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ESOP Valuation Tasks: How An Experienced Appraiser Can Help

According to an appraiser specializing in this corporate structure who ran an ASA-sponsored "webinar" last month for other appraisers, there are 4 types of services/reports for ESOPs and potential ESOPs.

ESOP Feasibility Studies: When management believes that an ESOP can foster the goals of the ownership and that of the employees, a feasibility study will model and, from a financial point of view, determine whether the structure makes sense or not, and under what general parameters. The feasibility effort will generally involve legal and accounting advisers as well, but the role of the appraiser is key: the determination of base value will determine how much the existing ownership will cash out at, and what happens if the ESOP only buys a portion of the equity in a first stage, with more purchases later on. Also, what are the ins and outs of a leveraged structure, if advisable, and is the bank likely to approve. Of course, requirements to qualify for an ESOP should also be reviewed, and key governance issues determined and settled, at least for the time being. ESOPs allow the owners to sell the business in part or in toto to a trust for the benefit of its employees, and if structured properly, at a limited capital gains tax cost. Involving the employees, through a trustee, is generally believed to make them consider themselves aligned with the owners, although no guarantees are available in this area.

Fairness Opinions: in the transaction-related analysis relevant to the establishment of a new ESOP at a sponsor company, fiduciaries are required by law not to pay more than adequate consideration for the shares of the sponsor; they in turn rely on a fairness opinion, signed by an appraiser, to demonstrate that they have not.

Annual Update: ESOPs have various annual regulatory requirements, of which one is the annual appraisal.

Litigation Support: Due to increased level of regulatory oversight by both the U.S. Department of Labor and the IRS, litigation support may be required. Here again, it pays to engage an ESOP-experienced appraiser.

Are there any conflicts between the above 4 areas as performed by an appraisal firm? According to the speaker, there would be a perceived conflict attached to a firm performing both the feasibility study, the fairness opinion and the annual appraisals even as many firms have routinely performed all three in the past; the trend, however is not to have the same firm do the feasibility and the fairness opinion. In fact, several ESOPs sued by the DOL had fallen in that category. However, there would be no appearance of conflict if an appraisal firm performs the feasibility analysis and the annual appraisals.

Estate of Tanenblatt v. Commissioner [T.C. 2013-263]
Why such Poor Trial Strategy ?

The Decedent died owning a 16.67% membership interest in an LLC held by a revocable trust. The LLC owned a 10 story building with retail and office space located on the southern periphery of Mid-town Manhattan. The parties stipulated that the NAV was $20.6 million. A national appraisal firm engaged by the Estate to prepare the estate return determined the discount for lack-of-control at 20% and the discount for lack-of-marketability at 35%.In its notice of deficiency, the Service pegged the discounts at 10% and 20%, respectively. So far, so good, perhaps paving the way for a dueling of the experts routine..

The Estate, however, went another way, and instead of relying on the first appraisal, hired an academic who valued the interest significantly lower than the estate's first appraiser, concluding with discounts of 10% and 26%, respectively. Further, the estate did not accept the submission of the new appraisal report into evidence. Accordingly, the Court needed to determine whether to place the new appraisal into evidence, whether the interest at issue was an interest in the LLC or merely an assignee interest, and finally what it was worth, no matter what its characterization.

Under its own rules, the Court is the gatekeeper of evidence. The Court stated that the petitioner tried to "end-run" the rules by demanding that the respondent stipulate to the new report. The Court rejected that argument. Had the author of the new report been available to testify, her report would have been admitted as evidence. But she was not available and counsel's comments at the hearing put the blame on a fee dispute. Citing the estate's failure to follow the stipulation rules, the new report was excluded by the Court. The Court opinion includes a legal analysis of the Court's rules and those of the federal judiciary generally.

The Court also determined that the trust ownership in the LLC was irrelevant, as the Decedent retained powers to appoint. The Estate had painted itself into a corner by not submitting an appraisal; thus the Court decided for the Service in total.

Hospitals Buying More Doctors' Practices

If you ask a physician why he/she sold the practice to a hospital and subsequently became its employee, you usually get something like, "I did not want to be bought, I wanted my independence to help my patients, but..it is getting harder to do so" and "I got tired of it" as more time needs to be devoted to relations with reimbursing insurers, not to mention the federal and state health bureaucracy. The system seems to push doctors inexorably into the hospitals' arms. Hospitals are growing their payroll with professional staff and, in some areas, a majority of physicians have now made the transition to hospital staff. From the point of view of the doctor, it avoids the issues of practice management and instead provides a steady paycheck and, often, better benefits to the staff. This argument is even more compelling for new physicians, who have large student loans to re-pay. Another benefit of the arrangement is that large medical providers have the wherewithal to negotiate for better reimbursements from insurers, in fact even Medicare pays more for many procedures if performed by a hospital [in or outpatient] than by a medical practice [this may or may not change in the future.] Another benefit is that hospitals now provide care in all medical specialties, freeing the doctor to practice in

his/her field. According to the American Hospital Association, the number of doctors and dentists employed by hospitals rose 40% between 2001 and 2011.

Facility fees are the difference between what Medicare pays, for the same procedure, to a hospital outpatient facility and an individual practice. In their 2013 report to congress on Medicare payment policy, the commissioners of MedPac, an independent body funded by congress to provide advice on Medicare, calculated total fees at $1.5 billion in 2011. Of course, facility fees have been providing a large incentive for hospitals, which, compared with physicians' practices, have large overheads to support, including unionized employees and extensive facilities. They also have legal departments which make the institutions somewhat self-perpetuating and are useful for lobbying regulators. However, some non-profit hospitals do not bill the facility fee to patients of acquired practices.

While the jury is still out on the cost issue, it is likely that, as hospitals become the dominant providers in their market, higher costs and institutional self-perpetuation will ensue, which at least in the short term is not favorable to patients. In their projections, many hospitals assume their new employees will be less productive than when they were as their own bosses [despite incentives.] Some referrals are also clearly taken into account, particularly to other areas of the hospital [which may not square with the regulations.] This is now the 2nd wave of such purchases, as some 15 years ago hospitals paid dearly for practices, failed to realize their intended benefits, and eventually returned them without compensation to their original owners. This time around, the purchases clearly affect the competitive landscape, hence the purchases may be permanent unless the population as a whole or the insurers rebel. The purchases also reflect the movement towards more Accountable Care Organizations as defined by law. Bear in mind that many health care attorneys recommend leasing the practice to a hospital.

The value of practices acquired by hospitals is subject to extensive federal regulations, starting with the Stark Act, which preclude paying/receiving anything like goodwill, being too close conceptually to future referral value [which is prohibited.] Transactions take place at fair market value, *as defined by the statutes and the regulations*. This would imply that, from a practical perspective, buyers and sellers have an incentive to employ an independent valuer knowledgeable of the issues and the law involved. A practice valuation is considerably more comprehensive when performed for mergers/acquisition purposes than, say for marital equitable distribution purposes. The price must be consistent with what the law allows under penalty meted out by the regulators. While there would be advantages to having both parties engage the appraiser, in practice the hospital's financial executives often do the analysis internally. Particularly in these instances, it is incumbent to the selling practitioner to obtain independent and credentialized advice and thus obtain a clear understanding of what can be negotiated and what can not. Needless to say, more than one approach to valuation - income, market, cost is advisable.

Optimizing the Attorney-BV Expert Relationship

Attorneys and experts need each other, but that alone does not make for a successful relationship. At a recent industry conference, attorney were polled and the following tips emerged.

The Expert should read all the documents provided by the attorney to avoid embarrassing

lack of familiarity during deposition.
The Expert should know the Federal Rule of Evidence 26, which essentially limits disclosure to “facts or data” used by the expert. The rule also prevents opposing counsel from requesting draft reports, with the exception of information related to the expert’s compensation, information provided by the attorney to the expert, and assumptions actually used by the expert in formulating the value opinion.

State courts also have their own discovery rules. An expert’s disclosure of all prior testimony and all prior publications to the attorney allows the latter to make sure that the expert did not previously testify in a manner that contradicts the theories underlying the current matter. The expert needs to put his/her best foot forward in deposition, because performance may make or break the attorney’s case. As an educator, the expert may assist in reaching a satisfactory settlement after a convincing performance. A plaintiff’s expert specifically needs to tie the defendant’s wrongdoing to the loss, even if the attorney is planning to present the legal theory of causation.

J.L. Pierson, ASA is an experienced business appraiser who supports the NY, NJ and CT business community from his base in Darien, CT. His clients are closely-held businesses with revenues of up to $300 million in all industries, as well as owners of family limited partnerships/LLCs, professional corporations and their advisors. He specializes in business valuation for estate/gift tax, succession planning, sale/purchase and litigation such as shareholder disputes and divorce, corporate development and transactional support purposes. This newsletter is generated internally to reflect key development in BV which appear to affect users. Court decision analysis is prepared from the perspective of a BV analyst, not from that of attorney.

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