable level of value,
- Ignoring the rules of the jurisdiction for which the report was prepared, and
- Applying a discount without understanding the data and procedures used in compiling the underlying discount studies.

Other typical inaccuracies include reports that are too brief and don't adequately explain the expert's thought process and failure to understand what entity is being valued (assets vs. stock, which assets and liabilities are included, multiple entities covered in one opinion).

First things first

The first thing you should do when evaluating a valuation report is check the preparer's credentials. Then look for the common mistakes outlined here. This will help you evaluate the report's usefulness in supporting your case. ❑

How to find weaknesses in the "third-party" limiting condition

The "statement of limiting conditions" is intended to limit an expert's exposure to liability caused by inappropriate reliance on a report. But the limiting conditions may also provide a basis for effective cross-examination. For instance, here is a typical limiting condition attempting to limit third parties' use of the report, along with some questions that address some of its possible weaknesses.

Limiting condition no. 1. This valuation is made for the purpose the report states and is to be used in its entirety. *No third parties should rely on the information contained in this report without the advice of their attorneys or accountants, and without confirming for themselves the information contained herein.* Neither the report nor the information it contains should be used for any other purpose or function, and it is invalid if so used. Neither this valuation nor any part of it shall be used separately or in connection with any other valuation.

This statement suggests that the expert lacks confidence in his or her work. Cross-examination questions directed to the expert might include:

- Isn't it true that you believe that before relying on your opinion, a client should seek a second opinion?
- Isn't it true that you have not sufficiently verified the material to support your own opinion?

This limiting condition also suggests that the expert has tailored his or her opinion to accomplish a particular objective. Cross-examination questions might include:

- Is it correct that you have opined as to the fair market value of XYZ Corp.?
- Are you confident that your opinion of the fair market value of XYZ Corp. is accurate?
- Fair market value is a generally accepted measure of value in the field of business valuation, correct?
- And fair market value is a measure that can be applied in a variety of situations, correct?
- It could be used for estate tax purposes, correct?
- It could be used for buy-sell purposes, correct?
- It could be used for insurance purposes, correct?
- Isn't it true that your report states that the information contained within it is invalid if used for any purpose other than the one stated in your report?
- So it seems that your report says that, for the purposes stated in it, your opinion of fair market value is valid, but for any other purpose your opinion is invalid. Correct?

These questions show how you can pinpoint problematic aspects of the limiting condition and undermine the opposing expert's defenses.

J.L. PIERSON & CO. LLC

BUSINESS VALUATION AND APPRAISAL

J.L. Pierson is an Accredited Senior Appraiser designated by the American Society of Appraisers (ASA) in the Business Valuation discipline. He specializes in business valuation for closely held businesses, family limited partnerships (FLPs), Limited Liability Companies (LLCs) and professional corporations. Valuations are performed for investment, estate planning, financial reporting, corporate insolvency, gift/estate tax and income tax purposes. This type of valuation work often involves discounts that must be based on reasoned and well-documented judgment — not a formula or software package — that is fully consistent with case law.

J.L. Pierson specializes in Business Valuation and appraisal only, including such projects as:

- Valuation of interests in FLPs and LLCs holding marketable securities, real estate or other investments including partnership interests.
- Valuation of professional practices, including accounting, medical and law, often for marital dissolution cases, earn-outs and other purposes.
- Succession planning, gift and estate planning, and asset protection for the closely held business in all industries.
- Determination of the appropriate corporate development strategy for enhanced business value including exit strategy.

We also provide valuation and litigation support services for a broad range of other purposes, including:

- Complex fractional real estate portfolio valuations.
- Lost profits/Business Interruption: Damage calculations and other litigation claims.
- Buy/Sell agreements.
- Dissenting & Oppressed shareholder suits.
- Employee Stock Ownership Plans (ESOPs): Feasibility studies and annual valuations.
- Financial reporting: Fair Value studies. Goodwill Impairment testing. SFAS 141/142/144.
- Mergers and acquisitions transaction support, fairness opinions, solvency opinions.
- Corporate development.
- Bankruptcy planning.
- Marital dissolution.
- High-tech, Internet, options, intellectual property [trademarks, copyrights, etc.] and other intangibles.

We welcome the opportunity to serve you. Please call us at (203) 325-2703 or e-mail: info@NYNJCT-BV.com and let us know how we can be of assistance.

J.L. PIERSON & CO. LLC

P.O. Box 2392 Darien, CT 06820-0392

NYNJCT-BV.COM